Tax Tips for You & Your Family

Knowing how the tax rules affect your investments is essential to maximizing your after-tax return. Keeping up-to-date with changes to the tax rules is also important to understanding new opportunities that could affect the way you structure your financial affairs.

As we enter the New Year, the following are some ideas that you may want to incorporate into your family's wealth management strategy. This is a summary of BMO Nesbitt Burns' 2012 edition of Tax Tips for Investors, a 12 page document that outlines tax tips that may be relevant to you and your family's finances. To obtain a copy, please contact an Investment Advisor.

Reduce Tax with Income Splitting

Under our tax system, the more you earn, the more you pay in income taxes on incremental dollars earned. With this in mind, it makes sense to spread income among family members who are taxed at lower marginal rates in order to lower your family's overall tax burden, subject to the income attribution rules. Some of the more common income-splitting strategies you may want to discuss with your tax advisor include:

- An interest-bearing loan at the prescribed interest rates to family members in a lower tax bracket. This strategy is particularly attractive because rates are currently at historically low levels.
- Pension income splitting between spouses (or common law partners).
- Gifts to adult children or other adult family members.
- Gifts to a minor child – directly or through a trust structure – to acquire investments that generate only capital gains.

Make Your Portfolio Tax Efficient

In evaluating investments for your portfolio, you should consider the impact of income taxes, since not all investment income is taxed in the same manner.

Despite the wide range of investments available, there are three basic types of investment income: interest, capital gains and dividends. Interest income is fully taxed at your marginal tax rate whereas you only pay tax on 50 per cent of a capital gain. Canadian dividends also receive special tax treatment through federal and provincial dividend gross-up and tax credit mechanisms. A new dividend tax regime exists for dividends paid by a Canadian corporation to a Canadian individual investor after 2005 which results in lower effective tax rates for these "eligible" dividends.

Maximize Your Tax Deferred Savings with an RRSP or TFSA

Your RRSP is likely one of the most important elements in your overall retirement strategy. Allowable contributions to your RRSP are tax deductible and the income earned in an RRSP is not taxed until it is withdrawn, which means that your savings will grow faster than they would if held outside an RRSP.

Some ideas to optimize use of your RRSP include maximizing your annual contribution limit, contributing securities "in-kind" to your RRSP, deferring the maturity of your RRSP until age 71 and contributing to a spousal RRSP if you and your spouse/partner will have disproportionate retirement income levels.

The Tax-Free Savings Account (TFSA), introduced in 2009, is a general purpose tax-efficient savings vehicle that allows individuals 18 years of age or older to contribute up to $5,000 annually to a registered account where income and withdrawals are tax-free.

A TFSA is beneficial for many investors and for many different reasons, including saving for short-term purchases such as an automobile or saving longer-term for retirement. TFSAs can also be an effective income-splitting tool. A higher-income spouse can give funds to the lower-income spouse or an adult child so that they can contribute to their own TFSA (subject to their personal TFSA contribution limits). As well, the attribution rules will not apply to income earned within the spouse's (or adult child's) TFSA.

Because of its flexibility, a TFSA complements other existing registered savings plans for retirement and education. As a result, the TFSA is quickly becoming an important investment vehicle for many Canadians.

Use an RESP to Save for Children's Education Needs

The increasing cost of post-secondary education is causing many parents to be concerned about funding. The benefits of Canada Education Savings Grants (CESGs), combined with other recent enhancements to Registered Education Savings Plans (RESPs), make RESPs a very attractive vehicle to fund your children's or grandchildren's education. Contributions to an RESP are not tax deductible. However, the income from investments in an RESP is tax sheltered as long as it remains in the plan. Withdrawals to pay education expenses from accumulated income and the CESG will be taxable in the beneficiary's hands at his/her marginal tax rate.

Use an RDSP to Save for the Financial Needs of a Disabled Child

The Registered Disability Savings Plan (RSDP) is a registered savings plan intended to help parents and others save for the long-term financial security of persons with severe or prolonged disabilities who are eligible for the Disability Tax Credit. Contributions up to a lifetime maximum of $200,000 per beneficiary can be made to an RDSP until the end of the year in which the disabled beneficiary turns 59, with no annual limit. Contributions are not tax deductible; however, any investment earnings that accrue within the plan grow on a tax-deferred basis.

In addition, Canada Disability Savings Bonds (CDSB) and Canada Disability Savings Grants (CDSG), up to annual and lifetime limits, can be received in an RDSP from the federal government depending on family income.

Donate Appreciated Securities

The benefits of making a charitable donation are countless – from helping those in need to the personal satisfaction we feel when giving something back to a cause we feel passionate about. With proper planning, you can also reduce your income tax liability and maximize the value of your donation.

A donation of qualifying publicly-traded securities may be preferred over a cash donation of equal value, particularly in cases where you have already decided to dispose of the securities during the year. The fair market value of securities donated to charity will reduce your taxes through a charitable donation tax credit. On donations over $200 this can result in a tax savings of approximately 46 per cent of the value of the donation (depending on your province of residence). A donation of securities is considered a disposition for tax purposes. However, because of the tax incentives, on a donation of appreciated qualified securities to charity the capital gain inclusion rate is nil instead of the normal 50 per cent that would otherwise apply.

Use Borrowed Funds to Invest

Generally, interest expenses are deductible for tax purposes if the funds are borrowed for the purpose of earning income from a business or an investment vehicle. Therefore, consider paying down non-deductible personal debts (such as RRSP loans, mortgages on home purchases and credit card balances) before paying down deductible investment-related debt and speak with your tax advisor about structuring your borrowing to achieve tax deductibility.

Reduce Tax for Your Estate

Your estate plan can accommodate a number of tax-saving strategies to reduce or defer the amount of tax payable by your estate and maximize the amount available to your heirs. Some of the most common planning strategies include using a trust created in your Will to split investment income, naming a beneficiary for your RRSP/RRIF or TFSA, making charitable bequests in your Will and bequesting appreciated assets to your spouse (or a qualifying spousal trust) to defer tax on the accrued capital gains.

John Waters, CA and Linda Leung, CPA are responsible for providing BMO Nesbitt Burns Investment Advisors and their clients with Canadian and U.S. tax planning support. They also produce client facing articles and publications on a variety of tax planning topics.

01/12-013

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