tax planning

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Personal tax planning

The purpose of wealth planning is to preserve the wealth you've built, enhance it by taking a commensurate amount of risk and then transfer it efficiently to those you ultimately want it to benefit. Weaved throughout wealth planning is the impact that income taxes has on our ability to achieve our goals. Having a basic understanding of a few key tax planning strategies can make the difference between missing and achieving your goal.

This publication focuses on tax planning strategies that will minimize or defer income taxes for individual investors.

RRSP

Registered Retirement Savings Plans are one of the last great tax shelters available to individual investors. Eligible contributions to an RRSP are deductible and reduce the investor's taxable income. Lower taxable income means less tax paid. Additionally, the income and gains generated by the investments accumulated inside an RRSP account grow tax deferred. In other words, your RRSP investments grow tax free until you withdraw them. Over many years the tax free compounding of investment returns can add up to a tremendous advantage.

Assuming an annual return of 7%, by contributing $1,250 per month over twenty years to an RRSP will yield an additional $199,000 by virtue of compounding tax deferred growth.

Marginal tax rate

Often what drives a decision towards a particular tax strategy is a clear understanding of one's marginal tax rate. A person's marginal tax rate is simply the tax rate that will be applied to the next dollar you earn. In other words, if your taxable income is $75,000 and you were going to earn an extra dollar taking your total to $75,001 your marginal tax rate tells you how much tax you would pay on that extra dollar. If the tax owed on that extra dollar is 44 cents, then your marginal tax rate is 44%. As your income increases, the amount of that income you must pay to government also increases. The marginal tax rates on Canadian dividend income and capital gains are lower than on other types of income, but more on that later. Suffice it to say that when buying investments, having some understanding of how much of the return is going to be reduced due to taxes is important.

TIP: Contribute to your RRSP early in the year. If, for example you contribute $15,000 each year at the beginning of the year rather than the end, over a 20 year period you would have earned an extra $43,000 in your RRSP (assuming an annual return of 7%).

TIP: If you are an employee who is making regular RRSP contributions, you can request that the amount of income tax withheld on your pay be reduced in order to reflect the savings those contributions will bring. Otherwise you are overpaying tax all year and then waiting for a refund the following year.

TIP: If you own a business and family members provide services to that business then you should consider paying them a reasonable salary in order to earn RRSP contribution room.

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Investment income and expenses

Interest income or compound interest investments like Canada Savings Bonds and Guaranteed Investment Certificates (GIC) generate interest income and are taxed at a higher rate than other types of income. Generally interest income is one of the most reliable forms of income and as a result it is taxed at the higher rates than other types of income.

The next form of income is the dividend. A dividend is a portion of a company's profits paid to its shareholders. Dividends paid by Canadian companies that have their shares listed on a public stock market like the Toronto Exchange are considered eligible dividends and are taxed at a lower rate than interest income.

From a tax perspective the best form investment income is the capital gain. A capital gain results when you sell an investment (or certain other assets) for more than you paid to purchase and hold it. Capital losses realized during the year should be used to offset the gains you have made. The difference between your capital gains and losses is your net capital gain or loss. A net capital gain is taxable in the year it is realized; however net capital losses can be carried back three years or forward indefinitely, to reduce gains of other years. What makes capital gains so attractive from a tax perspective is the fact that only half of the gain is included in your income and is taxable.

Finally, interest and dividends derived from foreign investments are taxed at the same higher rates as interest income. That is one of the ways the Canadian government encourages us to invest in Canada. While how investments are taxed is important, so is diversification and risk management and by no means should an investor avoid investing in U.S. or International securities purely because of the higher rate of taxes.

TIP: By holding interest bearing or foreign investments in a tax deferred account such as a RRSP, investors can benefit from good diversification while avoiding having to pay tax at least until he or she withdraws money from the account.

Taxation on types of investments

Type of income		* Marginal tax rate (BC)	$1,000 income, after tax
Interest: Canadian sources	Bank accounts, interest from GICs, bonds, or any other fixed income instrument	43.70%	$563.00
Eligible dividends: Canadian sources	Shares of publicly traded Canadian companies. Equity mutual funds holding Canadian shares.	18.46%	$815.40
Capital Gains from all sources	Shares or units of Canadian and foreign companies and mutual funds. Profits from the sale of bonds or similar securities.	21.85%	$781.50

* calculations in above examples based on the highest tax bracket for B.C.

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Superficial loss rules

The income tax act has special rules regarding the treatment of superficial losses. A superficial loss is created when you or your spouse sell a security at a loss and then buy that very same security back within 30 calendar days. A superficial loss cannot be used to offset eligible capital gains. This rule also applies to individuals who trade in the securities of a company they control. The term used to describe such an individual is an affiliated person.

RRSP contributions in kind

Having a self directed RRSP account offers a number of benefits. Primarily it allows you to hold a variety of investments in a single account with one consolidated statement. Investments such as stocks, bonds, GICs and mutual funds from a variety of mutual fund companies can all be held in a self directed RRSP. Another benefit is your ability to use an eligible security rather than cash as your RRSP contribution. You will receive a tax deduction equal to the market value of the investment at the time of contribution. When you make a contribution "in kind" you are deemed to have sold the investment to your RRSP account even though you have not actually sold the investment. The result is that any unrealized capital gains will become taxable.

Income splitting

Income splitting is another opportunity to reduce your family's combined tax bill by allocating a portion of income (usually from investments) from the family member that pays the higher rate of tax to the person that pays a lower rate of tax. Unfortunately its not as easy as simply giving the income to a family member, CRA has a few rules that one has to observe in order for this strategy to work. CRA calls these rules the attribution rules and they can be tricky so make sure you obtain professional assistance before you set out on any particular income splitting strategy.

Mutual fund distributions

If you own mutual funds outside your RRSP then you can expect to receive a T3 or T5 tax slip each year. The dividends, interest and realized net capital gains earned from the portfolio of investments inside the mutual fund are distributed out to the mutual fund investors, even if you are reinvesting the distributions into the same fund. Whether you elected to receive the distribution in a cash payment or chose to reinvest the amount, the tax treatment is the same. Additionally any profit on the sale of your mutual fund units is regarded as a taxable capital gain as well (e.g. if you buy a unit at $10 and redeem it at $14, then you will have a $4 / unit taxable capital gain).

TIP: By understanding the superficial loss rules you can work with your financial advisor to harvest losses each year and apply them to gains realized this year or in the previous three years.

TIP: Never contribute your losers in kind to your RRSP. In this case you cannot recognize any capital losses for tax purposes so it is best to sell your losers and apply the loss against any gains realized outside your RRSP. Alternatively, sell the loser and then contribute cash so that you have properly harvested the loss and can apply it against future gains.

TIP: If the higher earning spouse contributes funds to a Spousal RRSP, then that spouse receives the tax deduction at his or her high tax rate and the lower earning spouse will likely pay tax at a lesser rate on future withdrawals.

TIP: You may wish to sell an asset that has an unrealized loss to your spouse if you cannot make use of the loss or if your spouse has a lower marginal tax rate than you. When a security is sold to a spouse at its fair market value a loss cannot be realized due to the superficial loss rules. The result is your spouse will be deemed to have acquired the security at your original adjusted cost. Providing your spouse hold the security for at least 30 days, he or she can sell the security (presumably still at a loss) and use the capital loss to offset their taxable capital gains.

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Interest expense deductibility

Interest charged is tax deductible when borrowing money from a bank, brokerage firm or finance company provided that the borrowed funds are used to produce income from a business or an investment such as stocks, bonds and mutual funds. Interest you pay on money borrowed for investment purposes is deductible as long as you earn investment income, including interest and dividends. If the only earnings your investment can produce are capital gains you cannot claim the interest paid on the loan. Borrowing to invest is not suitable for all, so before engaging in any borrowing to invest strategies you should consult a professional. That being said, swapping a non-deductible debt such as a credit card balance, line of credit or mortgage for a deductible debt can reduce your expenses and free some disposable income. If you have a portfolio of investments outside an RRSP and you have some form of non-deductible debt, then you can (1) sell the investments (may generate taxable capital gains so be sure the strategy makes sense for your individual circumstance), (2) pay down all or part of the non-deductible debt, (3) borrow back the funds from your bank or investment dealer and repurchase the investments. Now your loan is an investment loan and the interest cost is tax deductible.

TIP: You can deduct fees (but not commissions) paid for advice received with respect to the purchase, sale and administration of specific investments, such as shares or securities, provided those fees are paid to a professional whose principal business involves managing investments.

Have you considered all available strategies to reduce the amount of tax dollars that your family pays each year? Every family's situation is unique, and deserves special attention. Preserve the wealth you've built, and enhance it with intelligent wealth planning. Let's get together and review your family's circumstances, and reduce the negative impact that income tax can have on your financial well-being.

At DundeeWealth, we believe that having a financial plan forms the foundation necessary to grow, protect and transfer wealth from one generation to the next. We are committed to provide information on a variety of financial planning topics so our clients are able to make informed decisions.

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