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TAX IMPLICATIONS OF NON-QUALIFIED INVESTMENTS IN A REGISTERED ACCOUNT OR TFSA

You should obtain professional advice from a qualified tax advisor before acting on any of the information in this article. This will ensure that your own circumstances have been properly considered and that action is taken on the latest information available.

Canadian tax legislation includes significant taxes and penalties should you find yourself holding non-qualified assets in your registered plans (i.e. RRSP, RRIF, locked-in plans and RESP) or TFSA accounts. It is possible that an investment you have purchased or contributed into one of these accounts is not a qualified investment or you may be holding an investment that has become non-qualified. In both of these situations, you should be aware of the tax implications of holding non-qualified investments in your registered or TFSA account and take the steps necessary to limit the impact on you. As a result of the 2011 federal budget, the rules related to holding a non-qualified investment in your RRSP, RRIF or locked-in plans have changed. These changes are highlighted below.

QUALIFIED OR NON-QUALIFIED

Most assets trading on a designated stock exchange (e.g. TSX, TSX Venture, CNSX, MSE, NYSE, NASDAQ, other American stock exchanges and many other foreign exchanges) are eligible for registered plans or TFSA accounts, but there are exceptions. Generally all over-the-counter (OTC) exchanges are considered ineligible. Qualified investments are defined in the Income

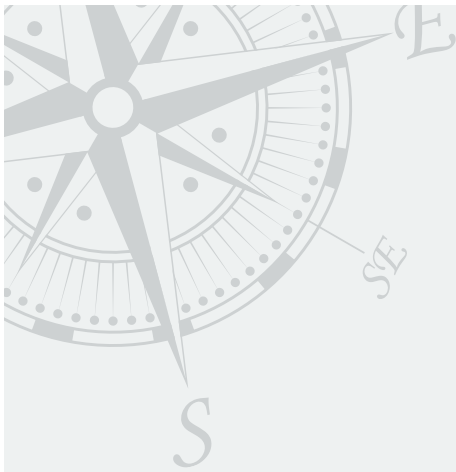
Tax Act (ITA) and the Income Tax Regulations.

Some of the more common non-qualified investments include:

- Foreign mutual funds
- Currency and index options
- All types of futures contracts, forward contracts and swap contracts



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You will be subject to the 50% penalty tax, which will apply at the time that a non-qualified investment is acquired by your RRSP, RRIF or TFSA or at the time an investment becomes non-qualified.

- Purchase of unlisted put options
- Sale of any put option and sale of any uncovered call option
- Unlisted limited partnerships
- Works of art, antiques or real estate
- Gold or silver coins, bullion, wafers, certificates, etc. that do not meet QI criteria, and all other precious metals

Speak to your advisor if you are uncertain whether a particular security is qualified or non-qualified for registered accounts and TFSAs. You should be particularly careful about purchasing OTC stock or limited partnership units not listed on a Canadian exchange in a registered account or TFSA as, in many circumstances, these investments are non-qualified.

WHAT ARE THE TAX CONSEQUENCES RRSPs, RRIFs (INCLUDING LOCKED-IN ACCOUNTS) AND TFSAs

The 2011 federal budget changed the rules related to holding a non-qualified investment in an RRSP or RRIF. Specifically, the new rules extend the application of the existing TFSA anti-avoidance rules to also apply to RRSPs and RRIFs.

Old Rules

Prior to these changes, if you acquired a non-qualified investment in your RRSP or RRIF, the fair market value of that investment at the time it was acquired would be included in your taxable income. If that investment earned income inside your RRSP or RRIF, it would be taxable to the RRSP or RRIF at the highest marginal tax rate.

However, if you subsequently disposed of the non-qualified investment from your RRSP or RRIF, you would receive a tax deduction for the lesser of the cost or proceeds of disposition of the investment. This “lesser of” rule means

that if a non-qualified investment is sold at a loss, you don’t get to deduct the loss and the net effect is an income inclusion equal to the amount of the loss. For example, if you acquired a non-qualified investment in your RRSP/RRIF for \$10,000 and you later sold it for \$8,000, you would have a \$10,000 income inclusion and only an \$8,000 deduction resulting in a \$2,000 net income inclusion. In another example, if the asset was instead sold when the fair market value was \$12,000, you would only be able to claim a \$10,000 deduction, which is the acquisition price, resulting in no net taxes owing.

The rules were quite different if a qualified investment held in your RRSP or RRIF becomes a non-qualified investment. If this occurs, the RRSP or RRIF is required to pay a tax for each month of 1% of the fair market value at the time of acquisition of the property. In this case you would not be subject to the income inclusion discussed above. If you were subject to the income inclusion rules discussed above then the 1% penalty would not apply. However, any income and capital gains earned on a non-qualified investment inside your RRSP or RRIF would still be taxable to the RRSP or RRIF at the highest marginal tax rate.

New Rules

The new legislation eliminates the income inclusion and deduction components of the old rules with respect to RRSPs and RRIFs, as well as the 1% per month tax. It is replaced by a penalty tax of 50% based on the fair market value of the non-qualified investment. You will be subject to the 50% penalty tax, which will apply at the time that a non-qualified investment is acquired by your RRSP, RRIF or TFSA or at the time an investment becomes non-qualified. This tax will generally be

The ITA states that an RESP is revocable, at any time, if it acquires property that is non-qualified or property held by the RESP becomes non-qualified and the property is not disposed of by the RESP within 60 days after that time. However, the CRA will not normally issue a revocation notice unless there is abuse.

refunded if the investment is disposed of from the RRSP, RRIF or TFSA by the end of the year following the year in which the tax applied (or by such later time as the Minister of National Revenue considers reasonable). If you knew, or ought to have known, that the investment was non-qualified, the refund of the 50% tax will not be available.

Investment income earned on a non-qualified investment in an RRSP, RRIF or TFSA will continue to be taxable to the RRSP, RRIF or TFSA at the highest marginal tax rate. This income (including capital gains) is called “specified non-qualified investment income”. If you receive a notice from the Minister of National Revenue to distribute specified non-qualified investment income, it must be distributed within 90 days of receiving the notice otherwise it will be considered an “advantage” and be subject to 100% tax.

The rules with respect to non-qualified investments related to RRSPs and RRIFs are effective as of March 22, 2011. However, if you were holding a non-qualified investment in your RRSP or RRIF before March 22, 2011 and you were already subject to the old rules (i.e. 1% penalty tax per month), you will continue to be subject to the old rules.

This means you will still be charged the 1% penalty tax for every month your RRSP or RRIF continues to hold a non-qualified investment. However, if an RRSP or RRIF acquires a non-qualified investment or an investment becomes non-qualified after March 22, 2011, it will be subject to the new rules.

Non-qualified investments held in a TFSA were already subject to these rules which are now extended to apply to RRSPs and RRIFs.

Although the new rules generally do not allow swaps into or out of RRSPs, RRIFs and TFSAs, you are allowed to swap a non-qualified investment out of your registered plan or TFSA in order to remove it as long as you are entitled to a refund of the 50% penalty tax.

RESP

The ITA states that an RESP is revocable, at any time, if it acquires property that is non-qualified or property held by the RESP becomes non-qualified and the property is not disposed of by the RESP within 60 days after that time. However, the CRA will not normally issue a revocation notice unless there is abuse.

If the registration of an RESP is revoked because it is holding a non-qualified investment, then the RESP would

become taxable. What this means is that all the income and capital gains earned in the RESP would be taxable to the RESP at the top marginal tax rate not just the income and capital gains earned on the non-qualified investments.

However, if the RESP's registration is not revoked but it is holding a non-qualified investment, it would not be subject to tax on its taxable income but would be subject to the 1% penalty tax mentioned above. In this case, the RESP would be required to pay a tax for each month equal to 1% of the fair market value at the time of acquisition on all property that it holds at the end of the month that is not a qualified investment. The tax applies to all non-qualified property held in the RESP at each month-end, regardless of whether the investment was non-qualified at the time of acquisition or the investment was qualified at the time of acquisition and later became non-qualified. The tax is payable at the time the annual return is required to be filed which is 90 days after the end of the calendar year.

If you have any questions or require clarification of any of the issues discussed in this document, do not hesitate to discuss these with your RBC advisor.

Please contact us for more information about the topics discussed in this article.

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