Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Tax planning basics

This article provides an overview of the Canadian tax system and how basic types of investment income are taxed for an individual. In developing a broader understanding of the Canadian tax system, you may be in a better position to invest tax-efficiently, which may help you keep more of your investment income and achieve your financial goals.

For the purposes of this article, it's assumed you're a tax resident of Canada. Please note that any reference to a spouse in this article also includes a common-law partner.

Canadian income tax system

Canada taxes its tax residents on their worldwide income. In most cases, this means you must report all 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.

Generally, if you establish residential ties with Canada during the year, you're considered 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 don't report all 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're 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.

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 the various types of income you've earned during the year (e.g. salary, interest, taxable Canadian dividends, taxable capital gains, etc.) and subtracting any deductions to which you're entitled (e.g. registered retirement savings plan (RRSP) contributions, eligible investment management fees, deductible interest expense, etc.). 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. 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. Please note that residents of Quebec file separate personal federal and provincial tax returns. You calculate your taxable income on the Quebec provincial return using Quebec tax rules.

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.

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. These accounts don't 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 securities. These may include investments such as bonds, stocks or mutual funds. 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'll pay on interest. The less tax you pay, the more of the investment 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.

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 and doesn't benefit from tax-preferred treatment.

For more information on the taxation of interest income, please ask your RBC advisor for 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 will automatically use any dividends payable to you to purchase additional shares of the same company on your behalf. Regardless of whether you receive the dividends or 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 offsetting dividend tax credits are deducted from your federal and provincial/territorial taxes payable.

Canadian corporations may designate a dividend as 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 are typically eligible dividends. Canadian-controlled private corporations (CCPCs) can pay both eligible and non-eligible dividends. In simple terms, a CCPC is a Canadian corporation that isn't controlled by a non-resident of Canada or a public corporation or a combination of both. In addition, no class of shares of a CCPC can be listed on a prescribed stock exchange. 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 a dividend gross-up. If you earn eligible dividends, you can claim a dividend tax credit. A provincial/territorial dividend tax credit is also available, which differs for each province or territory. 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 smaller. As with eligible dividends, you're eligible for an additional provincial/territorial dividend tax credit.

Some strategies involving dividend income

- If you only earn eligible dividend income, you may be able to receive an amount of eligible dividends tax-free depending on your province or territory of residence.

Canadian corporations may designate a dividend as an eligible or a non-eligible dividend. An eligible dividend will generally be subject to less tax than a non-eligible dividend.

  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.

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 factor varies by province/territory. Assuming the factor works out to 1.35 in your province/territory of residence, this means that an interest rate would have to be approximately 35% higher than a dividend yield, for after-tax returns to be similar, assuming all other investment factors are equal. Expressed as a formula, we get:

Dividend yield x Factor = Interest rate

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 consider your investment options in the light of your personal risk tolerance and time horizon.

Foreign income

Foreign income is fully taxable as income. If you receive a dividend from a foreign company, that dividend is taxed in the same way 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 payable.

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 , limited partnerships , and exchange traded funds .

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 may 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, which is taxable to you 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 capital gains because you're getting back more than you originally invested.

Capital gains and losses

You'll realize a capital gain when you sell a capital asset and the proceeds exceed the ACB 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).

If the amount of capital gains you realize is greater than the amount of capital losses you realize in a particular year, a portion of the net capital gains will be taxable to you for that year. Currently, the capital gains you realize will have an inclusion rate of 50%. In other words, 50% of the capital gains you realize are taxable to you as income.

You'll realize a capital loss when you sell a capital asset and the proceeds are less than the ACB of the asset. Your capital loss could become larger if you incurred fees to sell the asset. 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 the amount of capital losses you realized in the year is greater than the amount of capital gains you realized, 50% of the excess will become your net capital losses. You can use your net capital losses to reduce any taxable capital gains you realized in any of the three previous calendar years or carry them forward to future years to reduce any taxable capital gains you may realize in the future.

Investing in a registered account

Registered plans are plans set up for specific purposes. They offer tax incentives to entice you to save or invest and are generally subject to special tax rules and limits on the types of investments that can be purchased within the plan.

If the amount of capital gains you realize is greater than the amount of capital losses you realize in a particular year, a portion of the net capital gains will be taxable to you for that year.

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 an in-kind contribution of a security from your non-registered account to your registered account. When the investment is transferred from the non-registered account, you're considered to have disposed of it for tax purposes and you'll realize any capital gain or loss that has accrued. Capital gains are taxed as described earlier in the article. Capital losses that arise from a contribution from your non-registered to your registered account generally cannot be claimed and are permanently lost. For this reason, if you want to transfer property with an accrued loss to a registered account, you may want to consider selling the security, realizing the capital loss, and contributing cash to the registered plan. To ensure you can claim the capital loss, you may also want to consider waiting at least 30 days before repurchasing the security.

Registered retirement savings plan (RRSP)

An RRSP is a savings vehicle that benefits from tax incentives to encourage you 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 from the prior tax year, 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 to future years. You can deduct your RRSP contributions that are within your deduction 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 to you as income.

You can contribute to your own RRSP until the end of the year you turn age 71. If you're over age 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 at least the annual minimum income payments. The annual income payments are taxable to you as income.
- Use the RRSP funds to purchase an annuity. The annuity payments are taxable to you as income.
- 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.

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 an RESP are not deductible for tax purposes and are limited to a lifetime maximum of $50,000 per beneficiary. Income and grants earned in an RESP are not taxable until the funds are withdrawn. You may be able to benefit from income splitting, as qualifying withdrawals from an 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 provide 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.

Contributions to an RESP are not deductible for tax purposes and are limited to a lifetime maximum of $50,000 per beneficiary. Income and grants earned in an RESP are not taxable until the funds are withdrawn.

- Speak to a qualified tax advisor to determine the optimal amount of contributions to make to maximize government grants and tax-deferral.
- If the beneficiary is enrolled in a qualifying program, consider having the beneficiary withdraw income and government grants from the RESP before withdrawing original contributions from the plan. This will allow the income and grants 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. If you're not the plan holder, you'll need the plan holder's permission to contribute to an existing RDSP. Contributions are 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 your qualified tax advisor to minimize assistance repayments if possible.

Income, grants and bonds earned in the RDSP are not taxable until the funds are withdrawn. 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 to maximize government grants and tax-deferral.
- If the RDSP beneficiary is entitled to provincial/territorial disability support, determine if RDSP payments affect the beneficiary's eligibility for support under the program. In most cases, RDSP payments don't affect provincial/territorial disability support, so an RDSP can be a good way to save, and income split with the beneficiary.

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. This means a TFSA can be used to meet a wide range of goals such as creating emergency savings, saving the purchase of a home, 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 at the beginning of the following calendar year.

The following are some tax planning strategies involving TFSAs:

- TFSA withdrawals will not impact any income-tested government benefits you may receive, such as old age security . 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'll continue to earn TFSA contribution room throughout your life, regardless of your age.
- 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.

Tax-free first home savings account (FHSA)

The FHSA is a registered account to help qualifying individuals save up to a lifetime contribution limit of $40,000 on a tax-free basis to purchase their first home. Contributions you make to an FHSA are tax-deductible and subject to an annual limit of $8,000. Qualifying withdrawals (including contributions and income earned in the FHSA) used to fund building or buying a qualifying home will not be taxable.

The following are some tax planning strategies involving FHSAs:

- You're allowed to carry forward your unused annual contribution limit up to a maximum of $8,000 and contribute the unused amount on top of your annual contribution limit in the following year. Carryforward amounts only start accumulating after you open an FHSA for the first time.
- You can make both a qualifying withdrawal from an FHSA and your RRSP under the home buyers' plan to build or purchase a qualifying home.
- If you don't end up buying a home, you can direct the funds towards your retirement by transferring any unwithdrawn savings on a tax-deferred basis to your RRSP or RRIF.

Summary

The Canadian tax system is very complex. Various types of income are taxed in different ways and several 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 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 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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