Tax Tips for Investors

Knowing how tax rules affect your investments is essential to maximizing your after-tax return. In addition, keeping up to date on changes to the tax rules ensures that you take advantage of all the tax savings available to Canadian-resident individuals. This article provides an overview of select strategies to assist you in reducing your tax bill. Please note that this article should not be construed as tax advice and individuals should consult with a tax advisor regarding their personal situation.

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[1]:

- An interest-bearing loan at the prescribed interest rate to family members in a lower tax bracket. This strategy is particularly attractive now because of the current low prescribed interest rates;
- Pension income-splitting between spouses (or common law partners);
- Gifts to adult children or other adult family members (other than a spouse or common-law partner); and
- 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 taxable 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 the federal and provincial dividend gross-up and tax credit mechanisms.

Maximize your tax deferred savings with an RRSP or TFSA

Your Registered Retirement Savings Plan ("RRSP") is likely the cornerstone of 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 Allowable contributions to your RRSP are tax deductible and the income earned in an RRSP is not taxed until it is withdrawn. This means that your savings will grow faster in an RRSP than they would if held outside an RRSP. Some ideas to optimize your RRSP savings include maximizing your annual contribution limit, contributing securities "in-kind," 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 annually (up to $6,000 in 2020) to this registered account, where both income earned within the plan 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 a child's education or 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), since 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 has quickly become 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 their child's education. The benefits of the Canada Education Savings Grant ("CESG"), combined with the advantages of an Registered Education Savings Plans ("RESP"), 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 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. A charitable tax receipt equal to the fair market value of securities donated to charity will reduce your taxes through a donation tax credit. Because of changes to the calculation of the federal donation tax credit, donations over $200 made after 2015 from income subject to the 33% top federal marginal rate can result in tax savings of approximating 50 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 qualifying, appreciated publicly-traded 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. For more information, ask your BMO financial professional for a copy of our publication, *Leveraged Investment Strategies and Interest Deductibility*, and speak with your tax advisor about structuring your borrowing to achieve tax deductibility.

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Reduce tax for your estate

Your estate plan can accommodate a number of tax saving strategies which may help to reduce or defer the amount of tax payable by your estate and help maximize the amount available to your heirs. Some of the most common planning strategies include establishing a trust in your Will to split investment income with low income beneficiaries, naming an appropriate beneficiary for your RRSP/RRIF or TFSA, making charitable bequests in your Will, and bequesting appreciated assets to your spouse/common-law partner (or a qualifying spousal trust) with a view to deferring tax on the accrued capital gains.[2]

Consider U.S. estate tax implications if you own U.S. investments

U.S. estate tax can apply to Canadian residents on the value of U.S. assets owned at death, even if they are not U.S. citizens or Green Card holders. A Canadian may have a U.S. estate tax liability if the value of their U.S. assets exceed US$60,000. For 2020, the threshold level of worldwide estate assets held at death at which Canadians are exposed to U.S. estate tax is approximately US$11,580,000. The U.S. estate tax rates range from 18% to 40%.

Although any potential U.S. estate tax liability may be reduced or offset by credits and deductions available under Canadian and U.S. tax law, and the Canada-U.S. Tax Convention (the "Treaty"), a U.S. estate tax return may still need to be filed even if there is no ultimate U.S. estate tax liability. Failure to file a U.S. estate tax return can result in a denial of treaty benefits and credits. In addition, an estate, beneficiary or surviving joint owner may not be able to sell U.S. real property without proof that a U.S. estate tax return has been filed and the tax owing, if any, has been paid.

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Consult with your tax advisor to confirm the specific tax implications in your particular situation, and for assistance in developing and implementing any tax strategies.

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[1] On a related note, be aware that new tax legislation was recently enacted that seeks to limit income-splitting with certain adult family members involving private companies effective for the 2018 and subsequent taxation years. For more information, please ask your BMO Financial Professional for a copy of our publication, Tax Changes Affecting Private Corporations: Tax on Split Income (TOSI).

[2] Quebec does not allow the ability to name a direct beneficiary for an RRSP, RRIF or TFSA in the contract itself, instead a beneficiary can only be appointed in a Will.

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