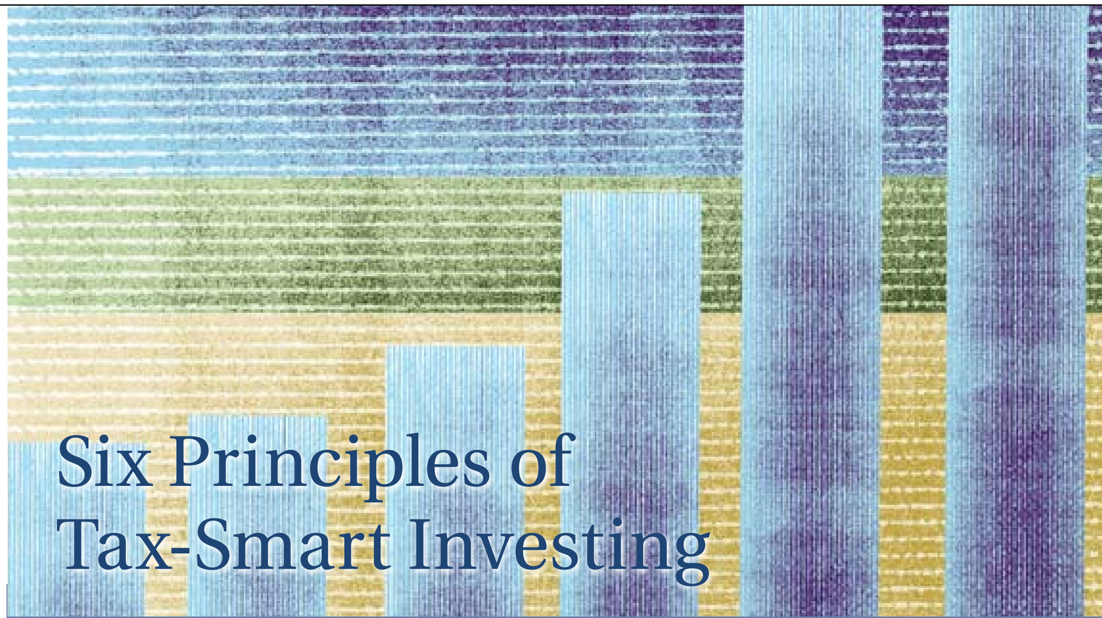
Portfolio advisor



Six Principles of Tax-Smart Investing

Keeping more of your investment returns in your pocket is always important – but especially when these returns have been as hard to come by as they have been lately. Following are six principles that can help you enhance your after-tax returns in today's volatile markets.

Principle #1 – Focusing on your after-tax returns can – literally – pay dividends

If you had a choice between an investment paying 5% annually versus one paying 4%, which one would you choose? Naturally, most people would choose the investment offering 5%. But what if the 5% investment paid interest income, while the 4% investment paid eligible dividend income from a Canadian corporation?

Because interest income is fully taxable at your marginal rate, your return would be just 3% after taxes, assuming a 40% tax rate. But with the 4% Canadian-source dividend, your after-tax return would be approximately 3.2% to 3.6% depending on your province of residence. In fact, you can earn between $20,000 – $50,000 in tax-free dividends if you have no other taxable income (varies by province).

The third main type of investment income – capital gains – also receives preferential tax treatment compared to interest income. Only one-half of any capital gain realized, for instance, by selling a stock that has increased in value, is taxable at your marginal rate. You can also offset capital gains with capital losses ("tax-loss selling") to reduce your taxes even further.

It's not what you make – it's what you keep
How much you keep after-tax for every $1,000 earned

Marginal tax rate	Interest income	Capital gains	Eligible dividends
20%	$800	$900	$1,000
30%	$700	$850	$930
40%	$600	$800	$830

All amounts are approximate. Based on blended average of provincial and territorial tax rates. Eligible dividends also assume that the amount of the eligible dividend is the only taxable income in the year.

Principle #2 – Maximizing your RSP means more than just maximizing your RSP contributions

You are probably very familiar with the tax virtues of your Retirement Savings Plan (RSP). Your RSP contributions are tax-deductible, resulting in significant tax savings, and they also grow on a tax-deferred basis.

But beyond simply making your RSP contributions every year, there are several ways you can maximize the tax advantages offered by your RSP.

- **Timing your deductions.** If your income fluctuates from one year to the next, consider making a contribution in a lower-income year, but waiting until a higher-income year to claim it for a potentially greater tax deduction.
- **Sheltering interest income.** In a regular non-registered account, interest income is fully taxable at your marginal rate. Given today's historically low interest rates, you may be left with little growth left over after taxes. Even accrued interest that you have not actually received is taxable every year. As a result, it can make sense to shelter interest-bearing investments such as GICs and government bonds within your RSP to maximize tax-deferred growth.
- **Remembering the "forgotten" RSP contributions.** You can make two final RSP contributions in the year you turn 71 before you have to convert your RSP into an income source such as a Retirement Income Fund (RIF). If you are turning 71 in the current year, remember to make your current year RSP contribution before you convert your RSP by the end of the year. You can also make an early RSP contribution for next year in December if you have earned income. Although you have to pay a small over-contribution penalty, the tax savings from the tax deduction should more than compensate for it.
- **Contributing to your spousal RSP past age 71.** Even if you are over 71, you can continue making tax-deductible contributions to your spousal RSP, if you have earned income and your spouse is 71 or younger.

Principle #3 – Don't settle for just tax-deferred growth when you can get tax-free growth too

You've probably heard all the hype about the new Tax-Free Savings Account (TFSA), which enables you to earn tax-free income and make tax-free withdrawals. While some have heralded the TFSA as an "RSP Killer", there are only a few situations where it would make sense to choose a TFSA over an RSP. In most situations, you can benefit from both.

From a tax perspective, the TFSA is better if you have lower income now, but anticipate much higher income during retirement. Although your TFSA contributions aren't tax-deductible, the ability to make tax-free withdrawals more than compensates for this. In the reverse situation, your RSP would typically come out the winner because the tax deductions you receive during your higher-income years outweigh the taxes you pay once you start making withdrawals in retirement.

But why choose?
Ideally, of course, you don't have to choose between your RSP and TFSA. In most cases, opening a TFSA in addition to your RSP makes most sense, as they both offer excellent – and complementary – tax advantages. Here's how the main features of a TFSA stack up against an RSP:

- **Making contributions.** Anyone with a Social Insurance Number over the age of 18 (or 19 in certain provinces) can open a TFSA and contribute up to $5,000 annually. Unlike an RSP, you can make contributions even if you have no earned income and unused contribution room carries forward throughout your lifetime. There's no age limit to close or convert a TFSA, as opposed to an RSP, which must be converted to an income source like a RIF in the year you turn 71.
- **Earning tax-free investment income.** You can invest in most of the same type of investments as an RSP and your investment income grows without annual taxes, much in the same way as it does in your RSP. However, unlike an RSP, you never pay taxes on the income – even when you withdraw it. You can make tax-free withdrawals at any time for any reason – and the amount withdrawn is added back to your available contribution room the following year.

› **Saving for various goals.** With the flexibility to make tax-free withdrawals at any time for any reason, the TFSA is an excellent way to save for a wide range of goals. You can save for shorter-term goals, like a vacation, automobile or property. You can create an emergency fund. You can supplement a family member's education savings. And so on.

An RSP, on the other hand, is designed for a very specific goal – saving for your retirement. It offers two key advantages over a TFSA – you can make much larger contributions and they are tax-deductible. That said, if you have already maximized your RSP contributions, you can also use your TFSA to augment your retirement savings – it's really a flexible, all-purpose account. To make the most of both your RSP and TFSA, consider investing the tax savings from your RSP contributions in your TFSA to enjoy further tax-advantaged growth.

How does a TFSA stack up?

	TFSA	RSP	Taxable Account
Tax-deductible contributions	✗	✓	✗
No annual taxes	✓	✓	✗
Tax-free withdrawals	✓	✗	✗
No restrictions on re-contribution of withdrawals	✓	✗	✓
No impact on government benefits	✓	✗	✗

Principle #4 – Create a tax-efficient retirement income stream

With traditional income-producing investments like GICs and government bonds currently offering ultra-low interest rates, it can be difficult to get the income you need. One way to enhance your after-tax income is to diversify your portfolio with more tax-efficient investments, as discussed in Principle #1. Here are some other ways you can create a tax-efficient income stream:

› **Draw your income in the right order.** In retirement, you have several income sources, such as your RIF, employer pension, personal accounts, annuities, Canada Pension Plan, Old Age Security and so on. By simply drawing on these various income sources in a certain way, you can enhance your after-tax income.

In general, you want to draw from less tax-advantaged sources earlier, and more tax-advantaged sources later. For example, if possible, delay converting your RSP into a RIF until the final deadline (the end of the year in which you turn 71). This way, you continue benefiting from tax-deferred growth within your RSP. To get the income you need now, draw from other sources that aren't so tax advantaged, such as GIC income from a taxable account.

Once you convert your RSP into a RIF, take only the minimum required payments, leaving the rest to continue growing on a tax-deferred basis. If you don't need the minimum payments from your RIF right now, consider depositing them into your TFSA (up to your TFSA contribution limit), where they can grow tax-free. Then, whenever you need, you can withdraw the funds from your TFSA – also tax-free.

› **Split your income with family members.** Recent tax changes enable you to split "eligible pension income" such as RIF income if you are at least age 65 50/50 with your spouse. This can help you to even out your income with your spouse's, putting you both into similar tax brackets. Because of Canada's marginal tax system – where the higher your income, the higher your tax rate – you generally pay less combined tax when you and your spouse have similar incomes and thus similar tax rates.

Other ways to split income include:

– Gifting funds to your spouse or adult children to contribute to their TFSAs.

– Establishing a family trust for your children, who can each earn approximately $20,000 in tax-free capital gains within the trust, assuming they have no other income.

– Paying family members a "reasonable" salary for actual work performed for your private Canadian corporation.

› **Look beyond traditional investments.** One of the best-kept secrets of investing is the tax-exempt life insurance policy, which enables you to invest in many of the same sort of investments as an RSP, earn tax-free investment income, and get a tax-free death benefit for your beneficiaries. Tax-exempt insurance is ideal for investors seeking more tax-efficient investment income who also have a need for insurance. While there are insurance costs to consider, the tax-sheltered growth offered by a tax-exempt policy typically outweighs these.

Another insurance-based strategy to enhance your after-tax income is the insured annuity. You invest a lump sum in a life annuity that pays a guaranteed income for life. The payments include both earned interest income, which is taxable, and return of capital, which is not, resulting in higher after-tax income compared to a conventional GIC. Plus, a portion of each payment funds an insurance policy, which provides the tax-free return of some or all of your initial capital to your beneficiaries. Bear in mind that, once you've committed capital to an insured annuity, you can no longer access it and you also lock in at a fixed interest rate. As a result, an insured annuity usually only makes sense for a portion of your assets.

Principle #5 – Enhance retirement income with special tax-advantaged plans for business owners

There are two special retirement plans available to business owners – the Individual Pension Plan (IPP) and Retirement Compensation Arrangement (RCA).

An IPP is ideal for both business owners and self-incorporated professionals (e.g. dentists, veterinarians, doctors, etc.). With an IPP, you can make larger contributions compared to an RSP, while enjoying tax-deferred growth just like an RSP. This results in potentially greater retirement income. Plus, contributions are tax deductible to your corporation.

An RCA – often referred to as the "super-sized pension plan" because there are no set limits on contributions or benefits – is designed to supplement existing retirement plans. It is a non-registered plan set up by an employer, most commonly for owner/managers or key employees who are already maximizing their traditional retirement plans and are looking for additional benefits. RCA contributions are tax deductible to the corporation and the contributions grow on a tax-deferred basis when the RCA is funded with a tax-exempt insurance policy.

Principle #6 – Enhance your legacy the tax-smart way

Because of the potential for large taxes on your estate, the government could be your single largest beneficiary when your estate is settled. Up to half of your RSP or RIF could be payable in taxes. Capital gains on your assets are also taxable as if they were sold – regardless of whether or not they are actually sold. What's more, there can be U.S. Estate Tax on your U.S. assets like stocks, bonds and real estate – even if you're not a U.S. citizen or resident. One way to deal with these potentially punishing taxes is through the use of insurance-based strategies, which are designed to cover the taxes, maximizing the value of your estate for your beneficiaries.

In today's uncertain investment climate, strategies to reduce taxes and enhance your after-tax returns are more important than ever. To find out how you can benefit from any of the strategies discussed in this newsletter, please contact us today.

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