



Di Iorio Family Wealth of RBC Dominion Securities

Think bigger. Act bolder. Invest better.

A 5 Step Strategy to Increase Gains and Lower Your Tax Bill

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Although it may not feel like it, the COVID-19 pandemic has both accelerated some positive trends, as well as shined a light on many areas which were previously underappreciated. We have seen firsthand how vital our healthcare system is, and we believe this renewed attention, along with advancements in technology has potentially pulled-forward the modernization of care and treatment, and potentially finding cures for many of today's most elusive and difficult to treat diseases.

One potential negative narrative that has emerged, which could prove to be a lasting one, has been astronomical government spending in response to the pandemic. The jury is out on how much of this was a result of poor planning and management, but the bottom line is that the current deficits are comparable to those that we saw during World War II.

This spending will unfortunately need to be made up for in other ways, and we've had conversations with many of our clients who are wondering if the time to realize gains is now, prior to a potentially higher tax regime in the not-too-distant future. One area of particular concern with respect to investment portfolios is a potential increase to the capital gains inclusion rate, which is currently set at 50%.

While we don't believe that predicting government policy decisions is a reliable source on which to base planning decision, we do believe that sticking to a disciplined process & methodology can position your portfolios for whatever the future may hold (see our own take on this, The DM5).

Here is a 5 Step Strategy to Increase Gains and Lower Your Tax Bill:

1. Focus on Capital Gains:

We have had countless discussions over the years on the topic of dividends. A common perception is that investing for dividends is superior to other investment strategies, but in our view this simply isn't the case. We've even dedicated a previous blog post to this subject, which can be found [here](#).

Dividends are simply cash being paid out of a company to its shareholders, and there is no reason why paying this cash out is inherently superior to retaining it and reinvesting the proceeds into the business in an effort to generate future growth. In fact, we would argue that when investing in companies with strong management teams looking to grow the business, we prefer they keep the capital to do exactly that.

None of this is to say we are against dividends, and in certain businesses, or even certain entire industries, they may be the ideal way to allocate capital. But, the bottom line is that investment returns will be dictated by cash flows regardless of whether they are paid out or kept in the business.

From a tax perspective, however, there is absolutely an argument to be made for looking for investment opportunities that generate returns via capital gain vs. dividends, or interest. Under the current tax regime, the tax rates on different sources of return are as follows (based on 2020 top marginal tax rate in Quebec, but results are similar for other provinces):

Capital Gains: 26.65%

Eligible Canadian Dividends Marginal Tax Rate: 40.11%

Interest & Regular Income Marginal Tax Rate: 53.31%

In our view, this only furthers the case to be made for something we have written and spoken about often: Investing for growth, and concentrating the core of portfolios in Generational Companies (who tend to reinvest their earnings into the businesses).

2. Generate CDA room generating capital gains

If you have a holding company (many of our clients do), one of the most effective ways of getting funds out of the company and into your personal name without paying extra taxes is by using the Capital Dividend Account (CDA).

The Capital Dividend Account gets credited by paying taxes on gains within the corporation over time. As gains are realized, the CDA increases, and the balance of the CDA can be withdrawn from the company into your personal name without paying any additional taxes.

Once again, for HoldCos, capital gains are the ideal way to generate investment returns.

3. Maximize registered plans like RRSPs, IPPs, TFSAs, and pensions

This may seem very obvious, but maximizing registered accounts is probably the best way to reduce tax bills over time. We all know that contributing to an RRSP is a turbo-charged way to save taxes now by lowering your T4 income in a given year by the amount you contribute. In addition, funds deposited to an RRSP can be invested, and compound returns on a tax-deferred basis until they are eventually withdrawn.

TFSA's are also an extremely valuable tool to use to lower tax bills. While contributing to a TFSA does not directly reduce your taxes, funds within a TFSA can generate returns with no tax consequences for as long as they remain within the account. In addition, there are no taxes owed on funds withdrawn from a TFSA (contrary to an RRSP), and the withdrawn funds can be re-contributed in the following calendar year.

The IPP or Individual Pension Plan is an enhanced version of an RRSP for business owners. IPPs require a certain amount of planning and setup, but in brief, result in advantages including: higher contribution limits, allowing companies to contribute funds directly to the plans on a pre-tax basis, and allowing for additional family members involved in the business to be added to the plans over time.

Last but not least, contributing to pension plans from your employer is also generally very advantageous. Not only does this allow for pre-tax earnings to be saved and compound returns over time, but the matching contributions offered by many plans result in a significant source of "free return", such that we nearly always recommend taking the necessary steps to receive the maximum matching contributions.

4. Evaluate the potential for long-term passive investment exposure

This is one option which may have its place in certain circumstances. Investing in a passive investment vehicle (example: an ETF which replicates the S&P 500) may potentially be a way to invest taxable capital that will not be needed for many years (or ever), that allows for compounded growth with no tax consequences. This is because buying and holding an ETF, and theoretically never selling it, means gains are not triggered – and thus taxes are not owed. Over time, it could have a similar profile to an RRSP, long-term capital appreciation on a tax-deferred basis, with taxes only eventually being owed when "withdrawals" (or in this case sales) of the funds are necessary.

While this type of approach will guarantee that you perform in-line with the market over time (minus whatever costs are associated with the strategy – generally low for ETFs), it removes all potential for added value via "active" management. While many proponents of "passive" investing will tout the statistics that over time the large majority of managers will not outperform the market, we have also been living through a golden age for passive investing (strong markets, low volatility). We have, and continue, to make the case that active management will offer much more potential for added value during periods of increased volatility – the best recent example of this being 2020.

Our opinion is that integrating a passive portion to an investment strategy can make sense within certain circumstances, and we also acknowledge that it may become even more compelling depending on future taxation regime changes. As always, we will adjust if and when necessary.

5. A final option: Life insurance

Life insurance should always be something that is looked at in the context of an overall Financial Planning framework. However, it is a tool that has the potential to significantly lower tax bills. There are several different ways of achieving this, including:

- Using insurance to offset future estate taxes
- Investing in insurance as an additional taxexempt source of savings
- Corporately owned insurance as a mechanism to flow money taxfree to heirs

This is a strategy which requires additional planning, so we always recommend our clients work closely with both us and an insurance specialist to examine the potential benefits.

While we are firm believers that, over time, making merit-based investment decisions will outperform making taxation-based investment decisions. We have learned from experience that attempting to maximize return should take precedence over minimizing taxes, but these two options do not need to be mutually exclusive. We believe using the framework & recommendations outlined in this post can help to achieve both of these outcomes.

We strive to make everyone around us into better investors. If you would like to learn more about our investment style, or if you have any other questions, please feel free to contact us at any time by email, by phone, or by direct message.

Sincerely,
Di Iorio Family Wealth

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