Wealth Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Daniel Kelly, MBA, CIM, FCSI
Senior Portfolio Manager
Tel: 519-675-2528
daniel.kelly@rbc.com

Gary Gorham
Senior Associate Advisor
Tel: 519-661-2510
gary.gorham@rbc.com
Kelly-Gorham Private Wealth
Kelly-Gorham Private Wealth
Chris Alexander
Associate Investment Advisor
Tel: 519-675-2667
chris.alexander@rbc.com

Lauralee Bushan-Jazey, CIM, FCSI
Associate Wealth
& Investment Advisor
Tel: 519-661-2557
lauralee.bushan-jazey@rbc.com

Jessi da Silva-Couto
Associate
Tel: 519-675-2664
Kelly-Gorham Private Wealth
jessi.dasilva-couto@rbc.com

Kelly-Gorham Private Wealth
of RBC Dominion Securities
148 Fullarton St - Suite 1900
London, ON N6A 5P3
Tel: 519-675-2000 | Fax: 519-675-2020
Toll free: 1 800-265-5911 ext.2528
www.danielfkelly.com

Tax planning basics

This article provides an overview of the Canadian tax system, basic investments and how the two interact. In developing a broader understanding of the Canadian tax system, you may be in a better position to invest tax-efficiently so that you may be able to keep more of your investment income and achieve your financial goals.

For the purposes of this article, it's assumed you are a tax resident of Canada.

Canadian income tax system

Canada taxes its tax residents on their worldwide income. In the majority of cases, this means you must report all of your taxable income for Canadian tax purposes, regardless of where in the world you earned that income. Tax residency is based on the relevant facts and circumstances, which include the residential ties you have in Canada, any ties you have abroad and the amount of time spent in Canada. Canadian citizenship is generally irrelevant in determining your obligation to pay Canadian tax.

If you move to Canada during the year, you are considered to be a part-time resident and are only taxed on your worldwide income from the time you become a tax resident of Canada.

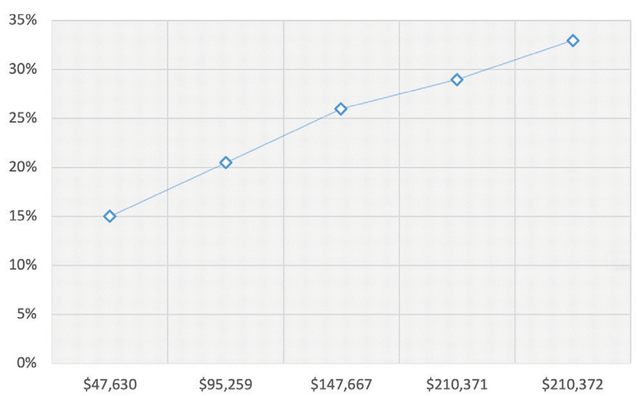
The Canadian tax system is an honour-based system that requires you to declare your income to the Canada Revenue Agency (CRA), whether an information slip was issued to you or not. You may be issued an information or tax slip on various types of income you earn, for example, employment income and interest income. Common types of income you may earn where you may not receive a tax slip include capital gains realized on the sale of real estate and foreign currency conversions. If you do not report all of your taxable income for Canadian tax purposes, you can be subject to interest and penalties.

The federal government has the jurisdiction to tax income earned in Canada. You may also be subject to provincial or territorial tax for the year if you are a resident of that province or territory on December 31 of that year or in some cases, earn income in that province or territory. The Canadian personal income tax system is based on graduated tax rates at both federal and provincial/territorial levels. This means increasing tax rates apply to increasing levels of taxable income.

The tax rates stay steady over a range of incomes and then increase and remain static over another range. These ranges are commonly referred to as tax brackets.

The following shows the federal tax rates and tax brackets:

Sample of Graduated Tax Rates



Source: Federal tax legislation, 2019.

Average and marginal tax rates

Your average tax rate (also referred to as your "effective" tax rate) is calculated as the total tax payable divided by your taxable income. Your marginal tax rate is generally the percentage of tax payable on the final dollar of your taxable income. There is a difference between the two rates because, as mentioned earlier, Canada has a system of progressive tax rates. Your average tax rate is always equal to or less than your marginal tax rate.

Your average tax rate can be used to estimate how much tax you'll pay on a similar amount of income in a future tax year, while the marginal tax rate can help you evaluate the after-tax return of an investment of new funds.

Calculating your tax liability

To estimate how much tax you'll have to pay, you must first calculate your taxable income for the year. You do this by adding up all of your various types of income (i.e. salary, interest, taxable Canadian dividends, taxable capital gains, etc.) and subtracting any deductions to which you're entitled, for example, registered retirement savings plan (RRSP) contributions, eligible investment management fees and deductible interest expense. Your total income less your deductions represents your taxable income.

You calculate your total federal taxes by multiplying your taxable income by the appropriate federal tax rates. You then subtract the various tax credits from the federal tax you've calculated to arrive at a net federal tax amount.

Your average tax rate can be used to estimate how much tax you'll pay on a similar amount of income in a future tax year, while the marginal tax rate can help you evaluate the after-tax return of an investment of new funds.

Examples of tax credits you may be entitled to include: the basic personal tax credit, charitable donation tax credit, dividend tax credit and foreign tax credit.

You then follow the same process, starting with your federal taxable income, to calculate your provincial or territorial taxes using the applicable provincial/territorial tax rates and tax credits. Most Canadian residents complete this calculation on one harmonized federal and provincial/territorial tax return administered by the CRA. (Residents of Quebec file separate federal and provincial tax returns. You calculate your taxable income on the Quebec provincial return using Quebec tax rules, unlike the other provinces.)

You combine your net federal tax and provincial/territorial taxes to determine your total tax payable. You then subtract any prepaid tax, such as tax withheld at source and tax instalments that you paid during the year, from the total tax payable to determine if you will receive a refund or if you have a balance owing.

Investment income earned in non-registered accounts

A non-registered account is a type of account that's not registered with the CRA. The Income Tax Act (the Act) does not impose restrictions on this type of account and as a result, these accounts do not benefit from tax-deferred or tax-free treatment like RRSPs or Tax-Free Savings Accounts (TFSAs).

Inside a non-registered account, you can invest in many different types of products. These may include: bonds, stocks or mutual funds (which are pools of investments that have a manager(s) guiding the investment choices). The income you earn in a non-registered account is taxable according to the type of income generated. For example, you'll usually pay less tax on capital gains and Canadian dividends than you will on interest. The less tax you pay, the more of the investment's return you keep. In general, the tax on dividends and capital gains is lower but the investments that generate this type of income can carry more risk. Although it's a good idea to consider the after-tax return when making investment choices, don't forget to consider the amount of investable assets you own, your cash flow, the risk associated with the particular investment, the opportunity for capital appreciation, the liquidity of the investment and your personal investment objectives.

In contrast, a registered account is a type of account that must meet certain conditions and must be registered with the CRA. These types of accounts typically benefit from special tax treatment; for example, income earned in a TFSA may be exempt from tax. (Common types of registered accounts are discussed later in the article.)

Interest income

Interest is an amount a borrower pays a lender in return for the use of their money for a set period of time. There are a number of investment products available for purchase whereby you act as a lender and the seller of the investment pays you interest and repays the original principal of the investment to you after a set period of time. The interest you receive is fully taxable as income at your marginal tax bracket and does not benefit from tax-preferred treatment.

Interest can be paid at varying frequencies depending on the investment. Payments frequently occur monthly, semi-annually, annually or at maturity. Investments of many years of duration that only pay interest at maturity are called "compound investments." Some common examples of compound investments are Canada Savings Bonds, strip or discount bonds, compound bonds or GICs.

For more information on the taxation of interest income, please ask your RBC advisor for the articles on bonds and discount instruments.

Dividend income from Canadian corporations

Dividends are payments that a corporation makes to its shareholders, usually as a way of distributing profits to those who invested in the company. Companies may have Dividend Reinvestment Programs (DRIPs) that allow you to automatically have any dividends payable to you, reinvested in additional shares of the same company. Regardless of whether you receive the dividends or you reinvest the dividends, they are taxable to you.

Individuals will pay a preferred tax rate on Canadian dividends in recognition of the fact that Canadian corporations have already paid tax on its earnings. To achieve this preferential tax rate, dividends are 'grossed-up," meaning the amount included in your taxable income is higher than the actual dividend received, and an offsetting dividend tax credit is then deducted from your federal and provincial/territorial taxes payable.

Individuals will pay a preferred tax rate on Canadian dividends in recognition of the fact that Canadian corporations have already paid tax on its earnings.

Canadian corporations can designate a dividend as either an eligible or a non-eligible dividend. An eligible dividend will generally be subject to less tax than a non-eligible dividend. The ability to declare a dividend as eligible or non-eligible depends mostly on a corporation's status and tax attributes. Dividends paid by Canadian public corporations (companies that trade on a stock exchange) are typically classified as eligible dividends. Canadian Controlled Private Corporations (CCPCs) can pay both eligible and non-eligible dividends. Generally, eligible dividends are paid out of corporate profits that have not been subject to a preferential corporate tax rate (such as the small business tax rate).

Eligible dividends

Eligible dividends are subject to an enhanced dividend "gross-up." Individuals who earn eligible dividends can claim a federal dividend tax credit against the grossed-up dividends. A provincial/territorial dividend tax credit is also available, which differs for each province or territory. The federal gross-up for eligible dividends is 38% and the federal dividend tax credit is 15.02% of the grossed-up dividend. In effect, the tax you pay on eligible dividends is lower than the tax you pay on interest income.

Non-eligible dividends

Non-eligible dividends are subject to a dividend "gross-up" that is smaller than that applied to eligible dividends. The dividend tax credit for non-eligible dividends is also generally smaller. As with eligible dividends, you're eligible for an additional provincial/territorial dividend tax credit. The federal "gross-up" for non-eligible dividends is 15%. The federal dividend tax credit is 9.03% of the grossed-up dividend.

Some strategies involving dividend income

- If you earn only eligible dividend income, you may be able to receive over $50,000 tax-free depending on your province or territory of residence. This is because under certain circumstances, the dividend tax credit and the basic personal amount (and other tax credits to which you may be entitled) reduce the taxes on dividends to zero.
- Examine the mix of assets in your portfolio to consider

taking advantage of the lower effective tax rates that apply to eligible Canadian dividend income and capital gains.

The dividend interest relationship

When you're evaluating your investment choices, one of the things to consider is the after-tax returns on the various types of investments. You can calculate a factor to help you compare the after-tax returns on interest and Canadian eligible dividend-paying investments using the following formula:

$$\frac{\text{(1-tax rate) x Dividend}}{\text{(1-tax rate) x Interest}} = \frac{\text{After-tax dividend}}{\text{After-tax interest}}$$

The current range is between 1.18 and 1.42, and varies between provinces and territories. This means an interest rate would have to be approximately 42% higher than an eligible dividend yield, in the province with the highest multiplier, for after-tax returns to be similar, assuming all other factors are equal. Remember that the risk associated with a dividend-paying investment is generally different from the risk associated with an interest-paying investment. You should always speak with a qualified advisor when determining the investments are suitable for your personal risk tolerance and time horizon. It is also important to seek guidance from a tax professional.

Foreign income

Foreign income is fully taxable at your marginal tax rate. If you receive a dividend from a foreign company, you will pay tax on that dividend at the same marginal tax rate as interest income. Dividends you receive from foreign corporations are not subject to the same preferred tax rates that are available for dividends from Canadian corporations. If you were subject to foreign withholding tax on the dividend, you may be able to claim a foreign tax credit to reduce your Canadian taxes by some or all of the foreign tax paid.

Return of capital

Some investments will distribute a payment to you called a return of capital (ROC). ROC represents a return of all or a portion of the original capital you invested. There are certain types of investments that could make ROC distributions to you. These include, but are not limited to: mutual funds, real estate investment trusts (REITs), limited partnerships (LPs), and mortgage-backed securities (MBSs).

ROC distributions are not taxable in the year you receive them but these distributions reduce the adjusted cost base (ACB) of your investment for tax purposes. As a result, you will have a larger capital gain or a smaller capital loss when you eventually dispose of your investment.

If a ROC payment reduces the ACB of your investment below zero during the tax year, the negative amount will be deemed to be a capital gain in the year it arises. The ACB of your investment will then be deemed to be zero. If you receive future ROC distributions, they will also be taxed as a capital gain because you are getting back more than you originally invested.

Capital gains and losses

You will realize a capital gain when you sell an asset and the proceeds exceed the cost base of the asset. A capital gain can be further reduced by any fees you incur to sell the asset (e.g. transaction fees or commissions).

You will realize a capital loss when you sell an asset and the proceeds are less than the cost base of the asset. Your capital loss can become larger if you incurred fees to sell the asset. You must report capital gains and losses on your tax return in the year they are realized. If you realized capital losses in the year, you must use these losses to reduce capital gains that you realized in the same year.

If you did not reduce your total capital gains to zero after subtracting your current losses for the year, you will report 50% of the balance on your tax return as a taxable capital gain. Any taxable capital gains that remain after applying any available prior-year losses will be subject to tax at your marginal tax rate that year.

If your losses for the year are greater than your gains, you will add 50% of the losses to your net capital loss pool. You can use the losses in this pool to reduce any taxable capital gains reported in any of the three previous calendar years, or carry them to future years to reduce any taxable capital gains you may realize in future years.

ROC distributions are not taxable in the year you receive them but these distributions reduce the adjusted cost base (ACB) of your investment for tax purposes. As a result, you will have a larger capital gain or a smaller capital loss when you eventually dispose of your investment.

After-tax return on investment income

The following chart shows how interest, dividends and capital gains compare on an after-tax basis when you earn $1,000. The chart assumes you pay tax at the highest marginal tax rates in effect in 2019, depending on your province or territory of residence.

	Interest	Non-eligible dividend	Eligible dividend	Capital gains
Alberta	520	577	683	760
British Columbia	502	554	686	751
Manitoba	496	533	t622	748
New Brunswick	467	523	665	734
NL&Labrador	487	554	574	744
Nova Scotia	460	517	584	730
Nunavut	555	622	669	778
NWT	530	632	717	765
Ontario	465	526	607	732
PEI	486	548	658	743
Quebec	467	538	600	734
Saskatchewan	525	596	704	763
Yukon	520	578	711	760

Source: RBC Wealth Management. Calculated based on federal and provincial legislation, 2019.

Superficial losses

Tax-loss selling is a common year-end tax planning strategy. It involves selling investments with an accrued loss so you can use the capital loss you realize on the sale to offset any capital gains you incurred in the year.

There are special tax rules that prevent you from selling a security at a loss, quickly repurchasing it and then using that loss to reduce your capital gains. If you sell an investment and incur a capital loss, be sure to consider the superficial loss rules.

A superficial loss will occur when a security is sold for a loss and both of the following occur:

1. You acquire or reacquire the identical security during the period beginning 30 days before the disposition and ending 30 days after the disposition of the original security; **and**
2. At the end of the above period, you still hold the identical security.

Among other situations, the superficial loss rules also apply if you sell an investment at a loss and it is acquired by your spouse or a corporation controlled by you and/or your spouse or a trust of which either you or your spouse is a majority interest beneficiary during the time period described earlier.

When a security is subject to the superficial loss rules, you will not be able to claim the capital loss you realize on the disposition. The denied loss is added back to the ACB of the security held. For more information on the superficial loss rules, please ask your RBC advisor for the article on this topic.

Investing in a registered account

Registered plans are plans set up for specific purposes. They benefit from tax incentives and are generally subject to special tax rules and limits on the types of investments that can be purchased within the plan.

You can make contributions to these accounts with cash or you may be able to transfer assets you already own as a contribution. It's important to understand the tax consequences of making in-kind contributions of a security from your non-registered account to your registered account. When the investment leaves the non-registered account, you are considered to have disposed of it for tax purposes and you will realize any capital gain or loss that has accrued. Capital gains are taxed as described above. Capital losses that arise from a contribution from your non-registered to your registered account are denied. Losses denied on an in-kind transfer to a registered account are permanently lost; for this reason, if you want to transfer property with an accrued loss to a registered account, you should consider selling the security, realizing the capital loss and contributing cash to the registered plan. The security should not be repurchased in the registered plan for at least 30 days after disposing of it in order to avoid the superficial loss rules.

Registered retirement savings plan (RRSP)

An RRSP is a savings vehicle that benefits from tax incentives to encourage taxpayers to save for retirement.

You can make contributions to an RRSP if you have contribution room. Your contribution room is determined annually as a percentage of your "earned income," up to an annual maximum. Earned income includes income from various sources, the most common of which is employment or self-employment income. Unused RRSP contribution room can be carried forward for future contributions. You can deduct your RRSP contributions that are within your contribution limit against any taxable income on your tax return. This can help you reduce your taxable income and therefore, your taxes payable in a particular year.

Any investment income and capital gains you earn in the RRSP will compound on a tax-deferred basis. Withdrawals from an RRSP are taxable as income at your marginal tax rate.

You can contribute to your own RRSP until the end of the year you turn 71. If you are older than 71, you can still contribute to a spousal RRSP if your spouse is younger than this age.

Before, the end of the year in which you turn 71, you need to choose an RRSP maturity option. There are three RRSP maturity options:

- Convert your RRSP to a registered retirement income fund (RRIF) and begin to take annual income payments. The annual income payments are taxable as income at your marginal tax rate.
- Use the RRSP funds to purchase an annuity. The annuity payments are taxable as income at your marginal tax rate.
- Collapse the RRSP and take the funds as a taxable payment in one year.

The following are some tax planning strategies involving RRSPs:

- If you have excess cash or available non-registered assets, consider making your RRSP contributions early in the year to maximize tax-deferred growth on your investments.
- If your income is low in a particular year, you may wish to make an RRSP contribution but defer taking the deduction until a future year when you have higher income.

> An RDSP is a savings plan designed to provide government-assisted, long-term savings for a beneficiary who is eligible for the disability tax credit.

Registered education savings plan (RESP)

An RESP is a savings plan designed to provide a tax-effective method of saving for post-secondary education.

Contributions to the RESP are not deductible for tax purposes and are limited to a lifetime maximum of $50,000 per beneficiary. However, income earned in the plan is only subject to tax when it is withdrawn. You may be able to benefit from income splitting, as qualifying withdrawals from the RESP can be taxed in the hands of the beneficiary rather than in the hands of the contributor.

In addition to the mentioned tax benefits, you may also be eligible for an annual government grant. The Canada Education Savings Grant (CESG) is a federal government grant of 20% on the first $2,500 contributed to an RESP per eligible beneficiary per year, subject to certain limitations. If you don't make an RESP contribution in a year, you can carry the grant room forward to use in a future year. Some provinces and territories have additional payments for RESP holders resident in those provinces or territories.

The following are some tax planning strategies involving RESPs:

- If you have excess cash or available non-registered assets, consider making your RESP contributions early in the year to maximize tax-deferred growth on your investments.
- Speak to your qualified tax advisor to determine the optimal amount of contributions to make in order to maximize government grants and tax-deferral.

- If the beneficiary is enrolled in a qualifying program, have the beneficiary withdraw income and government grants from the RESP before withdrawing original contributions from the plan. This will allow the income and grant to be taxed in the beneficiary's hands. Original contributions can be withdrawn at any time tax-free.

Registered disability savings plan (RDSP)

An RDSP is a savings plan designed to provide government-assisted, long-term savings for a beneficiary who is eligible for the disability tax credit.

Anyone can make contributions to an RDSP, to a lifetime maximum of $200,000 per beneficiary. You will need the plan holder's permission to make a contribution to an existing RDSP and your contribution is not tax deductible. The government will pay grant and bond assistance payments into an RDSP depending on the beneficiary's family income. The first $1,500 of contributions per year is eligible for a government grant of up to $3,500. The maximum government grant a plan beneficiary can receive over their lifetime is $70,000. Depending on family income, a government bond may be available of up to $1,000 per year to a lifetime maximum of $20,000.

The implications of withdrawals from an RDSP will depend on the age of the beneficiary and the length of time the RDSP contributions and assistance payments have been in the plan. Generally, if withdrawals are made before the beneficiary is 60, some of the government assistance received may need to be paid back. You should discuss the implications of a withdrawal from an RDSP with an RBC advisor or qualified tax professional to minimize assistance repayments if possible.

Withdrawals of government assistance and income are taxable to the beneficiary. Withdrawals of original contributions are not taxable.

The following are some tax planning strategies involving RDSPs:

- If you have excess cash or available non-registered assets, consider making your RDSP contributions early in the year to maximize tax-deferred growth on your investments.
- Speak with your qualified tax advisor to determine the optimal amount of contributions to make in order to maximize government grants and tax-deferral.
- If the RDSP beneficiary is entitled to provincial or territorial disability support, determine if RDSP payments affect the beneficiary's eligibility for support under the program. In most cases, RDSP payments do not affect provincial disability support so RDSPs can be a good way to save and income split with the beneficiary.

The TFSA enables you to earn tax-free investment income and capital gains. Funds can be withdrawn tax-free at any time, but you don't need to withdraw or take income from your TFSA until you're ready to do so.

Tax-free savings account (TFSA)

The TFSA enables you to earn tax-free investment income and capital gains. Funds can be withdrawn tax-free at any time, but you don't need to withdraw or take income from your TFSA until you're ready to do so. This means a TFSA can be used to meet a wide range of goals—from emergency savings to renovations, or to supplement your retirement income.

Contributions to a TFSA are not tax deductible. Your TFSA contribution room limits the funds you can invest in a TFSA. You can determine your contribution room by adding together the annual limits set by the government for every year during which you're eligible to contribute. You then subtract the contributions you've made to a TFSA to calculate your remaining room. If you've made a withdrawal from your TFSA, the amount you withdraw will be added back to your TFSA contribution room for the following calendar year.

The following are some tax planning strategies that involve TFSAs:

- The funds you withdraw from your TFSA are not subject to income tax so any withdrawals you make will not have an impact on any income-tested government benefits you may receive, such as Old Age Security and Employment Insurance. If you're currently receiving income-tested government benefits, you can consider using the funds in your TFSA if you require the cash flow.
- The TFSA can be an ideal complement to an RRSP, especially if you're able to make the maximum contribution to these plans each year. You will continue to earn TFSA contribution room throughout your life, regardless of your age.
- The investment income earned inside your TFSA is not taxable, so if you borrow funds to invest in a TFSA, you will not be able to deduct the interest you pay for income tax purposes. Keep this in mind if you're deciding where to invest your borrowed funds. It's also important to note that using borrowed money to finance the purchase of securities involves greater risk than a purchase using cash resources only. If you borrow money to purchase securities, your

responsibility to repay the loan as required by its terms remains the same, even if the value of the securities purchased declines.

- You can use the assets in your TFSA as collateral for a loan, subject to the lender requirements.
- TFSAs can be used as a means of income splitting. If you have a spouse or adult children who have unused TFSA contribution room, consider making a gift to them so they can invest in their TFSA. The attribution rules will not apply to the income earned in the TFSA.

Summary

The Canadian tax system is very complex. Various types of income are taxed in different ways and a number of government-assisted programs exist to help taxpayers save. The taxation of income earned on investments depends on the nature of income earned and the type of account the investments are held in. While investment decisions should be made considering all of your goals and objectives, you may be able to maximize your after-tax returns by holding your investments strategically.

Speak with a qualified tax advisor about the programs and strategies described in this article to determine whether they may make sense for your circumstances.

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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