RBC Dominion Securities Inc.

Portfolio Advisor

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A Little Tax-Smart Personality Goes a Long Way

How Much Are You Paying in Taxes?

A. Too much

B. Not enough

C. Only what I have to

The correct answer is "C." No one wants to pay taxes, but in reality we are all taxpayers. The good news is, there are strategies available for us to help reduce our tax bill. Which strategies are best for you? It depends on what "personality" you have as a taxpayer. Some common tax-payer personalities discussed here are:

- The Family Breadwinner
- The Prudent Investor
- The Small Business Owner

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The Family Breadwinner

As the breadwinner of the household, you bring in the most income to help support your family. This means you are in a higher tax bracket (i.e. you pay tax at the highest rate in your family). The following strategies can potentially help reduce your tax burden, allowing you to "win" much more of your hard earned "bread."

Loan Your Spouse Some Money

If you loan money to your lower-income spouse to invest the proceeds, the investment income earned is then taxable at his/her lower marginal tax rate. All you need is a formal, written loan arrangement with your spouse. Your spouse has to pay you interest on the loan at the Canada Revenue Agency's (CRA's) prescribed rate. But, the good news is, that rate is currently at a historic low of 1%.

The benefit: When the investment income is taxed at your spouse's lower rate, the tax savings are meant to outweigh the 1% cost of the loan.[1]

Split Your Retirement Income

If you report "eligible pension income" for tax purposes, you can actually transfer up to 50% of your "eligible pension income" – including RRIF income – to your lower-income spouse. You simply split the income reporting on both your and your spouse's tax returns.

The benefit: In addition to being taxed at the lower spouse's rate, it could also potentially bring you down to a lower tax bracket.

Keep It in the Family

If you don't wish to "gift" to your children directly, you can transfer or loan assets[2] to a properly structured trust set up for the benefit of family members who have little or no income of their own (for example, to help fund their education costs).

The benefit: Your beneficiaries can receive all the investment income from these assets tax-free up to their basic personal exemption amount, with anything above that taxed at their lower tax rates.

The Prudent Investor

Whether you are hands-on or hand-off, active or passive, the most prudent investors are keenly aware that "it's not what you make, it's what you keep." Ignoring the eroding consequences of taxation can significantly stunt a portfolio's growth. These three "prudent" strategies could help reduce and/or defer the taxes you are paying on your investments.

Put It Off Until Tomorrow

It's usually wise to avoid "putting off until tomorrow, what you can do today," but when it comes to strategies that help delay taxes, this is often exactly what you should be doing. Contributing to tax-advantaged accounts like your RRSP and Tax-Free Savings Account (TFSA) allows your investments to grow tax-free for as long as they are in the account. And registered accounts like Registered Retirement Savings Plans (RRSPs) provide an added benefit of a tax deduction "today."

The benefits:

1. Paying less in taxes now means more money is left in your portfolio working for you. This can have significant positive compounding effects on your investments over the course of many years.
2. During your retirement years when you start withdrawing the money from your retirement funds, you will likely be earning less than in your working years (i.e. in a lower tax bracket) and therefore taxed at a lower rate.

Tip: Ensure that you are contributing to your tax-advantaged and taxable accounts in the right order for your situation. Most (but not all) investors should contribute the maximum amount possible to their accounts in the following order:

[1] The high-income spouse must declare the interest received on the loan as income on their tax return.
[2] At the CRA prescribed rate.

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Make Your Losses Useful

Known as tax-loss selling, your can offset some of your capital gains with capital losses. These are both triggered by actually selling an investment. You must first apply capital losses you have triggered in a given tax year against any capital gains also triggered in the current tax year. If you have any losses left over, you can apply them against gains you have realized in any of the previous three calendar years or carry them forward indefinitely against future capital gains.

The benefit: This can reduce the tax you pay on capital gains.

Organize for Better Tax Treatment

Where possible, you may want to allocate more of your fully taxable, interest-bearing investments to your non-taxable RRSP/RRIF accounts. Also, allocate more of your tax-efficient investments, which pay Canadian dividends and potentially capital gains, to your regular taxable accounts. They're already tax-efficient, and lose this relative advantage versus interest-paying investments in a non-taxable account.

The benefit: The investments will be sheltered from annual taxes, enabling them to grow faster on a tax-deferred basis, until you withdraw them.

The Small Business Owner

As a business owner, you want to enjoy the "fruits of your labour." You may have significant personal assets invested in the business in addition to your long-term time commitment. Structuring your assets to utilize the tax planning strategies available to the small business owner in Canada, can allow you to enjoy something else – the benefits of a lower tax burden.

A Family That Works Together

You can share income with lower-income family members by employing them in the corporation and paying them a reasonable salary based on the services they perform. Also, if you have an active corporation, you may be able to transfer some or all of the future growth of the business to the next generation of your family using an estate freeze with a family trust. This common business succession strategy allows you to pay dividends from the corporation to your spouse and adult children.

The benefit: If they have no other income, they may be able to receive tax-free dividends from the corporation. Approximately $10,000 – $50,000 of tax free dividends and could be paid to them from the corporation every year if structured properly.[3]

Make It a Family Affair

A business owner can claim a one-time capital gains exemption on the sale of his/her qualifying shares. However, if your operating company is owned by a family trust, with your family members as beneficiaries, each and every family member can claim the capital gains exemption.

The benefit: You can multiply the tax benefit, versus just the business owner claiming his/her own capital gains exemption.

Corporate Investment Shelter

The "Corporate Investment Shelter" strategy is designed for business owners (must be Canadian-controlled private corporation) with surplus corporate assets – investments in excess of what is needed for corporate / personal needs. This innovative concept uses permanent life insurance to tax-exempt growth and reduces taxes payable on these investment assets while maximizing the estate value to your loved ones (you must qualify for life insurance coverage). In addition, the cash value can be accessed in a tax-efficient manner during your lifetime if cash flow is required.

This strategy is ideal for individuals who own a holding company and:

- Want to reduce income tax on corporate cash and fixed income investments
- May not require income from their holding company
- Have excess income distributed from their operating company to their holding company
- Wish to maximize shareholder value and minimizing disruption to surviving stakeholders

The benefit: Maximize the size of the estate to be passed on and increase the return on corporate assets by sheltering them from annual corporate taxes. Insurance can also help structure assets to maximize benefits of all available tax-relieving rules (including the capital gains exemption, loss carryback planning, spousal rollover provisions, etc.).

To discuss the strategies which may work best for your "taxpayer personality," please contact us for more information.

[3] The amount varies depending on the type of dividends and the family member's province/territory of residence.

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Preserve Your Estate With the "Tax Protector"

Life insurance is most commonly used to provide financial security to your family and other beneficiaries in the event of your death. However, life insurance can also be used to protect the full value of your estate from taxes. At death, your assets often trigger significant tax obligations, which are frequently met by liquidating the assets of your estate. The "Tax Protector" solution (utilizes life insurance proceeds) to cover your estate tax obligations at a significantly lower cost compared to liquidating assets or savings – leaving your estate intact.

The benefit: If you own substantial assets that you wish to protect from taxes, the tax protector strategy can assist in the preservation of the value for your beneficiaries.

[4] Applies only to Canadian residents who are not U.S. citizens or U.S. green card holders. State taxes may also apply. No estate taxes will apply if worldwide asset are less than $5.43 million US or U.S. situs assets are less than $60,000 US regardless of your worldwide assets (based on fair market value). Individuals investing in the U.S. should note that life insurance proceeds generally factor into the calculation of worldwide assets. You may consider holding your insurance policy within an Irrevocable Life Insurance Trust (ILIT) to reduce your exposure.