RBC Dominion Securities Inc.

# PortfolioAdvisor

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## Axe the Tax

### How to Keep More of Your Wealth After Taxes

As a Canadian, you are one of the most heavily taxed people in the world. You may have to pay nearly half of your income in taxes if you are in a high tax bracket. Fortunately, there are some ways you can chop down the tax you pay – and protect more of the wealth you have worked hard to build.

### Invest Tax Efficiently

Whether you are building or preserving your wealth, it's important to be aware of the different ways that investment income is taxed. In a regular taxable account, dividends and capital gains are taxed less than interest:

- 100% of the interest you earn from investments like bonds is taxable.
- 50% of the net capital gain earned on the sale of stocks is taxable.
- Eligible dividends from Canadian corporations receive a Dividend Tax Credit to reduce tax payable.

### Key Strategies

This different tax treatment for different types of investment income opens up opportunities for you to invest more tax-efficiently. For example, consider the following strategies:

- **Hold more of your interest-bearing investments in your registered plans.** In a non-registered account, interest income from bonds and GICs is fully taxable – and you have to report the income annually even if you haven't actually received it yet.

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But in registered accounts such as your Registered Retirement Savings Plan (RRSP), interest income accumulates free of annual taxation. To be sure, capital gains and dividends also accumulate tax-free within your registered plan. However, unlike interest, they already receive preferential tax treatment in a regular non-registered account – an advantage they lose within a registered plan, where all income is treated equally.

As a result, it can make sense to hold more of your interest-bearing investments in your registered plans, and more of your stocks in your non-registered plans.

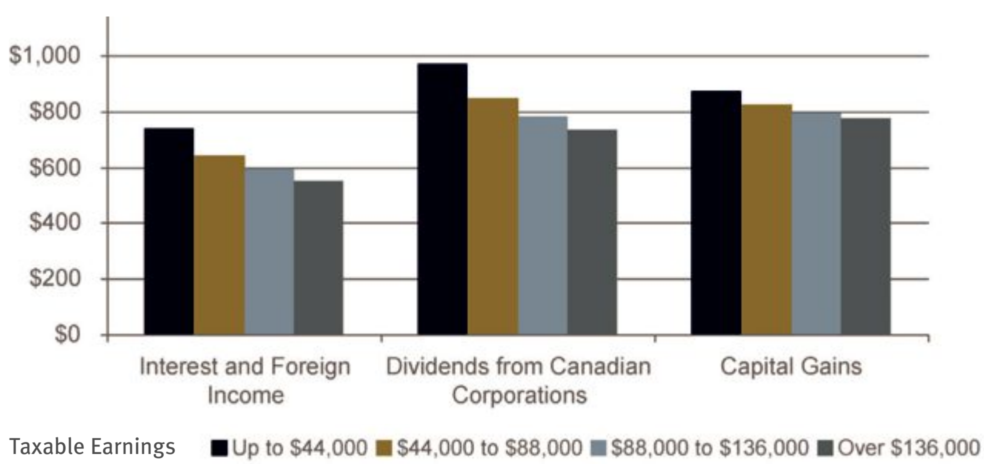
- **Offset taxable capital gains with capital losses.** You can reduce the tax you pay on capital gains by applying capital losses against them to reduce your net capital gain. You generally trigger capital gains or losses by actually selling an investment (it's not based on the market value of an unsold 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. You can also carry losses forward indefinitely to use against future capital gains.

Bear in mind the superficial loss rule, which is designed to prevent abuse of this tax-planning technique. A capital loss will be denied if you sell an investment at a loss, and if you or your spouse acquire an identical investment 30 days before or after the sale, and still hold it on the 30th day after the sale.

- **Consider using dividends for some of your retirement income.** For most retirees, bonds and GICs should form the core of their portfolio, because the interest and principal are both guaranteed. Dividend-paying stocks aren't guaranteed, but you may reduce the risk level through diversification. What's more, due to today's longer life expectancy, you may have more time to let the ups and downs of the stock markets smooth out over time. That way, you can benefit from the historically superior long-term growth potential dividend-paying stocks may offer.

## How Much You Keep After Tax per $1,000 Earned in a Taxable Account

### Based on Average Canadian Marginal Tax Rates for 2014



## Maximize Your Tax-Advantaged Plans

### Registered Retirement Savings Plan (RRSP)

You are probably already aware of the tax advantages offered by your RRSP. Your contributions are tax-deductible and they grow on a tax-deferred basis inside your RRSP, resulting in greater growth. Generally, try to make your RRSP contributions earlier in the year to maximize tax-deferred growth, or consider making regular contributions through the year with a Pre-Authorized Contribution (PAC).

If possible, keep your RRSP open as long as possible to benefit from tax-deferred growth. You don't have to convert your RRSP into a Registered Retirement Income Fund (RRIF) or other income source until the end of the year in which you turn 71. Remember to make your final two RRSP contributions if you have contribution room – one for the year you convert your RRSP and another early contribution for the following year. While you will have pay a small over-contribution penalty for the early contribution, the tax savings from the deduction should more than compensate for that.

### Individual Pension Plan (IPP)

If you are an incorporated business owner or professional, such as a doctor or dentist, an IPP gives you the ability to make larger contributions compared to an RRSP and provides tax deductions for your corporation.

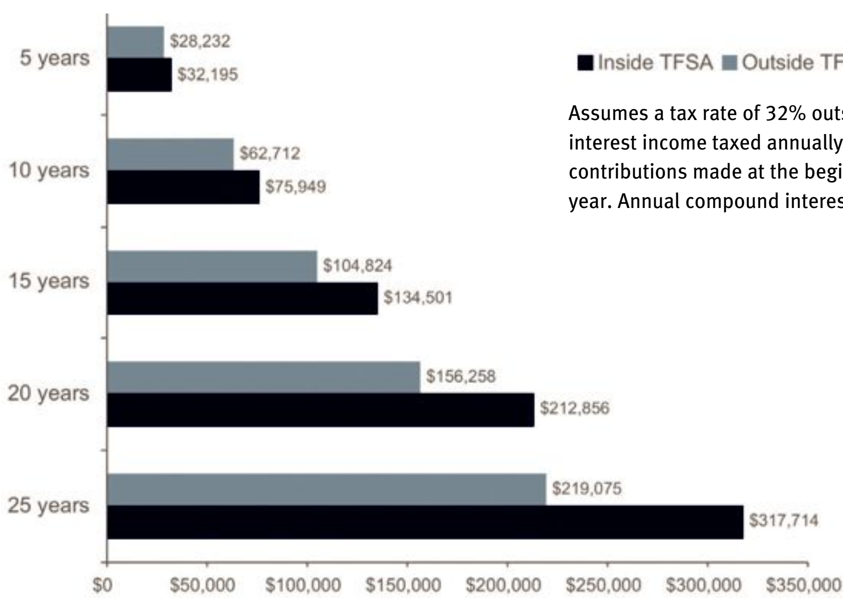
### Tax-Free Savings Account (TFSA)

Your TFSA gives you the ability to earn tax-free investment income and make tax-free withdrawals. Every Canadian resident aged 18+ automatically receives contribution room, which carries forward if you don't use it. The annual contribution limit has been $5,500 since 2013, and was $5,000 for 2009-2012. That means if you haven't opened a TFSA yet, you can contribute as much as $31,000. You can also give money to your adult family members to contribute to their own TFSAs. A family of four could contribute as much as $124,000 to grow tax-free. You can also make tax-free withdrawals any time, and the amount you withdraw is added back to your available contribution room the following year.

### Your Registered Retirement Income Fund (RRIF)

Similar to an RRSP, investments within your RRIF grow on a tax-deferred basis, but you can no longer make contributions and you have to withdraw a certain amount each year. If you haven't converted your RRSP yet, consider waiting until the deadline – the end of the year in which you turn 71 – in order to benefit from continued tax-deferred growth. Once you convert your RRSP into a RRIF, consider taking out only the minimum required withdrawals to leave more within your RRIF to benefit from continued tax-deferred growth. This may be an option if you have other income sources you can draw on.

## Tax Free Compound Growth




Assumes a tax rate of 32% outside TFSA, with interest income taxed annually and $5,000 contributions made at the beginning of each year. Annual compound interest rate 6%.

For illustration only and not indicative of future returns. Excludes fees and commissions. Actual tax rates may vary.

## Split Income with Lower-Income Family Members

Income splitting is one of the most effective ways to reduce your family's overall taxes. It involves transferring the responsibility for declaring taxable income from a higher-income family member, who is taxed at a higher tax rate, to lower-income family members taxed at lower rates. Here are a few ways you can do this:

- **Invest the earnings of the lower-income spouse.** If you have a lower-income spouse, consider keeping their employment income separate from yours, and investing this income, while you pay for the household expenses from your income. That way, the investment income your spouse earns will be taxed at their lower tax rate.

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- **Split pension income with your spouse.** Any income that is considered pension income, such as RRIF income if you are age 65 or older, can be split 50/50 with your spouse when you file your tax returns.
- **Contribute to a spousal RRSP.** Before pension income-splitting was introduced a few years ago, contributing to a spousal RRSP was probably the best way to split retirement income with your lower-income spouse. It can still be useful, because there is no 50% limit. You could, for example, make 100% of your RRSP contributions to a spousal RRSP. You receive the tax deductions, then when you convert your spousal RRSP into a RRIF, your spouse makes the withdrawals, which are taxed at their lower rate.
- **Set up a spousal loan.** You can loan money to your lower-income spouse to invest, enabling them to earn investment income taxable at their lower rate. For this strategy to work, you need to make a formal, written loan arrangement with your spouse. In addition, your spouse must pay you annual interest at the Canada Revenue Agency's (CRA's) prescribed rate. However, with the CRA's prescribed rate back down to a historic low of 1%, the spousal loan strategy is currently very practical.
- **Establish a family trust.** You can make outright gifts to adult children with no tax consequences. They can invest the money to earn income that is taxed in their hands. However, if you wish to retain some control, you can loan money to a family trust instead. The investment earnings, when used for the benefit of the trust beneficiaries (e.g. to pay for private or post-secondary school), are taxable in their hands. If they earn no other income, they can earn up to a certain amount tax-free due to their basic tax exemption, and anything above that is taxed at their lower rate.

## Use Insurance to Earn Tax-Free Income and Create a Tax-Free Benefit

During your lifetime, you can invest through a tax-exempt life insurance policy to earn tax-free income. First, you take out a life insurance policy and pay the premiums for life insurance coverage that you need. You can also contribute additional amounts to the policy and invest them in a wide range of investment products. Your investments grow tax-free because life insurance has tax-exempt status with the CRA. If you need income, you can take out tax-free bank loans using the policy's cash value as collateral. Then, when your estate is settled, the proceeds pay back the loan. Any leftover amounts go to your beneficiaries as part of the tax-free death benefit.

Insurance can also used to cover tax liabilities that arise when your estate is settled. For example, your estate may have to pay up to 50% of any remaining RRSP/RRIF balances when you (or your surviving spouse) pass away. In addition, there is a "deemed disposition" on any other assets you own on death (the CRA essentially regards them as having been sold, even if they haven't). Any resulting capital gains (aside from those on your principal residence) are taxable to your estate. This includes vacation properties, family heirlooms and

non-registered investment portfolios. Often, beneficiaries are forced to liquidate their inheritances in order to cover the taxes. However, you can take out an insurance policy in advance to cover the taxes. Depending on your situation, the cost of the insurance coverage may be much less than the taxes.

*To "axe the tax," please contact us for more information about tax-minimization strategies and tax-efficient investment solutions.*