Wealth Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT 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 income 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. Two common investment savings accounts are the Registered Retirement Savings Plan (RRSP) and the Tax-free Savings Account (TFSA). 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provides you with a tax deduction today, which allows you to defer the tax on your contribution until the funds are withdrawn in a future year.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 most beneficial when you are 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 are not 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).

Strategies for investing in your non-registered accounts

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

Deferring income 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, 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.

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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) results in a larger capital gain or smaller capital loss when you eventually dispose of the investment in the future.

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 income 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.

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 (say, shares or mutual funds) and then you or someone affiliated with you (including your spouse or common-law partner)

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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 an 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 and labour-sponsored venture capital corporations (LSVCCs) are two such examples of investments that provide 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 is 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.

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By the time you sell your flow-through investment, the tax cost will generally be nil. So any proceeds derived from the investment's sale in the future would trigger a capital gain, of which 50% 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.

It is 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.

Labour-sponsored investments

LSVCCs are corporations sponsored by a labour union, which invest primarily in small- to medium-sized private firms seeking alternative funding for development or expansion. It's important to recognize that they're considered higher-risk investments.

The federal government provides the original holder of an LSVCC with a federal tax credit of 15% (maximum of $750). Some provinces and territories also provide tax credits to the original investor. The specific amount of these credits is different for each jurisdiction. Depending on when you purchase the LSVCC, you may be able to claim the credit on your income tax return for the current or the previous taxation year.

LSVCCs must be held for a set period of time. If they're not, the tax credits you received will be withheld from the proceeds when you dispose of the investment. This amount withheld will then be repaid to the government. Also, there are typically additional costs (such as management and performance fees) associated with investing in LSVCCs.

Please contact us for more information about the topics discussed in this article.

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 an 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.

This article may contain several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

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