Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Tax planning checklist for high-income earners

Depending on your province or territory of residence, you may be subject to tax at a rate of about 50% or higher when your income exceeds around $200,000. This article highlights a non-exhaustive list of tax minimization strategies to consider with a qualified tax advisor. The use of these strategies will vary based on personal circumstances. As such, it's crucial to check with a qualified tax advisor prior to implementing any of these strategies.

For the purposes of this article, any reference to a spouse includes a common-law partner.

Income splitting with family members

Family income splitting is a strategy that benefits from the progressive tax system where marginal tax rates rise as taxable income increases. It involves moving taxable income from a family member in a higher tax bracket to one in a lower tax bracket. By spreading taxable income among family members, a family may be able to retain more after-tax income.

It's important to understand the impact of the "attribution" rules in the Income Tax Act if you plan to income split with your family members. These rules have the effect of attributing taxable income back to the family member who supplied the capital for investment so that in effect, no tax savings are achieved. For more information on income splitting and the attribution rules, ask your RBC advisor for an article on this topic.

Prescribed rate loan

If you have a low-income spouse, consider whether it makes sense to establish a spousal loan to shift investment income and capital gains to them. This will allow you to take advantage of your spouse's lower marginal tax rate. The strategy involves you transferring funds to your low-income spouse through a formal loan arrangement at the Canada Revenue Agency (CRA) prescribed interest rate. Your spouse may then be able to earn investment income on these loaned funds and pay taxes on the income and capital gains at their lower marginal tax rate, decreasing the overall family tax bill.

The prescribed interest rate is set by the CRA quarterly. The rate in effect at the time the funds are loaned should be used and will apply to the loan so long as it remains outstanding. Your spouse must pay you annual interest on the loan, which may be deductible to them. You (the lender) must include the interest you receive in your taxable income. This strategy may result in tax savings if the rate of return on your spouse's investments is higher than the interest paid to you by your spouse. The lower the prescribed interest rate at the time of the loan, the more potential there is for an income splitting benefit. When the prescribed interest rate is high, this strategy may be less attractive.

The prescribed rate loan strategy may also function between a parent and low-income adult child or grandchild. If you have minor children or grandchildren with little or no income, and you wish to split income with them, you may want to consider making a prescribed rate loan to a family trust. This may also depend on the prescribed interest rate in effect at the time of making the loan.

Family trust

If you have children, grandchildren, nieces or nephews with little or no income, you may wish to consider establishing a family trust to shift investment income that would otherwise be taxed in your hands at a high marginal tax rate, to the hands of your low-income family members. If the trust is properly structured, income and capital gains earned in the trust that are paid or made payable to the trust beneficiaries may be taxed at their marginal tax rate.

As mentioned previously, when contemplating any income splitting strategy, you need to consider the attribution rules. To ensure the attribution rules do not apply and the trust income can be taxed in the beneficiary's hands, consider making a prescribed rate loan to the family trust. For more information, ask your RBC advisor for an article on using a family trust for a prescribed rate loan. In addition, you also need to consider the Tax on Split Income (TOSI) rules and how they might apply to the trust income earned and allocated to the trust beneficiaries. If the TOSI rules apply, income and capital gains allocated to a beneficiary would be taxed at the highest marginal tax rate in their hands. The TOSI rules are complex and should be discussed with a qualified tax advisor.

Expense optimization

If you have a low-income spouse, consider paying for all of your household expenses. Your lower-income spouse can then save and invest more of their income and the investment income earned can be taxed at your spouse's lower marginal tax rate.

If you have children, grandchildren, nieces or nephews with little or no income, you may wish to consider establishing a family trust to shift investment income that would otherwise be taxed in your hands at a high marginal tax rate, to the hands of your low-income family members.

Invest in registered accounts

Tax-free savings account (TFSA)

In addition to investing in a TFSA of your own, consider making a gift to your spouse or other adult family members to enable them to contribute to a TFSA. All of the investment income in the TFSA grows tax-free and future withdrawals are not taxable. Further, any income or capital gains earned in the TFSA do not attribute back to you.

Registered retirement savings plan (RRSP)

If you contribute to an RRSP, you can deduct the amount of your RRSP contribution from your taxable income, up to your annual RRSP deduction limit. This will reduce the taxes you have to pay for a particular tax year. In addition, funds in an RRSP grow on a tax-deferred basis. The investment income and capital gains generated in the plan are not subject to tax until you make a withdrawal in the future.

You may also want to consider contributing to a spousal RRSP for your low-income spouse to equalize future retirement income. Any contributions you make to a spousal RRSP utilizes your own RRSP contribution room and can be claimed on your tax return and deducted against your taxable income. Withdrawals from a spousal RRSP will be taxable to your spouse (provided you did not make a contribution in the year of withdrawal or in the two previous tax years.)

Registered education savings plan (RESP)

Are you planning on paying for your child's post-secondary education? If so, consider setting up an RESP. While your contributions to an RESP are not tax-deductible, there are no taxes paid on the income and capital gains earned in the plan until the funds are withdrawn. Also, contributions to the plan may attract government grants which help your savings grow faster. When your child attends a qualified post-secondary education program, and withdrawals are made from the plan, the income earned in the plan may be taxed in your child's hands, presumably at a lower tax rate than your own.

Tax-free first home savings account (FHSA)

If you and/or your spouse currently don't own a home that you live in as your principal place of residence and haven't owned a home that you lived in at any time during the past four years, you may be eligible to open an FHSA and contribute $8,000 annually (up to a maximum of $40,000) to this account. Like an RRSP, contributions you make to the FHSA are tax-deductible against any sources of income. And like a TFSA, all of the investment income grows tax- free. You may also potentially withdraw the investment income (along with your original contributions) tax-free if you use the funds to purchase a first home. In addition, you can also help your child purchase a home by gifting them funds to contribute to their own FHSA (assuming they meet the conditions for opening the FHSA). For more information on the FHSA, ask your RBC advisor for an article on this topic.

Invest in tax-efficient investments

Flow-through shares

A flow-through share is a type of tax-advantaged investment vehicle designed to encourage investing in resource companies engaging in exploration and development in certain sectors. If structured properly, the resource company may "renounce" or "flow through" certain expenses it incurs to you, which you can then deduct personally on your tax return. The maximum amount you can deduct is the amount you paid for the investment. You may apply the deductions against all sources of income, thereby reducing your net income and the associated tax liability. It's very important to consider the quality of the investment, and not just the potential tax write-off.

Tax-exempt life insurance

If you have surplus assets that you plan to pass on to your heirs, you should probably consider how these assets are invested. If you invest these assets in a non-registered account, the investment income earned will be exposed to your high marginal tax rate. As well, on death, you will generally be deemed to have disposed of these non-registered assets at fair market value, triggering any unrealized capital gains. This may result in a significant tax liability, reducing the size of your estate left to your heirs. As well, estate assets may need to be liquidated to meet this tax obligation.

Investing in a permanent tax-exempt life insurance policy may help achieve a variety of objectives. It may be used to provide an income replacement for your family should you die prematurely. It may also serve as a separate asset class to grow your estate tax-free. Under current tax laws, income earned within a tax-exempt life insurance policy is free from tax. As well, when you pass away, the death benefit is received by beneficiaries or your estate tax-free. A tax-exempt life insurance policy may also provide liquidity to your estate. The proceeds can be used to pay any taxes arising on death, preserving your estate for your beneficiaries.

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Speak to a licensed life insurance representative to determine if you have an insurance need and/or to find out how tax-exempt insurance may work for you.

Maximize tax credits and deductions available to you

It's important to be aware of the tax credits and deductions that may be claimed by you on your tax return to ensure maximum tax savings. One tax credit that's often overlooked is the medical expense tax credit. You may wish to keep a running tally of the eligible medical expenses paid for out-of-pocket, as well as the receipts, so that you can more easily determine whether you qualify for the tax credit. These types of expenses accumulate quickly and, with organization, may potentially reduce your taxes payable.

Making a charitable donation is another way you can significantly reduce the personal tax you pay. As an alternative to cash, consider donating publicly listed securities with an accrued gain in-kind to qualified charities. Any capital gain realized as a result of the donation will generally not be subject to tax. You will also generally receive a donation tax receipt equal to the fair market value of the security at the time of the donation. This may help reduce your total taxes payable and cost you less than if you were to sell the securities and donate the proceeds to the charity.

If you've thought about leaving a legacy for charitable purposes but are unsure about the best way to accomplish this, speak to your RBC advisor on the benefits of setting up your own charitable gift fund through the RBC Charitable Gift Program.

Speak with a qualified tax advisor to ensure you're claiming all tax credits and deductions available to you. Some commonly missed examples may include childcare expenses, the disability tax credit, the pension income credit, non-reimbursed union and professional dues, and other employment expenses.

Alternative minimum tax (AMT)

AMT is an alternative method to calculate the income tax you owe in Canada. It's a means to prevent high-income earners from paying little or no tax as a result of certain tax incentives, including claiming specific tax deductions and earning preferentially taxed income such as capital gains. Recently, the government has proposed changes that broaden the impact AMT may have on high-income earners. Some of the strategies discussed in this article may make it more likely that AMT could be triggered, which may make them less attractive from a tax planning perspective. In a tax year where you expect to earn significant tax-preferred income, make sizeable donations in-kind or claim certain tax deductions, it will be important to consult with your qualified tax advisor to determine if AMT will apply to you.

Tax residency planning

While moving to a lower tax jurisdiction is not a decision that should be taken lightly, it may be beneficial to consider this strategy if you have ties (e.g. family or a vacation property) in another province. The provincial or territorial tax rates to which you're subject are based on your province or territory of residence on December 31 of the taxation year. Residency status is always a question of fact and is based on the residential ties you have with each province. You should speak with a qualified tax advisor to determine your province of residence and whether this strategy may be beneficial to you.

Plan now

Tax planning should be an ongoing, dynamic process so that you don't overlook opportunities to minimize tax. Whether you're able to take advantage of the tax planning opportunities discussed earlier, or pursue other tax planning strategies, advance planning is a key part of the process.

This article may contain 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.

Wealth Management

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