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TAXSTRATEGY

The Right Investments

RRSPs?

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At the beginning of every February, I can always count on a call or email from my investment advisor about making sure I get my last minute RRSP contributions in before the end of the month. But I also rely on her to make the right investment decisions for me – I know where my strength lies, and it's not with the stock market. So I'm perfectly content to rely on her expertise in this area when it comes to my retirement fund. I know there are many of you out there that enjoy being more hands on with their investments. But when it comes to your RRSP, the guiding principle is not just getting the best return on your investment. Rather, it's ensuring that whichever investment you choose qualifies for RRSP purposes.

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The tax rules and regulations specify that if any of your investments are not on CanRev's qualified list, you could face a tax of 50 per cent of the fair market value of such investments at the time they were acquired or became non-qualified - even though they're held within your RRSP. Although this tax is refundable in certain circumstances, it is best to avoid these investments at the first instance. (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 – shares of corporations listed on qualifying stock exchanges, for example. For most stock-market-type investments, your broker should be able to tell you whether or not they're qualified. But sometimes the rules aren't clear - and that's where you can get into hot water. Much as they would like you to believe otherwise, financial institutions and investment advisors can be wrong about RRSP-qualified investments. If you're investing in anything offbeat, and your financial institution/advisor says it's qualified for RRSPs, my advice is to get this confirmed in writing, just to be safe.

Note on Qualified Investments

The following are some details on some qualified investments (this list is not meant to be exhaustive):

Money and Canadian bank, trust company, or credit union deposits, including GICs. According to CanRev, money denominated in any currency is a qualified investment in an RRSP. However, the value of "money" cannot exceed its stated value as legal tender. This is to prohibit investments in "collectibles" such as rare coins or gold "Maple Leafs".

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; an educational institution or hospital if repayment is made, guaranteed, or secured by a province.

Included are Canada Savings Bonds. 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 Canadian National Stock Exchange; the Toronto Stock Exchange; the Montreal Exchange; and the TSX Venture Exchange (formerly known as The Canadian Venture Exchange, which was the merger of the Vancouver, Alberta and Winnipeg Stock Exchanges). This includes all types of listed preferred or common shares (for warrants and rights, see below). 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 designated stock exchanges (see list above) are qualified investments.

Foreign shares, if listed on a designated foreign stock exchange which has been designated as such by the Minister of Finance. 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 to be 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 giving 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. However, CanRev has indicated that a put option would not qualify. CanRev does not consider a convertible debenture to be a "warrant or right", although such a debenture may, of course, qualify under another category. However, as per amendments in 2005, 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, unit or debt of another person or partnership, or a warrant to acquire such property, which 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 quite 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 the use of 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 or options can be complex. 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."

Options – Calls and Puts. CanRev used to consider the writing of "naked call options" or the short sale of a call option as being speculative in nature, thus resulting in the taxation of the RRSP on its taxable income for the year. However, the amendments to the Income Tax Regs in the Fall of 2005 made certain derivatives eligible as qualified investments for your RRSPs. These include call options, and put options on stocks, currencies and indexes. Therefore, purchasing calls (instead of stocks), covered call writing and purchasing puts instead of selling stocks short are now allowed in RRSPs.

Mortgages. Generally, a qualifying mortgage must be from people who you deal with at "arm's length" - so you can't hold a mortgage from members of your immediate family or an in-law, for example. And if you and your neighbour give each other a mortgage - i.e., in a "criss-cross" arrangement, this could also violate the "arm's length" requirement. 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). Accordingly, there will be a couple of hurdles to make sure you don't 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 (e.g. bankers' acceptance, commercial paper, debt of a foreign government) that has an investment grade rating and that is part of a minimum $25 million issuance. ❑