The Navigator

RBC WEALTH MANAGEMENT SERVICES

www.kentrisfinancial.com

Kentris Financial Group
RBC Dominion Securities

17 King Street East, 3rd Floor
Oshawa, ON L1H 7M9

Tel: (905) 434-6010
Fax: (905) 436-5068
kentris.group@rbc.com

Tax-Efficient Investing – Part 1

Income Deferral & Income Tax Deductions/Credits

Tax-efficient investment strategies can enhance your after-tax income and increase the overall rate of return on your portfolio. Year-end is an opportune time to review your portfolio with your RBC advisor to determine what tax planning strategies are still available to you. Tax efficient investing comprises a number of key components including: income deferral and income tax deductions or credits (discussed in this article) as well as income splitting and income rebalancing (discussed in part two of this article series).

Income Deferral

Income tax deferral involves pushing current tax obligations to a future year. By doing so you are not only able to reduce your current annual tax bill and reap the benefits of the time value of money, but you may also be able to pay tax in the future, when your marginal tax rate may be lower.

Registered Accounts

Contributing to a Registered Retirement Savings Plan (RRSP) (including a spousal RRSP) provides you with a tax deduction today and effectively defers the tax on the full amount of the contribution until the funds are withdrawn. RRSPs allow your investments to grow tax-free during your higher income working years. Then, during your retirement years, when you start withdrawing taxable income, you will likely be in a lower tax bracket since your income from all sources will likely be lower than during your working years.

Bear in mind that you have until the end of the year in which you turn 71 to convert your RRSP into a Registered Retirement Income Fund (RRIF), or purchase an annuity in order to continue deferring the income and resulting taxes payable to future years. If you do not choose either of these options, your RRSP will need to be deregistered and the value of the RRSP will be fully taxable to you in the year of deregistration.

Tax-Free Savings Account (TFSA)

Since January 1, 2009, you have been able to use the TFSA to save $5,000 per year for a variety of your short-term and long-term goals with the benefit of tax-free growth. The funds within the TFSA can grow sheltered from tax, however contributions are not tax deductible. This means your investment will be made with after-tax dollars, but the investment income earned and capital gains realized inside the TFSA will be sheltered from tax. Because of this tax-free growth, the TFSA allows for greater tax savings and faster investment growth in a shorter time frame. For this reason, the TFSA may complement your existing registered savings plans including RRSPs and RRIFs.

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Non-Registered Accounts

Within your non-registered accounts, you should try to minimize the turnover of growth investments to defer tax. The more often you sell your investments, the more often you will trigger taxable capital gains. Furthermore, consider deferring the sale of a security with accrued capital gains to a year when your income will be lower or you have capital losses to offset the gains. If your portfolio contains government debt obligations, such as T-bills, consider structuring T-bill purchases so that maturity dates are after the end of the current calendar year. This strategy can defer tax for up to 16 months.

Certain investments, such as real estate investment trusts (REITs), royalty income trusts, as well as some mutual funds typically distribute a non-taxable return of capital payment to you. Return of capital distributions can be thought of as tax-deferred income because the distributions reduce the cost base of the investment for income tax purposes. As a result, although the distributions are not taxable in the year received, the reduced tax cost results in a larger capital gain or smaller capital loss when you dispose of the investment in the future. These investments allow you to convert high taxed interest to lower taxed capital gains, and benefit from the deferral of tax and the time value of money.

Income Tax Deductions and Credits

Claiming tax deductions and credits is an effective way of boosting the return from your investments.

Tax Loss Selling

If your portfolio contains investments that have decreased in value, prior to the end of the calendar year, consider selling these investments to recognize a capital loss. This capital loss can be used to reduce capital gains realized in the current year or in the three previous taxation years. If you cannot use the losses in any of those years, you can carry-forward the losses indefinitely to be used against future capital gains. If you intend to repurchase the investment, ensure that you do not invoke the "superficial loss" rules. A superficial loss may occur where the property is reaquired by you or someone affiliated with you, including your spouse or common-law partner, within a certain period of time.

Tax Shelters

There are certain investments which offer tax incentives, such as flow-through shares. Flow-through shares are offered by companies in the mining, oil and gas, and energy sectors to help finance their exploration and project development activities. The companies then renounce or "flow through" eligible expenses to you, the investor, up to an amount equal to the cash you paid for the shares. Depending on the type of tax shelter, you are able to claim a deduction for the full amount of funds invested, with most of the deduction available in the year you made the investment, and the balance deductible in the following one or two years. Since flow-through shares are generally deemed to have a tax cost of nil, any proceeds derived from the investment's sale in the future would trigger a capital gain, which is only 50% taxable. For certain investments, there are also additional federal and provincial investment tax credits allowed to be claimed. Just a cautionary note, when it comes to investments offering tax incentives, it's crucial to focus on the quality of the investment, and not just the tax incentives.

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Conclusion

Stay tuned for part two of this article series where we discuss ways to income split and rebalance your portfolio in order to invest tax efficiently. Being aware of and using the different opportunities and strategies available can help you build and protect your wealth. Working with your RBC advisor and your qualified tax advisor will allow you to make decisions on these opportunities and strategies that are appropriate to your own personal situation.

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