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RRSPINVESTOR

It's time for a refresher course on RRSPs for investors

What's in, what's out

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With the March 3rd RRSP deadline fast approaching, it's hard not to think about topping up your contribution for 2013.

For some of us, that's the extent of our concern as we leave our investments in the hands of an advisor. But for others that prefer a bit more of a hands on approach (like those of you who own self-directed RRSPs), here's a refresher course on what type of investments qualify for your RRSP.

Tax rules and regulations specify that if the investment is not on CanRev's qualified list, you could face an add-on to your income based on the cost of all non-qualifying investments – even though they're held within your RRSP. So these should be avoided. By the way, similar requirements for qualified investments apply to RESPs and TSFAs.

Of course, the government does not list each and every qualified investment; they're listed by category. Some types of investments are fairly straight forward, such as shares of corporations listed on qualifying stock exchanges.

For most stock market investments, your broker should be able to tell you whether or not they qualify. But sometimes the rules aren't clear. And that's where you can get into hot water.

So if you're investing on anything offbeat, and your financial institution or advisor says it's qualified for RRSPs, my advice is to get this confirmed in writing, just to be safe.

Qualified Investments

Here are some details on qualified investments. (Note: this is not meant to be exhaustive)

Money: This includes deposits in a Canadian bank or trust company. Money must be legal tender in Canada; accordingly, investments in Swiss francs, Japanese yen, etc., are not allowed.

To be a qualified investment, the value of "money" cannot exceed its stated value as legal tender. This is to prohibit investments in such things as rare coins or gold "Maple Leafs". Often, a qualifying foreign investment will generate foreign currency, e.g., if it pays dividends or is cashed in. CanRev has indicated that it would not treat such foreign currency as a non-qualifying investment if it is converted "promptly" (usually, within one month) into a qualifying investment.

Canadian government bonds, debentures or similar obligations: This includes bonds, debentures, notes, mortgages or similar obligations of the Government of Canada (or guaranteed by the Government of Canada); the government of a province (or an agent thereof); a municipality in Canada; most Crown corporations; and/or an educational institution or hospital if repayment is made, guaranteed, or secured by a province.

Canada Savings Bonds are included. Note that while Canadian government obligations denominated in a foreign currency are eligible investments, CanRev requires foreign currency received by an RRSP to be

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converted. Strip bonds or coupons are generally regarded as qualified investments, if the bond itself would qualify.

Precious metals: Investment-grade gold and silver bullion, coins, bars, and certificates on such investments are qualified investments for RRSP purposes. However, these investments must be acquired either from the producer of the investment or from a regulated financial institution.

Shares of companies listed on the Toronto, Montreal, and TSX Venture Exchange: This includes all types of listed preferred or common shares. Although over-the-counter shares do not qualify under this category, they may be qualified investments if they meet other criteria.

Limited partnerships: Units in or debt of a limited partnership listed on one of the stock exchanges listed above are qualified investments.

Foreign shares: Must be listed on foreign stock exchanges which are prescribed in Regulation 3201. Besides major U.S. exchanges (including NASDAQ), a number of major European exchanges are designated, as well as some in the Far East.

However, securities quoted on the NASDAQ Over-the-Counter Bulletin Board (and other over-the-counter shares) are not considered qualified investments.

It appears that you can write an option on these qualifying shares, provided it is "covered." If a plan sells short, CanRev could (among other things) take the position that the RRSP is actively engaged in a business, resulting in certain tax penalties.

Warrants or rights: Give the owner a right to acquire a qualified investment. This appears to include Canadian exchange-traded call options, provided that the underlying investment is qualified (i.e., a call option for a Canadian-listed company).

CanRev has indicated, however, that a put option would not qualify; the agency does not consider a convertible debenture to be a "warrant or right", although such a debenture may (of course) qualify under another category.

Also, the issuer of the warrant or right will be required, on an ongoing basis, to deal at arm's length with each person who is an annuitant, a beneficiary, an employer or a subscriber under the plan. Moreover, the underlying property has to be a share or unit of the issuer, or a share or unit of another person or partnership that at the time of the issuance did not deal at arm's length with the issuer.

REITs and Income Trusts: Canadian REITs and income trusts which are structured as mutual fund trusts are qualified RRSP investments. While the main popularity of these trusts stems from higher apparent yields than conventional interest-bearing investments, the tax features can also be beneficial.

Corporations pay tax on their income and then distribute profits as dividends, which are taxed again in the hands of shareholders (with the dividend tax credit available to non-RRSP investors in Canadian Companies).

Income trusts and REITs, on the other hand, are designed so that income is reported and tax is paid by the investor, not the trust, so there is only a single level of tax.

In most trusts, there is a significant element of tax shelter on cash distributions due to depreciation or similar deductions claimed by the trust. Effectively, the benefit of this shelter will eventually be "recaptured" when the investor sells the trust units, but usually as a capital gain.

If income trusts and REITS are held by an RRSP, these tax benefits will be lost. However, to the extent that distributions from the trust generate taxable income, there will be no current tax to the RRSP either.

While loss of tax benefits may make personal ownership preferable, the degree of shelter relative to the taxable income will vary from fund to fund, and may decrease over time (e.g., as assets in the trust become fully depreciated, leaving more ongoing tax exposure).

However, flipping such a fund into an RRSP may result in significant tax exposure on the transfer, especially since the cost base of the fund will decrease as shelter is used.

One innovation is funds that effectively bifurcate income trusts into high-tax components (designed for RRSPs), and low-tax units, designed for individual investment.

Stock market index units: A Canadian "iUnit" (e.g., iUnits S&P/TSX 60 Index Fund, known as an "i60") is a qualifying investment, since it is a "mutual fund trust." A tax regulation (4900)(1)(n.1) has been added to provide allowed exchange-traded index units listed on foreign prescribed stock exchange (SPDRs, DIAMONDs, etc.).

Puts/Calls/Spreads: CanRev used to consider the writing of "naked call options" (or the short sale of a call option) speculative in nature, which resulted in the taxation of the RRSP on its taxable income for the year. However, the amendments to the Income Tax Regulations in the fall of 2005 made certain derivatives eligible as qualified investments for your RRSPs.

These include call and put options on stocks, currencies and indexes. Therefore, purchasing calls (instead of stocks) and purchasing puts instead of selling stocks short are not allowed in RRSPs.

Mortgages: Generally, a qualifying mortgage must be from people you deal with at "arm's length." This means you can't hold a mortgage from members of your immediate family or an in-law, for example. Additionally, the mortgage must not exceed the fair market value of the property, other than as a result of a decline in the market after the mortgage was given.

And if, say, you and your neighbour give each other a mortgage in a "criss-cross" arrangement, you could be in violation of the "arm's length" requirement.

So there will be a couple of hurdles that you should be careful not to trip over.

Happily, there's a second alternative – the RRSP mortgage which involves having your RRSP make you a loan secured by a mortgage on your home.

This can be permissible if the mortgage loan from your RRSP is insured and you pay your RRSP interest at market rates in effect when the RRSP loan is made.

Corporate Debt: Debt obligations issued by a Canadian corporation or trust are qualified investments, assuming that certain conditions are met.

The purpose behind the inclusion of corporate debt was to accommodate investments in debt obligations (more commonly known as asset-backed securities) that are backed by cash flows from pools of loans and other receivables.

Debt Obligations: Any debt obligation that has an investment-grade rating and that is part of a minimum $25 million issuance. ❐