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In the previous edition of the Canadian Tax Planners Newsletter, we reviewed the tax consequences of owning various investment vehicles. Our review focused on the more common investments such as fixed income products, shares, mutual funds, exchange traded funds and flow through shares. In this edition, we shall review more sophisticated investments, including:

- index linked GIC's
- Labour Sponsored Venture Capital Corporations
- limited partnerships
- commodities
- call and put options
- rights
- income trusts

Index Linked Guaranteed Investment Certificates

The low interest rates paid on GIC's have resulted in the increased popularity of index linked guaranteed investment certificates. Unlike traditional GIC's that offer a fixed rate of return, these GIC's offer a guarantee of capital, plus a rate of return that is based upon a predetermined index. This may sound like the ideal investment product, i.e., the principal amount is guaranteed to retain its value and there is a possibility of an increased rate of return, if the stock index outperforms the interest rate on similar GIC's. However, as we shall discuss later this is not necessarily the case. We shall review this investment from the following perspectives:

- product features
- potential disadvantages
- tax consequences

Product Features – Although most financial institutions offer this investment, there are significant differences between the various products. Key differences include:

Lock in Time – The GIC cannot be redeemed for a fixed period of time, normally three or five years.

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Index – The rate of return is based upon a predetermined index, but there are various indexes that can be selected. For example, The Bank of Montreal allows investors to select from the following options:

- S&P/TSX Bank Index
- S&P 500 Market Index
- S&P 60 Market Index
- G7 Market Index, which is based on a number of indices from the G7 countries, such as Japan, United States and Germany

There are also banks that offer a rate of return based upon the results of their actively managed mutual fund.

Participation Restrictions – Although the payout is based upon the performance of a predetermined index, there may be various restrictions imposed upon the payout. Typical restrictions include a maximum payout, such as 30% or a cap on participation such as 60% of the actual return on the index.

Potential Disadvantages - Despite the possibility of achieving an increased rate of return with index linked GIC's, there are a number of potential disadvantages. These include:

- they are locked in for a predetermined time and investors may not be able to find an index linked GIC's for a shorter term such as one or two years
- as we shall discuss later, it does not receive favourable tax treatment
- if the stock market declines over the life of the GIC, the investor will receive a nil return on the investment. Although there will not be a loss of capital, there is an opportunity cost. Given the decline in the market in the past few months, many investors who purchased index linked GIC's will receive a nil rate of return

Tax Ramifications – The return on the GIC is treated as interest income, even though it is based upon a stock index, which results in the least favourable tax treatment. If the investor had purchased the index through an exchange traded fund or index based mutual fund, not only would there be no restrictions on the magnitude of the gain, the profit would be treated as a capital gain.

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