November 18, 2010

FINANCIAL ADVISORY SUPPORT

Tax Planning for Canadian Bank Shares

A checklist of tax strategies to consider if you own any of the big five Canadian Bank shares:

Shares of the big five Canadian banks (Royal Bank of Canada, TD Canada Trust, Bank of Nova Scotia, Bank of Montreal and CIBC) are one of the most widely-held stocks by investors in Canada. Given the high dividend yield (approximately 4%) and the large accrued capital gains that many investors are sitting on with the big five bank shares, here is a checklist you can go through with your advisor to minimize the tax related to these popular stocks.

- If you own bank shares in a registered plan, then consider swapping them out of your registered plan (RRSP/RRIF) for cash or interest bearing investments in order to take advantage of the lower tax rates for dividends. Dividends from publicly-traded companies, including Canadian bank shares, are considered eligible dividends and are taxed at lower rates than RRSP withdrawals. This lower tax rate would only apply for dividends earned in a non-registered account. Although dividends on bank shares earned in the RRSP/RRIF are tax-deferred, they will be taxed as regular income when withdrawn in the future. In many provinces, the tax rate on RRSP/RRIF income will be 16-25% higher compared to the tax on the Canadian dividends and capital gains earned outside the RRSP/RRIF.

  Before employing this strategy, note that your current taxable income may now increase due to the additional taxable dividend income. This could impact Old Age Security benefits and other income tested government benefits so this should be taken into consideration when evaluating this strategy.

- If you own identical bank shares inside and outside your RRSP/RRIF, then swapping your bank shares out of your RRSP/RRIF for cash or interest-bearing investments, will likely increase your Adjusted Cost Base (ACB) per bank share in your non-registered account. This strategy will minimize your future capital gain per share.

  This strategy also taxes the future growth of the bank shares swapped out of the RRSP/RRIF at the capital gains tax rate (50% of marginal tax rate), compared to your full marginal tax rate if left in the RRSP/RRIF and later withdrawn.

- If you are planning to make charitable donations, then consider donating your low ACB bank shares “in-kind”. You will get a donation receipt equal to the fair market value of the shares at the time of donation and will not have to pay any capital gains tax if donated to qualified charities. If you are interested in donating the shares to a family foundation, then speak to your advisor about the RBC DS Charitable Gift Program which can be started with a contribution of as little as $25,000.

- Speak to your advisor about running the “Stock Donation Calculator” for you. This calculator provides you with the exact number of shares you have to donate in order to eliminate the current capital gains tax on the shares that you keep.

For example, if you own 5,000 shares of TD with an ACB of $40 per share and current market value of $75 per share, you would need to donate approximately 946 of your TD shares in-kind. If TD is still favoured, the remaining 4,054 shares of TD would be sold and immediately bought back to increase the ACB of the TD shares to the current market value of $75 per share. The donation receipt on the 946 shares donated in-kind ($70,946) will eliminate the capital gains tax on the sale and buy back of the 4,054 TD shares.

- If you own bank shares in a corporation (e.g., Holdco) then consider paying the dividends out of the Holdco to you each year. If the dividends are reinvested in the Holdco, they will be subject to a refundable tax of 33.3%. If the dividends are paid out of the Holdco to you in the same year they are earned, then there is no corporate tax on the dividends and you pay personal tax on the dividends at the lower eligible dividend tax rate.

- If you have a low-income spouse, then consider transferring your bank shares to a separate non-registered account in the name of your spouse. This transfer can occur on a roll over basis without triggering the capital gain. The dividend income generated on the transferred shares would attribute back to you for tax purposes however the dividend income now becomes your spouse’s capital for tax purposes. Any investment income earned on this capital will not be attributed back to you for tax purposes. To facilitate record keeping, the capital should be transferred to a second non-registered account in the name of your spouse. This way, the capital now belonging to your spouse and any investment income it produces, will not be confused with the dividend income that is attributed back to you.

- If you are over age 65 and require the dividend income from your bank shares to meet your retirement expenses, then consider the following strategy to increase your after-tax retirement income and potentially donate to your favorite charity:

  Step 1: Sell a portion of the bank shares and buy a prescribed annuity or insured annuity. A prescribed annuity can offer you enhanced income for your lifetime with the advantage of tax deferral. An insured annuity can increase your yield and preserve your estate. This will increase your after-tax income but will also create a one-time capital gain on the sale. If you have charitable intent and want to minimize the tax on the capital gain, go to Step 2.

  Step 2: Donate in-kind a portion of the bank shares to your favorite charities or your own family foundation. If the fair market value of the shares donated equal the taxable capital gain realized in Step 1, the donation tax credits will offset the capital gains tax, so no tax is paid.

- If you have a low-income spouse and you are planning on selling some bank shares in the near future, then consider a more advanced income splitting strategy, prior to the sale, that will effectively transfer 25% of the capital gain to your lower-income spouse without the attribution rules applying. Given the sophisticated nature of this strategy, it is imperative you consult with a qualified tax advisor prior to implementing this strategy. Your advisor can provide you with the general steps involved in implementing this strategy. Ask them for a copy of the article titled “Transferring Capital Gains to Your Spouse”.

- If you are planning to sell some bank shares but your spouse has securities with unrealized capital losses, then speak to your advisor on a strategy to transfer your spouse’s capital losses to you so you can reduce your taxable capital gains on the sale of your bank shares.

- If you have low-income children or grandchildren and are planning on buying more bank shares then consider buying these shares through a family trust. If the trust is properly set up, then the future capital gain on the bank shares can be taxed in the hands of your low-income children. Each child/grandchild in Canada who has no other income, can earn up to 2 times their provincial basic personal exemption tax-free every year. This ranges from a low of $15,400 to a high of $33,650 depending on your province. If the money to buy the bank shares is gifted or loaned to the trust at low or no interest, then any dividend income earned on the bank shares will be attributed back to you. Note that any capital gains or dividend income earned in the family trust and allocated to the child/grandchild must be used for the child’s benefit. If you are interested in setting up your own family trust then speak to your advisor about the RBC DS Family Trust.

- If you are over 65 and live in a province with high probate taxes and have considerable bank shares, then consider rolling your bank shares on a tax-deferred basis to an alter-ego trust or joint partner trust. The advantage of this strategy is that the value of bank shares will not form part of your estate so probate taxes will be avoided. There are a number of issues to consider before employing this strategy such as legal fees to set up the alter ego trust, ongoing tax return preparation fees, loss of testamentary trust opportunity, etc.

- If you have bank shares with large accrued capital gains, then there would be a large tax bill on the disposition of the shares upon death of the last spouse. One of the most cost effective ways for the estate to pay for this large tax bill at death is to purchase life insurance. Speak to your advisor if you would like a quote on the cost of life insurance premiums in this case.

- If your bank share position is more than $2,000,000, then speak to your advisor about the Equity Monetization Strategy (EMS). EMS allows you to convert your concentrated bank share position into a diversified portfolio and defer the capital gains tax.

- If you are donating to charity on an annual basis, then consider donating some bank shares in-kind to qualified charities and then using the tax refund on the donation to pay for the premiums on either life insurance, disability insurance or living benefits if there is a need for this coverage.

- If you have a large position in bank shares creating considerable taxable dividend income, then consider amending your Will to include a testamentary trust provision to provide an income splitting opportunity. This allows the dividend income and capital gains after death to be taxed within the trust at graduated tax rates rather than on your beneficiary's personal tax return. In order for this strategy to work, the bank shares must go through your estate and probate taxes would be paid. However, the annual tax savings for your beneficiaries in many cases will outweigh the probate tax cost. Speak to your advisor to determine if you qualify for a Will and estate planning review to discuss the testamentary trust strategy and other Will and estate planning strategies.