



Wealth
Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Tax-efficient investing

Enhancing your after-tax return on personal investments

There are tax-efficient investments and strategies that may enhance your after-tax income and increase the overall rate of return on your investment portfolio. This article discusses a few key components of tax-efficient investing, including maximizing your registered accounts and deferring tax through your choice of investments.

Maximizing the benefits of your registered accounts

The government provides tax incentives to encourage individuals to save and plan for the future. Some common investment savings accounts are the registered retirement savings plan (RRSP), tax-free savings account (TFSA) and tax-free first home savings account (FHSA). There are limits to how much you can contribute to each of these accounts. Consider taking advantage of these registered accounts before you invest in a non-registered account in order to maximize your returns.

RRSPs

Contributing to an RRSP, including a spousal RRSP, provides you with a tax deduction today, which allows you to defer the tax on your contribution until the funds are withdrawn in a future year. In addition, your investments grow on a tax-deferred basis within the plan.

Contributing to an RRSP is generally the most beneficial when you're in a higher income tax bracket, for example, during your working years. If you can make withdrawals from the RRSP when you are in a lower income tax bracket, possibly during your retirement years, it may have a significant impact on your after-tax return.

TFSAs

While you don't get to enjoy a tax deduction when you make a contribution to your TFSA, the funds invested within the TFSA grow tax-free and aren't taxed when you withdraw them at a future date. Because of this tax-free attribute, the TFSA may allow you to generate greater tax savings and faster investment growth in a shorter time frame. Often, the TFSA can be used to complement your existing registered savings plans, including RRSPs and registered retirement income funds (RRIFs).



FHSAs

The FHSA is a registered account to help you save for the purchase of your first home if you meet certain eligibility criteria. With a FHSA, you can enjoy tax deductions for your contributions alongside tax-free growth of invested funds. Withdrawals may also be tax-free, if you make a qualifying withdrawal to fund the purchase of your first home.

Strategies for investing in your non-registered accounts

If you have maximized your registered account contributions or have determined that investing in those vehicles isn't appropriate in your circumstances, there are a number of strategies you can consider when investing in your non-registered accounts.

Deferring tax through your choice of investment

Income tax deferral involves pushing what otherwise would be a current tax obligation to a future year. By doing so, not only are you able to reduce your current year's tax bill and potentially benefit from the time value of money, but you may also be able to pay tax on that income in the future, when you're subject to a lower rate of tax.

If your objective is to defer paying tax, you might want to consider investing in certain types of securities that may help you achieve this goal. These securities include growth securities as well as exchange-traded funds (ETFs) and mutual funds that don't generally allocate income or capital gains or may only make return of capital distributions.

If your portfolio contains debt obligations, such as bonds or guaranteed investment certificates (GICs), consider structuring these purchases so that maturity dates are after the end of the current calendar year. For example, let's say you purchased two bonds today. One bond matures on December 31 of Year 1, and the other matures on January 1 of Year 2. For the bond that matures on December 31 of Year 1, you will have to report and pay tax on the interest income you received by April 30 of Year 2. However, for the bond that matures on January 1 of Year 2, you'll only have to pay tax on the interest income you received by April 30 of Year 3. This strategy may allow you to defer the payment of tax.

In addition, certain investments such as real estate investment trusts (REITs) as well as some mutual funds distribute non-taxable return of capital payments. Return of capital distributions can be thought of as tax-deferred income because the distributions aren't taxable in the year you receive them. Instead, they reduce the cost base of the investment for income tax purposes. The reduced adjusted cost base (ACB) generally results in a larger capital gain or smaller capital loss when you eventually dispose of the investment in the future.

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Although the objective of these investment choices may be to defer income, and consequently the resulting tax, it's always important to consider the investment merits of securities first and foremost.

Deferring tax through your choice of investment strategy

Certain strategies may be used to defer recognizing income within your non-registered accounts. Adopting a buy-and-hold investment philosophy, for example, would minimize the turnover of growth investments and would therefore defer tax. This is because the more often you sell your investments, the more often you realize taxable capital gains. For even more tax-efficiency, you could 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.

Timing the realization of capital gains

The capital gains inclusion rate has been increased from 50% to 66.67% as of June 25, 2024. However, the first \$250,000 of capital gains realized by an individual, will continue to be subject to the 50% inclusion rate. This \$250,000 threshold is available annually. Given this change, if you have a significant amount of unrealized capital gains in your investments, you may want to consider realizing a portion of these capital gains annually to benefit from this \$250,000 threshold.

Reducing income through tax loss selling

If your portfolio contains investments that have decreased in value and are no longer aligned with your investment strategy, consider selling these investments prior to the end of the calendar year in order to realize the capital loss. While selling at a loss may seem counter-intuitive, the tax benefits can be significant if you've realized capital gains on other investments. This is because the capital loss realized can be used to reduce capital gains realized in the current year or, potentially, in the three previous years. If you can't use the capital losses in any of those years, you can carry them forward indefinitely to offset capital gains you may realize in the future.

The investments you sell at a loss for tax purposes can be replaced by investments that have stronger growth or income producing potential. Alternatively, you may still want to hold the specific investment you sold at a loss. If you intend to repurchase the investment you just sold, it's important to ensure you don't trigger the "superficial loss rules." These rules prevent you from claiming the capital loss, defeating what you were trying to achieve. A superficial loss may occur when you sell property (for example, shares or mutual funds) and then you or someone affiliated with you (including your spouse or common-law partner) acquires that identical property within 30 days and continues to hold it on the 30th day. For more information about the superficial loss rules, please ask your RBC advisor for the separate article on this topic.

Reducing income through your choice of investment

The government provides tax incentives to encourage investment in certain areas of the economy. Flow-through investments is an example of an investment that provides tax deductions or tax credits. Again, while evaluating investments based on the after-tax return is important, you should also consider other factors such as the investment risk, diversification, the opportunity for capital appreciation, liquidity and so on.

It's also important to note that certain investments require more complex tax reporting. For example, if you invest in a limited partnership, you have to annually track your ACB by factoring in your share of income or losses, as well as distributions made by the partnership. You may also need a professional tax advisor to help you determine the optimal use of federal or provincial deductions and credits with respect to the investment. For these reasons, investing in limited partnerships may increase the costs associated with your tax filings. You should factor in increased filing complexities and costs when evaluating whether an investment is right for you.

Flow-through investments

Flow-through investments are typically offered by companies in the mining, renewable energy and energy conservation sectors to help finance their exploration and project development activities. The companies then renounce or "flow through" certain eligible expenses to you, the investor. You can claim these expenses on your tax return and reduce your taxable income.

By the time you sell your flow-through investment, the tax cost will generally be nil. As such, any proceeds derived from the investment's sale in the future would likely trigger a capital gain of which, only a portion is taxable. For certain investments, there are also additional federal and provincial/territorial investment tax credits that you may claim, which may further boost the tax-efficiency of these flow-throughs.

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It's important to note that there are a number of potential risks associated with flow-through investments. The Canada Revenue Agency may deny the renunciation of expenses that do not meet certain criteria. In addition, certain flow-through limited partnerships have a holding period of approximately 18-24 months. As such, you might be required to wait before being able to liquidate your position and there is the possible risk of investment losses if the value of the underlying investment decreases over that time period.

Conclusion

It's not always what you earn, it's what you keep. If you want to keep more of what you earn as an investor, then investing tax-efficiently may help you build and protect your wealth. Working with your RBC advisor and a qualified tax advisor can help you make informed decisions on which tax-efficient investments or strategies may be most appropriate for you.

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