The Navigator

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Tax-Efficient Investing – Part 2

Income Splitting & Income Rebalancing

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 part one of this article series) as well as income splitting and income rebalancing (discussed in this article).

Income Splitting

Income splitting strategies shift investment income and capital gains from being taxed in your hands, at a higher marginal tax rate, to the hands of your lower-income family members to reduce your family's overall tax bill. If a family member has no other income, they could earn up to $10,000 of interest income, $20,000 of capital gains or $30,000-$50,000 of Canadian dividends tax-free annually through income splitting (note that the amount varies by province).

Expense Funding Strategy

Tax efficient investing and overall tax savings for your family can be accomplished by having investment income taxed in the lower-income spouse's hands. By having the higher-income spouse pay all the family expenses, it allows the lower-income spouse to save their earnings and invest them. The resulting investment income can then be taxed at the lower-income spouse's tax rate.

Spousal Loan

Consider lending money to a lower-income spouse at the Canada Revenue Agency's (CRA) current prescribed rate of 1% in order to take advantage of that spouse's lower marginal tax rate on future investment income. Your spouse must make the annual interest payment owed to you on the spousal loan by January 30 of the following year, otherwise, any income and capital gains earned on the borrowed funds will be attributed back to you for that particular year and every subsequent year that the loan is in place. While you will have to report the interest income from your spouse, your spouse will be entitled to a tax deduction for that interest payment and be able to claim the investment income generated, which will be taxed at their lower rate. This strategy may result in overall annual tax savings for your family, with even larger tax savings at retirement arising from years of accumulation of capital in the lower-income spouse's hands.

Since the income earned within a TFSA is not taxable, if you gift money to your spouse or adult child to contribute to their TFSA, the income and growth in the account will not be attributed back to you.

Family Trust Loan

Consider using a family trust to lend funds at the prescribed rate to other family members such as children or grandchildren, who are in lower tax brackets. The trust would invest the proceeds of the loan at a rate of return that is sufficient to cover at least the interest on the loan. The net income earned (after deducting the interest expense paid to you) will be taxed in the hands of your children or grandchildren at their lower marginal tax rates. It is important to discuss this option with your legal advisor prior to implementing this strategy.

TFSA Gift

Since the income earned within a TFSA is not taxable, if you gift money to your spouse or adult child to contribute to their TFSA, the income and growth in the account will not be attributed back to you. Unlike conventional income splitting strategies that consider the source of the invested funds, this TFSA account allows you, your spouse and/or adult child to earn tax-free investment income, regardless of whose money is invested. Keep in mind that although gifting assets allows you to split income, the assets you gift are no longer yours and become the property of the receiver.

Income Rebalancing

Consider your investment type

It is important to recognize that different types of investment income are taxed differently in non-registered accounts. For example, capital gains and Canadian dividends are taxed at more favourable rates than interest income and foreign income. Canadian dividends are effectively taxed at a lower rate than interest income due to the dividend tax credit that is applied to the federal and provincial taxes payable. The use of a tax credit is meant to recognize that the Canadian corporation paying the dividends has already paid tax on its earnings, which are now being distributed to investors. Capital gains are also taxed at a lower rate considering only 50% of net capital gains are included in your income. On the other hand, interest and foreign income (including dividends from foreign corporations) are fully taxable at your marginal tax rate.

As such, from a tax perspective, consider rebalancing the mix of assets in your portfolio to focus on holding equity investments outside your registered accounts to benefit from the preferred tax treatment of capital gains and dividends. Also, since the income generated from your investments is not taxed in your registered accounts, where possible, consider holding fixed income investments inside your registered plan to defer tax on the interest income. While evaluating investments based on after-tax return is important, you should also consider other factors such as the investment's risk, diversification, the opportunity for capital appreciation, liquidity and so on.

Consider rebalancing the mix of assets in your portfolio to focus on holding equity investments outside your registered accounts to benefit from the preferred tax treatment of capital gains and dividends.

Consider insured annuities

If you rely on GICs or similar interest-bearing investments for income, you are paying tax at high rates on that interest income. Consider an alternative to interest-only GICs that will increase your yield while minimizing taxes. An insured annuity provides an income stream (usually for life) and capital security for your beneficiaries through the purchase of a permanent life insurance policy (which you must qualify for) and a prescribed life annuity. The insured annuity results in a higher monthly cash flow and more after-tax income than would otherwise be achievable through interest-only investments like GICs. This is because although a portion of the income stream you receive is considered interest, which is taxable, the other portion is a return of capital, which is not taxable. Then, to replace that capital (for the benefit of your beneficiaries) a portion of each annuity payment is used to fund the life insurance policy.

Conclusion

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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