

Portfolio advisor



Six tax tips for investors

A little tax planning can make a big difference to your after-tax investment returns and income. Following are six practical strategies you should consider as part of your overall investment plan.

1 Maximize your tax-advantaged investment accounts

For most (but not all) investors it makes most sense to maximize tax-advantaged accounts first, before regular taxable accounts. This includes:

- › **Your Registered Retirement Savings Plan (RRSP) and/or Registered Pension Plan (RPP).** In addition to receiving tax deductions for your RRSP/RPP contributions, you don't pay any taxes on investment income earned within your RRSP until it's withdrawn, enabling it to accumulate faster. To accelerate this tax-deferred growth, remember to contribute the maximum every year (18% of your earned income to a maximum of \$22,450 for the 2011 tax year). Also consider contributing earlier in the year, so your investments have more time to grow tax deferred. To benefit as long as possible from tax-deferred growth, consider waiting until the deadline to mature your RRSP – December 31 of the year in which you turn 71.

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- › **Your Registered Retirement Income Fund (RRIF).** A RRIF is a popular RRSP maturity option and, like an RRSP, it enables you to accumulate income on a tax-deferred basis. You have to take minimum withdrawals, which increase with your age. If you have adequate income from other sources, it might make sense to take just the minimum, leaving the rest to continue growing as much as possible.
- › **Your Tax-Free Savings Account (TFSA).** Like an RRSP/RRIF, a TFSA enables you to accumulate investment income free of annual taxation. However, unlike an RRSP/RRIF, you never have to pay tax on the investment income. You can make withdrawals, any time, for any reason, and pay no tax. If you're a Canadian resident aged 18+, you automatically receive \$5,000 in TFSA contribution room annually. Your TFSA contributions aren't tax deductible like your RRSP contributions. However, the tax-free growth and withdrawals still make it very worthwhile to contribute funds that would otherwise be exposed to your higher tax rate to your TFSA.

2 Reduce taxes by prioritizing your investment accounts

From a tax perspective, it generally makes sense to maximize your RRSP/RRIF first, then your TFSA, and finally your non-registered account. (Ideally, of course, you're able to maximize all of them.)

There are exceptions to this general rule.

For example, say you expect more income during retirement than before retirement. In this situation, it can make sense to emphasize your TFSA first, then your RRSP. That's because you may save more tax on tax-free TFSA withdrawals during retirement (when your tax rate is higher) than on RRSP contribution tax deductions before retirement (when your tax rate is lower). However, it's important to bear in mind that this situation is relatively uncommon. In addition, your TFSA alone is unlikely to provide sufficient retirement income, due to the smaller contribution limits. The best strategy is to maximize both your TFSA and RRSP.

Another example is if you think you may leave behind a very large RRSP/RRIF balance, due to your life expectancy. While RRSP/RRIF balances transfer to your spouse tax free, they are fully taxed as regular income on your (or your spouse's) final tax return when transferring to another beneficiary. If you are in this situation, it may be better to accumulate and leave more assets in your non-registered account, as certain non-registered assets can transfer to your estate more tax efficiently than registered assets (which are fully taxable).

Up to nearly 50% of your remaining RRSP/RRIF balance may be payable in taxes by your estate. To cover this tax bill, you may wish to consider "tax protector insurance", which can be a cost-effective solution depending on your age and health.

In addition to maximizing your own TFSA every year, consider providing funds to any lower-income adult family members to help them maximize their TFSAs as well. If you have funds sitting in your bank account that are exposed to your higher tax rate, simply provide these funds to your lower-income adult family members, so they can contribute them to their own TFSAs. That way, you not only help your family members save, you can also reduce your family's overall taxes.



3 Allocate your investment assets tax efficiently

Because different types of investment income are taxed in different ways, how you allocate them can make a difference. In a regular taxable account:

- › Interest income from GICs and bonds is fully taxable at your marginal tax rate.
- › Half of any capital gain on the sale of an investment is tax-exempt.
- › Eligible dividends paid to you by Canadian corporations receive a Dividend Tax Credit.

In a non-taxable registered account, such as an RRSP or RRIF, all income is treated equally. All investment income accumulates tax-free inside the account. When it is eventually withdrawn, it is treated as regular income and taxed at your marginal tax rate (except for your TFSA, which also allows tax-free withdrawals).

As a result, when allocating investment assets between your taxable and non-taxable accounts, consider the following strategy:

- › Allocate more of your fully taxable, interest-bearing investments to your non-taxable RRSP/RRIF accounts. They will be sheltered from annual taxes, enabling them to grow faster on a tax-deferred basis, until you withdraw them.
- › 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.

How much you keep after tax for every \$1,000 earned in a taxable account			
Taxable income	Interest	Capital gains	Eligible dividends
Up to \$41,000	\$800	\$900	\$1,000
\$41,000-\$81,000	\$680	\$840	\$880
\$81,000-\$126,000	\$566	\$783	\$761
\$126,000+	\$536	\$768	\$738

All amounts are approximate.

4 Reduce capital gains taxes with tax-loss selling

Towards the end of any year, it makes sense to look at any investments you own in your non-registered account that are in a loss position, determine if they still meet your needs, and if not, sell them to deliberately realize the capital loss. You can then apply this loss against gains you have realized throughout the year, reducing your net taxable capital gain. If you have no gains in the current year, you can apply the loss against capital gains in any of the three previous years, potentially resulting in a tax reassessment and refund. If you have no gains in any of these years, you can carry the loss forward and apply it against future gains.

Be aware of the “superficial loss” rules, which will deny a capital loss in certain situations. Generally speaking, the loss is denied if:

- › You, your spouse or a corporation controlled by either you or your spouse acquire the identical investment within a 60-day timeframe starting 30 days before the sale and ending 30 days after the sale
- › You still own the identical property 30 days after the sale

5 Divide and conquer taxes with income splitting

Many tax-planning strategies revolve around the fact that in Canada the higher your income, the higher your tax rate. So if you can transfer income exposed to your higher tax rate to a family member with a lower tax rate, you can reduce your family's overall taxes. Here are a few easy ways you can do this:

- › **Pension income-splitting.** You can transfer up to 50% of your “eligible pension income” such as RRIF income to your lower-income spouse so it is taxed at their lower rate, and potentially bring you down to a lower tax bracket yourself. You simply report the income as your spouse's on both your tax returns.
- › **Spousal RRSP contributions.** You can contribute up to 100% of your available RRSP contribution room to a spousal RRSP, which also helps split income to reduce your combined taxes. You receive the tax deduction like a normal RRSP contribution – but your spouse receives the income from the spousal plan in retirement.
- › **Family trust.** You can transfer or loan assets to a trust set up for

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the benefit of family members who have little or no income of their own (for example, to help fund their education costs). Your beneficiaries can receive 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.

6 Create a tax-efficient income stream

Most retirees still rely on GICs and bonds to provide much of their retirement income, augmenting their government and pension benefits. The only problem is that there's often very little income left over after taxes, as interest rates remain low and the interest is fully taxable.

One solution is to diversify your income stream with more tax-efficient investments. This includes Canadian blue chip stocks, which pay dividends that receive a special Dividend Tax Credit. It also includes secure investment solutions, such as tax-exempt insurance. You can deposit assets into a tax-exempt insurance policy to grow tax-free, and receive income in the form of tax-free bank loans that use the insurance policy as collateral. At death, the loans are repaid with the assets in the insurance policy, and any remaining balance goes to your estate tax-free.

Another thing to consider is the order in which you withdraw income from your various income sources. For example, depending on your situation, it can make sense to take income from your non-registered accounts first, leaving assets in your RRSP/RRIF to continue growing on a tax-deferred basis for as long as possible. Then, when you start taking income from your RRIF, consider taking only the legally required minimum.

If you don't need your minimum RRIF payments, and you have TFSA contribution room, think about depositing your RRIF payments into your TFSA where they can continue growing tax-free.



Your Tax Time Resources

- › **Client Tax Reporting Guide**
www.rbcds.com/TaxReporting/home
A handy reference explaining the tax information you may receive as an RBC Dominion Securities client.
- › **Canada Revenue Agency website: www.cra.gc.ca**
A wealth of information including the *General Income Tax and Benefit Guide – 2010* to assist with your 2010 taxes.
- › ***Tax Planning for the Private Investor* guidebook**
A comprehensive guidebook designed to help private investors understand, manage and reduce their investment-related taxes. Ask us for a complimentary copy.



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