Four pillars of investment tax planning

Fully informing the tax strategy for your portfolio

You have harnessed your spending to set aside savings, and researched the investments you deem worthy of your hard-earned dollars. And now as you admire your accumulating wealth, a dark cloud lies ahead – *income tax*.

Yes, earning investment income and paying tax on it can sometimes feel like you're taking two steps forward, one step back. But taking a positive view, it's better to earn income and pay tax on it, than not to earn at all. Still, you don't have to leave yourself open to the full force of taxes.

Guided by a few simple principles, you can position your investments to optimally navigate toward your future spendable wealth.

DEFER – Making sense (cents?) of the time value of money

First, the later you pay tax, the longer that more of your money works for you. Second, given that inflation erodes the value of money over time, in effect it costs you less to use future dollars to pay tax than to use today's more valuable dollars.

An example in a non-registered account is that you don't pay tax while the market price of your holdings rises. This price increase is what we know as an unrealized capital gain, and you don't pay tax on that movement until you sell, which could be years into the future. That's when your gain is said to be realized – and even then you don't pay tax on the entire holding, but instead the tax is limited to the proportion that you sell. (And for more, see below how such gains are treated in a PREFERred way.)

Or with a registered retirement savings plan (RRSP), you get a current tax deduction when contributing, understanding you'll be taxed on the withdrawal – which you expect will be years or possibly decades ahead.

SHELTER – Keep your umbrella up, to keep tax erosion down

Beyond the initial deposit, an RRSP is also an ongoing tax shelter in that there is no tax on the income earned while inside the plan. However, the sheltering effect ends when money is withdrawn, at which time it is fully taxable.

Comparatively, a tax-free savings account (TFSA) is funded out of your after-tax money, which is another way of saying that you don't get a tax deduction for contributions to a TFSA. Still, just like RRSPs, all income and growth is tax-sheltered while inside, such that gross returns are reinvested. Then on eventual withdrawal, unlike RRSPs at this final stage before spending, there no tax on what is taken out of TFSAs, no matter how large such withdrawals.

PREFER – It's not just how much, but sometimes also 'what' you earn

Certain types of income are taxed more favourably than others. As a baseline, your original employment income will have been fully taxable, as are amounts that you take out of your RRSP.

In a personal non-registered account, interest and foreign stock dividends are also both fully taxable as earned annually, but:

- Half of capital gains are taxable [*Per Federal Budget 2024 (passage of enacting legislation pending), the 1/2 rate will apply to the first $250,000 of annual gains, after which 2/3 inclusion will apply.*], and
- Dividends from a Canadian corporation are taxed in a way that takes into consideration the income tax that has already been collected from the corporation. In a very real sense, you're not paying the full tax bill yourself, but simply topping-up the tax revenue the government is seeking. This is enjoyed by all of us, and can mean an especially low tax rate on Canadian dividends for those in low to mid tax brackets.

SPLITTER –
Whose income is it?

Up to now, we've looked at the what and where of the income; 'income splitting' shifts the focus to who is earning it. Because we have a progressive tax system – imposing higher tax rates as your annual income rises – the household tax bill may be reduced if income is split with someone at a lower bracket.

That could be as simple as contributing to RRSPs during your high-income working years, on the expectation that the money will be drawn out at a lower bracket later.

- Thus, just by making familiar use of RRSPs, present-you is income splitting with future-you.
- Alternatively, you could contribute to a spousal RRSP, with you taking the tax break on the contribution now, expecting that your spouse will withdraw at an even lower rate later than you could withdraw if it went to your own RRSP.
- Another complementary spousal strategy is to proceed with contributing to your own RRSP, knowing that you can income split with your spouse using the pension income splitting rules in your later years. This allows up to 50% of your eligible pension income to be taxed to your spouse annually. Generally, this is limited to registered pension plan payments when you're under 65, but applies to all registered annuities and registered retirement income fund (RRIF) withdrawals once you hit 65.

With non-registered investments, spousal income splitting is not as straightforward, but still possible with informed planning and conscientious recordkeeping.

As you can see, there is a fair amount of overlap among these concepts. Even so, it's important to clearly understand the distinctions among them, as sometimes trying to achieve one requires a concession with another. An effective advisor will help you evaluate the tradeoffs so that you can make good choices.

For more information, please consult your advisor and tax professional.