Tax Planning 101 for Canadian Investors

Tariq Ali Asghar

TABLE OF CONTENTS

Goal of Tax Planning Analysis

Part One: Tax Planning and Investment Management Strategies

1. Different Types of Investments are Taxed Differently in Canada
2. Smart Tax Savings Strategies
3. Concluding Thoughts on Tax Planning for Investments

Part Two: Tax Planning and Risk Management Strategies

1. Tax Planning for Risk Management
2. Smart Tax Savings Strategies

Goal of Tax Planning Analysis

The scope of this analysis is limited to application of tax strategies in the context of making investments and estate planning; and does not cover other aspects of tax saving.

These Strategies are grouped under two categories: (A)-Strategies deployed to make tax-efficient investments; and (B)-Strategies to make best tax-efficient use of Risk Management (Insurance) including Estate Planning.

Note this is generic analysis of tax strategies and successful application of these strategies will depend on your individual personal circumstances and needs.

For checking if these Strategies are suitable to your specific tax situation and needs, please consult your Accountant.

Part One: Tax Planning and Investment Management Strategies

Different Types of Investments are Taxed Differently in Canada

Canadian Investors need to design right mix of Investments for Tax-efficient Returns. It is important to understand that different types of Investments (and corresponding Income) are taxed differently in Canada. For example, Interest Income is taxed higher than dividends and capital gains.

Interest Income is taxed at the higher Marginal Tax rate (MTR). In other words, GICs and Fixed Income Securities need a higher return to equate their after-tax returns to dividends which have preferential tax treatment in Canada.

Although dividend paying investments require less returns to equate after-tax returns from fixed income, dividend paying securities have more risks than fixed income securities.

Dividend paying stocks can have more risks than Government backed Securities. This translates onto better expectation of returns and preferential tax treatment for dividend securities.

Dividends received from Canadian Corporations are taxed preferentially as compared to interest income. Dividends are given this preferential treatment to avoid double-taxation, one at the Corporate level and other at the consumer level. Dividends in fact are eligible for Tax-Credits to overcome double-taxation.

Capital Gains are also taxed preferentially in Canada. Capital Gain occurs when an asset is sold for more than you purchased it for. Moreover, expenses incurred toward the sale of the asset are also deducted from the capital gains.

It is not your gross capital gains but net capital gains that are taxed in a particular year.

Net capital gains are equal to gross capital gains less any capital losses in the same financial year. Taxable capital gain is equal to 50% of the net capital gain.

Conversely Capital Loss would happen when expenses exceed capital gains. Net Capital Loss is equal to Gross Capital Loss minus Gross Capital Gains. Net Capital

Losses can be carried back three years and applied indefinitely into future against gains, which is an advantage to investors.

Smart Tax Savings Strategies

Borrowing to invest is generally tax-deductible. For fixed income, you can deduct only to the extent of the yield. For example, if you borrowed 7% and return on debt instrument is 4%; you can deduct only 4%.

In case of preferred shares, interest expense on borrowed funds can be deductible at 1.25 times the rate of the preferred dividend.

Finally Interest paid to purchase common shares is deductible, provided common shares are going to generate some income in future.

<u>Tax Saving Strategy One</u>: It is possible to reduce non-deductible interest onto deductible interest. Pay cash to pay off non-deductible debt and borrow money to spend on income generating assets (and thus deduct interest expense).

<u>Tax Saving Strategy Two</u>: Apply income splitting which aims to reduce overall tax burden of the family. For example, if John's tax rate is 45% and Mary's (John's spouse) is 25%, the tax saving of 20% can be applied using this strategy. For $1000 income, the tax-saving would be substantial at $200. However, special care should be exercised to avoid attribution rules (which attribute income back to you).

<u>Tax Saving Strategy Three</u>: Avoid attraction of Attribution Rules: Contributing to spousal RRSP is one common example of income splitting. Attribution (where tax onus is attributed back to the initiator) is typically invoked if there is a withdrawal from a spousal RRSP in the year of withdrawal or preceding two years. For example, if John contributes to Mary's Spousal RRSP in 2007 and there is

withdrawal in 2009, John will be assigned back tax liability. However if withdrawal is done in 2010, there will not be any assignment of tax liability.

Tax Saving Strategy Four: Generate income on income: This strategy involves contribution of capital from a spouse in high tax bracket to a spouse in low tax bracket. The income on the original transfer is taxed in the hands of the transferring spouse; whereas income on income (compounding effect) is not assigned back to the transferring spouse (higher tax bracket) but becomes part of the transferee or lower income (lower tax bracket) spouse. This has overall positive impact on savings.

Tax Saving Strategy Five: Another interesting strategy is attribution (tax burden) back to parent or grandparent of capital gains and dividend income; while interest income is not attributed back. Part of this strategy would entail that transferring parents invest in stocks and funds which mostly involve capital gains while transferee invests in interest income. However if the children are in majority stage, there is no attribution (rolling back of taxes to parents or grandparents).

Tax Saving Strategy Six: Establish Tax-Free Savings Accounts (TFSAs) from the deduction cash stream generated by the RRSP. This way you are having best of both worlds. Investment income from all sources (interest income, capital gains and dividends) will be tax-free. On top of this, the withdrawal is added to future contribution room.

Tax Saving Strategy Seven: Taxes can be deferred on your capital assets upon your death by transferring to your surviving spouse. In this case, taxes will be due either on sale of assets or death of spouse whichever is earlier. Same principle holds for registered accounts. An exception to above is the Principal residence, which is exempt from all taxes anyways.

Tax Saving Strategy Eight: RRSPs continue to be an important tax-saving vehicle. RRSPs have one key disadvantage: all preferential tax saving investments (dividends and capital gains) get mingled with the non-preferential tax investments (interest income form fixed investments); and when withdrawn are subject to your highest Marginal Tax Rate (MTR). In nutshell, RRSP cannot be used as your cash cushion or shelter against rainy days.

RRSP is primarily tax-saving strategy that operates both in the short run and the long run. For folks in higher tax bracket, it is the one of the biggest source of tax break. It is possible to get $400 tax break by contributing $1000 to RRSP. Interestingly, the tax deduction for your RRSP contribution can be carried forward indefinitely. This is advantageous if you are climbing the ladder of income successfully.

Concluding Thoughts on Tax Planning for Investments

Tax planning and Investments go hand in gloves. They move in tandem and the correlation becomes stronger as you move to a higher income threshold. Finance Advisors must keep tax planning in perspective while designing portfolios of their Clients. More important they should address the following questions:

1. Design of Portfolio in a tax-efficient way. Run scenarios and compare effects under the umbrella of non-registered accounts.
2. Guide Clients on how to structure TFSAs based on proceeds from RRSPs so that both vehicles complement each other.
3. Run numbers to analyze that contribution to RRSP is beneficial to the optimal point and is not counterproductive.
4. Identify unique financial position of clients; and recommend best suitable tax saving strategies.
5. Structure Portfolios to demonstrate how asset mix is impacting Tax Saving for Clients under different assumptions.
6. Execute rebalancing so that transaction-tax costs stay in control.

Part Two: Tax Planning and Risk Management Strategies

Tax Planning for Risk Management

Tax planning Strategies can significantly impact your estate values both in your life time and after your death as your estate passes to your beneficiaries.

Canadians have access to risk-management strategies that would help them safe-guard and enhance the values of their estates tax-efficiently, sometimes without threat from creditors.

Broadly speaking, risk management strategies can be divided into two key vehicles in Canada:

1. Permanent (and universal) Insurance; and
2. Setting up Trusts and Private Foundations.

Following seven risk-management strategies are analyzed in the context of tax-planning and above classification.

Smart Tax Savings Strategies

Tax Saving Strategy One (Tax Free Growth of Wealth): Tax-exempt growth of cash flows is achieved in a permanent life or universal insurance policy. When you pay premiums for a policy, part of it is paid toward the cost of insurance and part is invested in a pool of investments. Dividends that accrue from these investments can also be reinvested.

To conclude these investments will grow tax-free within the prescribed limits (MTAR line). Viewed in this sense, a properly structured Permanent Life Insurance acts like a registered retirement plan, giving opportunity for tax advantaged growth to investors. Remember that investment income is not treated with favor and passive investment income is taxed at 47% plus in Ontario, when it is taken out of Holding Corporation.

Tax Saving Strategy Two (Replenishing loss of Assets to Taxes): Upon death of the owner (or/and his spouse), estate is transferred to beneficiaries after government takes its share in the form of taxes and probate. In this sense, taxes would greatly reduce the net value of estate which goes into the hands of the beneficiaries. For example, if estate was originally valued at $1M, it is possible that after the payment of taxes and probate, the heirs may end up receiving $600K worth of estate only (loss of $400K).

Properly structured insurance policy could replenish this loss of $400K by providing tax-free death benefit to beneficiaries in the amount of $400K. Note the policy would be designed and set up initially in response to this anticipated need of bridging gap of $400K on account of taxes owing to estate upon death of the owner.

Tax Saving Strategy Three (Tax advantaged income to supplement retirement income): An appropriate insurance policy can serve as a supplementary (enhanced) retirement income. One of the key retirement risks, with the advancement of medical science, is the longevity risk.

Permanent insurance policy, through its cash value, can provide supplementary retirement income (when you run out of RRSP and Pension Plans). These policies could be pledged with a bank to draw loans, creating retirement income that may not be taxable.

Shareholders of a corporation can similarly draw a tax-free loan against the cash value of a corporate-held insurance.

<u>Tax Saving Strategy Four (Guaranteed Tax-preferred Income using Life Annuities):</u> Annuities entail lump-sum payment of cash to insurance company (opposite of life insurance principle). You are guaranteed income stream for life. This stream comprises of return of capital and interest, and only the interest portion is taxed.

<u>Tax Saving Strategy Five (Efficient and Optimal tax use of cash stranded inside the corporation):</u> Taxes on income generated by cash inside the corporation is taxed at the highest rate. Structuring a whole life insurance around stagnant cash inside the policy would relocate it to tax-advantaged environment inside the Policy. The proceeds from cash generated inside the Policy and death benefit move to beneficiaries tax-free through Capital Dividend Account (CDA) upon demise of the owner.

<u>Tax Saving Strategy Six (Leave a legacy through Life Insurance):</u> A Policy Owner can minimize tax through charitable giving in the following Four Scenarios:

1. Paid up Policy assigned to a Charity, equivalent to gift of cash accumulated inside the policy.

2. Current policy in which policy owner is giving premiums. The owner receives tax write off during life of policy.
3. Create a new policy in the name of Charity and assigning it as a beneficiary. The transferring owner receives tax write off for annual premiums but not death benefits.
4. Make charity as beneficiary: there will not be any tax benefit during life-time but tax-benefit will accrue to the estate in the event of death.

<u>Tax Saving Strategy Seven (Deploy Trusts for tax-efficiency).</u> Trusts are structured through deed or will and have potential to drive tax efficiency as examined below:

1. Splitting income among family members to generate tax-efficiency and overall family savings.
2. Freezing of estate which transfer the onus of taxes on growth and higher valuation of estate to the next generation.
3. Protecting future growth of estate from creditors.
4. Set up private foundation both to carry your philanthropy goals as well as tax-hedging.
5. Reduction of Probate Fee based on estate freeze.
6. Trusts can potentially lead to deferral of tax on capital gains and reduction of tax on the terminal tax statement.
7. Materialize capital gains while still deferring capital gains tax.

Emerging Star Investment Group

Contact Details

295 Hagey Blvd,
Waterloo, ON,
Canada

T: 519-242-3384
E: ceo@emergingstar.ca
www.emergingstar.com