RBC Wealth Management
Dominion Securities

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This September stock markets made back some of what they lost in August and ended the quarter with modest gains. Even the bond markets eked out small gains at least in September. However it is easy to be superstitious about crash prone October (although historically September has been the worst month for the stock markets).

As I write this on October 5th, the US government is closed and for how long is unclear. I could imagine the budget showdown continuing perhaps just past the statutory debt limit which will be reached between October 17th and month end. But it is unimaginable that the government could stay closed for long. The situation is the opposite of what President Roosevelt faced in 1934; all we have to fear is that there is not yet enough fear. On the first day of the shutdown the big news seemed to be that the Washington Zoo's baby pandacam was turned off because the zoo staff were deemed to be non-essential government workers. If the shutdown continues much longer, things are going to get serious for the US economy and for the world. A default would potentially be catastrophic. There always seems to be something for me to worry about. History never ends, the world keeps turning. One thing that is a little more certain is taxes.

Enclosed with this letter is your quarterly portfolio valuation which consolidates all of your accounts into one overall snapshot of your investments. You receive directly from head office accounts statements which itemize, on an account by account basis, all of the activity in the accounts, such as dividends and transactions. As your Portfolio Manager I am concerned with the specifics but also with your overall investment picture and the taxes you will have to pay. The tax regime helps us decide where we want to own what type of asset. In this letter I've taken the perspective of a Canadian taxpayer who has different types of accounts. Similar but different thinking needs to be applied for other jurisdictions and every situation is unique. For all cases you should consult with a tax professional.

For example, for a resident of Canada, we strongly prefer to own Canadian dividend paying stocks in a taxable account. Otherwise, the Canadian dividend tax credit is wasted and that tax credit can make a substantial difference. The calculation, involving a dividend 'gross up' and 'tax credit', is complicated. But one way to think about the value of a Canadian dividend in a taxable account is in terms of its 'interest equivalent'. In other words, a taxpayer in a top tax bracket in Quebec would have to earn 1.295 more in interest to match Canadian dividend income (1.323 in Alberta). Or, $1,000 in dividend income is equivalent to $1,295 in interest income after tax. The dividend tax credit adds to the appeal of preferred shares in a taxable account but you will not find them in an RSP (Registered Savings Plan) or a TFSA (Tax Free Savings Account).

We also favour capital gains in a taxable account because for Canadians only half of a capital gain is taxable. Moreover, in a taxable account, capital losses may be applied against capital gains. In a registered account, capital losses are lost. A great tax shelter is an unrealized capital gain. It is like an interest fee loan from the government. Holding stocks in a taxable account for the long term allows for tax deferred compounding. Capital gains earned in a registered account, like an RSP or TFSA, would not get that favourable tax treatment. Indeed, eventually the RSP would be converted into a RIF and the required annual RIF (Retirement Income Fund) withdrawals would be taxed as ordinary income, like employment income or interest income. Wealthy people should think twice before adding to their RSP if they're prepared to invest for capital gains. There is of course no tax on withdrawals from a TFSA.

Interest income is fully taxed which is why we like to shelter it in a registered account like an RSP or a TFSA. Although even in a taxable account we like to have some reserves, usually in cash or interest bearing securities.

Dividends from US corporations are not eligible for the Canadian dividend tax credit and are taxed like interest income and employment income. We quite like to protect dividends from blue chip US companies in an RSP. Some US corporations like Berkshire Hathaway pay no dividends at all and are owned because of their potential to earn capital gains. Therefore, they fit quite well in a taxable account (although Warren Buffet's company's status, as a large diversified blue chip, makes it otherwise well suited for a registered account).

In a taxable account, withholding tax is applied on dividends from US companies but Canadians receive a tax credit for that tax paid. In a RSP there is no withholding tax on dividends from a US corporation as a Canadian RSP is recognized by the IRS as a retirement account. A TFSA does not have that recognition from the IRS. In a TFSA tax is withheld on US dividends and no offsetting foreign tax credit is earned.

Dividends from foreign companies, including from American Depositary Receipts (ADRs), are subject to various levels of withholding taxes, depending on the country of origin. Swiss companies dividends for example are subject to a 30% withholding rate, which is why we don't like to own them in an RSP.

For clients with a net worth approaching $5.2 million, US estate tax is a concern. One strategy to cope with that is to own shares of US companies in an investment holding company account.

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All of the preceding was of course abstract, meant to illustrate the kinds of considerations we make when we're deciding where to put what type of investment. I used the example of a Canadian tax payer with assets within and without registered accounts. You should consult with a professional tax advisor before considering any specific tax strategies. Investment returns come and go, taxes can be planned for.

Growing up I learned to steer clear of my father around tax time as the subject of taxes made him unusually grumpy. That's why I thought I would write about the sensitive topic of taxes in October, not April. My father felt privileged and thankful to be a Canadian that paid taxes but at tax time he questioned how privileged he had to be.

Have a great Thanksgiving.

Sincerely,

George Stedman, CFA
Portfolio Manager
Please visit us at www.georgestedman.com

P.S. By the way, Margarita Martinez Elizondo and I have welcomed Isabelle Cojocaru-Durand to Team Stedman. Please call on Isabelle, Margarita or me anytime.