Wealth Management

RBC Wealth Management Services

Tax planning basics

This article provides an overview of the Canadian tax system, basic investments and how the two interact. By investing tax-efficiently, you may be able to keep more of your investment income and achieve your financial goals more quickly.

This article outlines several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax advisor before acting on any of the information in this article.

Please contact us for more information about the topics discussed in this article.

Canadian income tax system

For the purposes of this article, we assume you are a tax resident of Canada.

Canada taxes its tax residents on their worldwide income. In the majority of cases, this means that you must report all your taxable income for Canadian tax purposes, regardless of where in the world you earned that income. Tax residency is based on the relevant facts and circumstances which include the residential ties you have in Canada, any ties you have abroad and the amount of time spent in Canada. Canadian citizenship is generally irrelevant in determining your obligation to pay Canadian tax.

If you move to Canada during the year, you are considered to be a part-time resident and are only taxed on your worldwide income from the time you become a resident of Canada.

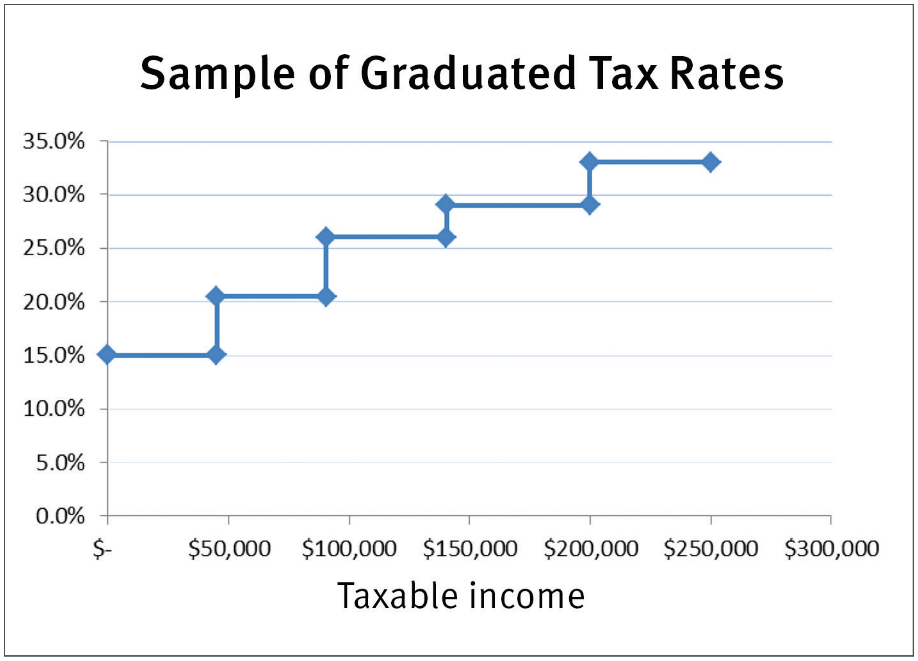
Generally, a non-resident of Canada is not subject to Canadian taxation unless they earn Canadian source income. In most cases, you are subject to non-resident withholding tax on your Canadian source income and you do not have to file a tax return. However, there may be cases where you must file a tax return, for example, if you earn employment income in Canada or realize capital gains from the sale of Canadian real estate.

The Canadian tax system is an honour-based system that requires you to declare your income to the Canada Revenue Agency (CRA), whether an information slip was issued to you or not. You may be issued an information or tax slip on various types of income you may earn, for example, employment income and interest income. Common types of income you may earn where you may not receive a tax slip include capital gains realized on the sale of real estate and foreign currency conversions. If you do not report your taxable income for Canadian tax purposes, you can be subject to interest and penalties.

Canada taxes its tax residents on their worldwide income. In the majority of cases, this means that you must report all your taxable income for Canadian tax purposes, regardless of where in the world you earned that income.

The federal government has the right to tax income earned in Canada. You may also be subject to provincial tax for the year if you are a resident of that province on December 31st of that year or in some cases, earn income in that province. The Canadian personal income tax system is based on graduated tax rates at both federal and provincial levels. This means that increasing tax rates apply to increasing levels of taxable income. The tax rates stay steady over a range of incomes and then increase and remain static over another range. These ranges are commonly referred to as tax brackets.

The following shows the federal tax rates and tax brackets:



Source: Federal tax legislation, 2016.

Average vs marginal tax rates

Your average tax rate (also referred to as your "effective" tax rate) is calculated as the total tax payable divided by your taxable income. Your marginal tax rate is generally the percentage of tax payable on the final dollar of your taxable income. There is a difference between the two rates because, as mentioned above, Canada has a system of progressive tax rates. Your average tax rate is always equal to or less than your marginal tax rate.

Your average tax rate can be used to estimate how much tax you will pay on a similar amount of income in a future tax year, while the marginal tax rate can help you evaluate the after-tax return of an investment of new funds.

Calculating your tax liability

To estimate how much tax you will have to pay, you must first calculate your taxable income for the year. You do this by adding up all your various types of income (i.e. salary, interest, grossed-up Canadian dividends, taxable capital gains etc.) and subtracting any deductions to which you are entitled, for example, registered retirement savings plan (RRSP) contributions, investment management fees and deductible interest expense. Your total income less your deductions represents your taxable income.

You calculate your total federal taxes by multiplying your taxable income by the appropriate federal tax rates.

Your marginal tax rate is generally the percentage of tax payable on the final dollar of your taxable income.

You then subtract the various tax credits from the federal tax you have calculated to arrive at a net federal tax amount. Examples of tax credits to which you may be entitled include: the basic personal tax credit, charitable donation tax credit, dividend tax credit and foreign tax credit.

You then follow the same process, starting with your federal taxable income, to calculate your provincial taxes using the applicable provincial tax rates and tax credits. You complete this calculation on one harmonized federal and provincial tax return administered by the CRA. Residents of Quebec file separate federal and provincial tax returns. You calculate your taxable income on the Quebec provincial return using Quebec tax rules unlike the other provinces.

You combine your net federal tax and provincial taxes to determine your total tax payable. You then subtract any prepaid tax, such as tax withheld at source and tax instalments that you paid during the year, from the total tax payable to determine if you will receive a refund or if you have a balance owing.

Investment income earned in non-registered accounts

A non-registered account is a type of account that is not registered with the CRA. The Income Tax Act (the Act) does not impose restrictions on this type of account and as a result, these accounts do not benefit from tax-deferred or tax-free treatment like RRSPs or Tax-Free Savings Accounts (TFSAs).

Inside a non-registered account, you can invest in many different types of products. These may include: bonds, stocks or mutual funds (which are pools of investments that have a manager(s) guiding the investment choices). The income you earn in a non-registered account is taxable according to the type of income generated. In contrast, a registered account is a type of account that must meet certain conditions set out in the Act and must be registered with the CRA. These types of accounts typically benefit from special tax treatment, for example, income earned in a TFSA may be exempt from tax. Common types of registered accounts are discussed later in the article.

It is important to recognize that different types of investment income are taxed in different ways in a non-registered account. For example, you will usually pay less tax on capital gains and Canadian dividends than you will on interest. The less tax you pay, the more of the investment's return you keep. In general, the tax on dividends and capital gains is lower but the investments that generate this type of income can carry more risk. Although it is a good idea to consider the after-tax return when making investment choices, don't forget to consider the amount of investable assets you own, your cash flow, the risk associated with the particular investment, the opportunity for capital appreciation, the liquidity of the investment and your personal investment objectives.

Interest income

Interest is an amount that a borrower pays a lender in return for the use of their money for a set period of time. There are a number of investment products available for purchase whereby you act as a lender and the seller of the investment pays you interest and repays the original principal of the investment to you after a set period of time. The interest you receive is fully taxable as income at your marginal tax bracket and does not benefit from tax-preferred treatment.

Interest can be paid at varying frequencies depending on the investment. Payments frequently occur monthly, semi-annually, annually or at maturity. Investments of many years duration that only pay interest at maturity are called

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compound investments. Some common examples of compound investments are Canada Savings Bonds, strip or discount bonds, compound bonds or GIC's. Generally, when an individual receives interest from an investment during the year, or the investment matures during the year, they report the interest on their tax return for that year. You need to report annual accrued interest on investments that pay at maturity in a future year.

The interest you must report in a year, regardless of whether it is actually paid to you in the year or at maturity, is the interest that has accrued up to the anniversary date of the investment that falls within the year.

Example interest reportable for a year:

Assume that Jane purchased a $1,000 bond on its issue date of April 1, Year 1, bearing interest at 4% payable annually on April 1 until maturity. No interest is reported on Jane's Year 1 tax return since her tax year ends on December 31st of Year 1 which has not reached the anniversary date of the bond yet. On April 1, Year 2, Jane reaches the first anniversary date of the bond and she must report $40 of interest on her Year 2 tax return.

In the year that a compound-interest-paying investment matures, you must report the amount of interest you receive less the amount of interest you declared in prior taxation years. This ensures that you are only paying tax on the interest income once. If you sell this investment prior to maturity or you purchase it at a premium or a discount, you may have to recognize a capital gain or loss in addition to the interest income.

If you are investing in compound investments in your non-registered account, or thinking about doing so, be sure to consider the fact that you are required to declare "accrued" interest on your tax return that you did not actually receive during the year. This may have an effect on your cash flow. For this reason, consider investing in compound investments in your registered accounts.

Dividend income from Canadian corporations

Dividends are payments that a corporation makes to its shareholders, usually as a way of distributing profits to those who invested in the company. Companies may have Dividend Reinvestment Programs (DRIPs) that allow you to automatically have any dividends payable to you, reinvested in shares of the same company. Regardless of whether you receive the dividends or you reinvest the dividends, they are taxable to you.

Canadian corporations can designate a dividend as either an eligible or a non-eligible dividend. The ability to make such a designation depends mostly on a corporation's status. Since 2006, dividends paid by Canadian public corporations (companies that trade on a stock exchange) are typically classified as eligible dividends.

Canadian Controlled Private Corporations (CCPC) can pay both eligible and non-eligible dividends. Generally, the first $500,000 of active business income earned by a CCPC, may be taxed at lower rates when the corporation's income is eligible for the Small Business Deduction (SBD). The $500,000 is the federal SBD limit (the provincial limit varies by province).When a corporation pays dividends from income that has been taxed at the low SBD rates, the dividends are designated as non-eligible. If a CCPC has active business income that exceeds the SBD limit, it pays tax on that income at the higher general corporate tax rate. Dividends paid from this pool of income are designated as eligible dividends. A

Dividends are payments that a corporation makes to its shareholders, usually as a way of distributing profits to those who invested in the company.

CCPC may also pay shareholders the eligible dividends it receives from other corporations. Dividends paid from other types of investment income earned by the CCPC, such as interest, taxable capital gains and non-eligible dividends need to be designated as non-eligible dividends.

Eligible dividends

Eligible dividends are subject to an enhanced dividend “gross-up”. Individuals who earn eligible dividends can claim a federal dividend tax credit against the grossed-up dividends. A provincial dividend tax credit is also available, which differs for each province. The federal gross-up for eligible dividends is 38% and the federal dividend tax credit is 15.02% of the grossed-up dividend. In effect, the tax you pay on eligible dividends is lower than the tax you pay on interest income. The tax credit is applied in recognition of the fact that the Canadian corporation has already paid tax on its earnings, which are now being distributed to its investors.

Non-eligible dividends

Non-eligible dividends are subject to a dividend “gross-up” that is smaller than that applied to eligible dividends. The dividend tax credit for non-eligible dividends is also generally smaller. As with eligible dividends, you are eligible for an additional provincial dividend tax credit. The federal “gross-up” for non-eligible dividends is 17%. The federal dividend tax credit is 10.52% of the grossed-up dividend.

Some strategies involving dividend income

- If you only earn eligible dividend income, you may be able to receive over $50,000 tax-free depending on your province of residence. This is because under certain circumstances, the dividend tax credit and the basic personal amount (and other tax credits to which you may be entitled) reduce the taxes on dividends to zero.
- In general, consider receiving Canadian dividends outside your RRSP or other tax-deferred vehicles to take advantage of the dividend tax credit.
- Examine the mix of assets in your portfolio to consider taking advantage of the lower effective tax rates that apply to eligible Canadian dividend income and capital gains.

The dividend interest relationship

When you are evaluating your investment choices, one of the things to consider is the after-tax returns on the various types of investments. You can calculate a factor to help you compare the after-tax returns on interest and Canadian eligible dividend-paying investments using the following formula:

$$\frac{\text{(1-tax rate) x Dividend}}{\text{(1-tax rate) x Interest}} = \frac{\text{After-tax dividend}}{\text{After-tax interest}}$$

The current range is between 1.19 and 1.45, and varies between provinces. This means that an interest rate would have to be approximately 45% higher than a dividend yield, in the province with the highest multiplier, for after-tax returns to be similar, assuming all other factors are equal. Remember that the risk associated with a dividend paying investment is generally different from the risk associated with an interest paying investment. You should always consider your investment options in the light of your personal risk tolerance and time horizon.

Foreign income

Foreign income is fully taxable at your marginal tax rate. If you receive a dividend from a foreign company, you will pay tax on that dividend at the same marginal tax rates as interest income. Dividends you receive from foreign corporations do not receive the dividend tax credit that is available for dividends from Canadian corporations.

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Return of capital

Some investments will distribute a payment to you called a return of capital (ROC). A ROC represents a return of all or a portion of the original capital you invested and it is non-taxable. There are certain types of investments that could make ROC distributions to you. These include, but are not limited to: certain mutual funds, Real Estate Investment Trusts (REITs), Limited Partnerships (LPs), and Mortgage-Backed Securities (MBSs).

ROC distributions are not taxable in the year you receive them but it is important to understand the long-term tax impact of these distributions. ROC distributions reduce the adjusted cost base (ACB) of your investment for tax purposes. This frequently means that you will have a larger capital gain or a smaller capital loss when you eventually dispose of your investment.

If a ROC payment reduces the ACB of your investment below zero during the tax year, the negative amount will be deemed to be a capital gain in the year it arises. The ACB of your investment will be deemed to be zero. If you receive future ROC distributions, they will also be taxed as a capital gain because you are getting back more than you originally invested.

Taxable capital gains / net capital losses

You will realize a capital gain when you sell an asset and the proceeds exceed the cost base of the asset. A capital gain can be further reduced by any fees you incur to sell the asset (e.g. transaction fees or commissions).

You will realize a capital loss when you sell an asset and the proceeds are less than the cost base of the asset. Your capital loss can become larger if you incurred fees to sell the asset. You must report capital gains on your tax return in the year they are realized. If you realized capital losses in the year, you must use these losses to reduce capital gains that you realized in the same year.

If you did not reduce your capital gains to zero after subtracting your losses, you will report 50% of the balance on your tax return as a taxable capital gain. You pay tax on this amount at your marginal tax rate the year.

If your losses for the year are greater than your gains, you will add 50% of the losses to your net capital loss pool. You can use the losses in this pool to reduce any taxable capital gains reported in any of the three previous calendar years, or carry them to future years to reduce any taxable capital gains you may realize in future years.

ROC distributions are not taxable in the year you receive them but it is important to understand the long-term tax impact of these distributions.

After-tax return on various types of revenue

The following chart shows how interest, dividends and capital gains compare on an after-tax basis when you invest $1,000. The chart assumes you pay tax at the highest marginal tax rates in effect in 2016, depending on the province where you live. Tables showing this information for those with different marginal tax rates by province can be found as an appendix to this article.

	Interest	Non-Eligible Dividends	Eligible Dividends	Capital Gains
Alberta	520	598	683	760
British Columbia	523	594	687	762
Manitoba	496	543	622	748
New Brunswick	467	542	658	734
NL&Labrador	502	581	595	751
Nova Scotia	460	530	584	730
Nunavut	555	636	669	778
NWT	530	643	717	765
Ontario	465	547	607	732
PEI	486	561	658	743
Quebec	467	562	602	733
Saskatchewan	520	601	697	760
Yukon	520	598	752	760

Source: RBC Wealth Management. Calculated based on federal and provincial legislation and legislative proposals, 2016.

Registered plans are plans set-up for specific purposes. They benefit from tax incentives and are generally subject to special tax rules and limits on the types of investments that can be purchased within the plan.

Superficial loss rule

Capital losses can reduce your capital gains and allow you to pay less tax but the tax rules prevent you from selling a security at a loss, quickly repurchasing it and then using that loss to reduce your capital gains.

Tax loss selling is a common year-end tax planning strategy. It involves selling investments that are not performing so you can use the capital loss you realize on the sale to offset any gains you incurred in the year. If you sell an investment and incur a capital loss, you should be careful of the superficial loss rules. If these rules apply, your loss is denied and cannot be used to offset your capital gains. The superficial loss rules apply when you meet **both** the following conditions:

1. During the period that begins 30 days before and ends 30 days after the settlement date of the disposition, you or a person "affiliated" with you (i.e. your spouse, a company controlled by you and/or your spouse, or a trust in which you and/or your spouse are a majority interest beneficiary) acquires property that is identical to the property that you sold at a loss. When you sell something at a loss, you need to consider the 61 days that includes the 30 days before, the day of and the 30 days after the settlement date of the disposition.

2. At the end of that period (i.e. on the 30th day after the settlement date of the disposition), you or a person affiliated with you owns or has a right to acquire the identical property. You can purchase the identical property at any time during the61-day period without triggering the superficial loss rules as long as you or someone affiliated with you does not own that identical property on the 30th day following the settlement date of the sale of the original investment.

If you trigger the superficial loss rules, your capital loss will be denied and the amount of the loss will be added to the ACB of the substituted property. This means that you cannot claim the capital loss for tax purposes. However, because the denied capital loss is added to the ACB of the substituted property, you may be able to realize the tax benefit of this denied capital loss in the future when you sell the substituted property. If you delay your repurchase until after the 30-day period has expired, the superficial loss rules will not apply and you will be able to claim the capital loss.

Investing in registered accounts

Registered plans are plans set-up for specific purposes. They benefit from tax incentives and are generally subject to special tax rules and limits on the types of investments that can be purchased within the plan.

You can generally make contributions to these accounts with cash or by transferring assets you already own. It is important to understand the tax consequences of making in-kind contributions of a security from your non-registered account to your registered account. When the investment leaves the non-registered account you are considered to have disposed of it for tax purposes and you will realize any capital gain or loss that has accrued. Capital gains are taxed as described above. Capital losses that arise from a contribution from your non-registered to your registered account are denied. If a loss is denied, you will not be able to use it to reduce your capital gains. If you wish to use your capital loss, you may be able to achieve this by selling the security, realizing the capital loss and contributing cash to the registered plan. Do not repurchase the security in the registered plan for 30 days after disposing of it in order to avoid the superficial loss rules.

An RRSP is a savings vehicle that benefits from tax incentives to encourage taxpayers to save for retirement.

Registered Retirement Savings Plans (RRSPs)

An RRSP is a savings vehicle that benefits from tax incentives to encourage taxpayers to save for retirement.

You can make contributions to an RRSP if you have room. You create RRSP contribution room by generating 'earned income' which you can get from several sources of income, the most common of which is salary from employment. You can deduct your RRSP contributions that are within your contribution limit against any taxable income on your tax return. This can help you reduce your taxable income and therefore, your taxes payable in a particular year.

Any investment income and capital gains you earn in the plan will compound on a tax-deferred basis. Withdrawals from an RRSP are taxable as income at your marginal tax rate. As withdrawals are fully taxable, consider holding investments that yield Canadian dividends and capital gains, which are taxed at preferential rates, outside your RRSP. Also, consider holding interest-bearing securities, which are fully taxable, inside your RRSP where you can defer taxation to a future year.

You can contribute to your own RRSP until the end of the year you turn 71. If you are older than 71, you can still contribute to a spousal RRSP if your spouse is younger than this age.

At the end of the year in which you turn 71, you need to choose an RRSP maturity option. You can also choose to mature your RRSP prior to age 71. There are three RRSP maturity options:

- Convert your RRSP to a registered retirement income fund (RRIF) and begin to take annual income payments. The annual income payments are taxable as income at your marginal tax rate.
- Use the RRSP funds to purchase an annuity. The annuity payments are taxable as income at your marginal tax rate.
- Collapse the RRSP and take the funds as a taxable payment in one year.

The following are some tax planning strategies involving RRSPs:

- If you have excess cash or available non-registered assets, consider making your RRSP contributions early in the year to maximize tax-deferred growth on your investments.
- If your income is low in a particular year, you may wish to make an RRSP contribution but defer taking the deduction until a future year when you have higher income.
- You can make an RRSP contribution even if you have no earned income in the current year as long as you have accumulated RRSP contribution room in a prior year (e.g. retirees). Consider making an RRSP contribution if you have excess funds that you do not need. These funds may benefit from tax-deferred growth in the RRSP.

Registered Education Savings Plans (RESPs)

An RESP is a savings plan designed to provide a tax-effective method of saving for a post-secondary education.

Contributions to the RESP are not deductible for tax purposes and are limited to a lifetime maximum of $50,000 per beneficiary. However, income earned in the plan is only subject to tax when it is withdrawn. You may be able to benefit from income splitting as qualifying withdrawals from the RESP can be taxed in the hands of the beneficiary rather than in the hands of the contributor.

An RDSP is a savings plan that is designed to provide government-assisted, long-term savings for a beneficiary who is eligible for the disability tax credit.

In addition to the above tax benefits, you may also be eligible for an annual government grant. The Canada Education Savings Grant (CESG) is a federal government grant of 20% on the first $2,500 contributed to an RESP per eligible beneficiary per year, subject to certain limitations. If you do not make an RESP contribution in a year, you can carry the grant room forward to use in a future year. Some provinces have additional payments for RESP holders resident in those provinces.

The following are some tax planning strategies involving RESPs:

- If you have excess cash or available non-registered assets, consider making your RESP contributions early in the year to maximize tax-deferred growth on your investments.
- Speak to your qualified tax advisor to determine the optimal amount of contributions to make in order to maximize government grants and tax-deferral.
- If the beneficiary is enrolled in a qualifying program, have the beneficiary withdraw income and government grants from the RESP before withdrawing original contributions from the plan. This will allow the income and grant to be taxed in the beneficiary's hands. Original contributions can be withdrawn at any time tax-free.

Registered Disability Savings Plans (RDSPs)

An RDSP is a savings plan that is designed to provide government-assisted, long-term savings for a beneficiary who is eligible for the disability tax credit.

Anyone can make contributions to an RDSP, to a lifetime maximum of $200,000 per beneficiary. You will need the plan holder's permission to make a contribution to an existing RDSP and your contribution is not tax deductible. The government will pay grant and bond assistance payments into an RDSP depending on the beneficiary's family income. The first $1,500 of contributions per year is eligible for a government grant of up to $3,500. The maximum government grant a plan beneficiary can receive over their lifetime is $70,000. If the beneficiary has low income, a government bond may be available of up to $1,000 per year to a lifetime maximum of $20,000.

If you make withdrawals from an RDSP before age 60, some of the grant and bond assistance payments received by the RDSP may need to be repaid to the government.

The following are some tax planning strategies involving RDSPs:

- If you have excess cash or available non-registered assets, consider making your RDSP contributions early in the year to maximize tax-deferred growth on your investments.
- Speak with your qualified tax advisor to determine the optimal amount of contributions to make in order to maximize government grants and tax-deferral.
- If the RDSP beneficiary is entitled to provincial disability support, speak to the benefit provider to determine if RDSP payments affect the beneficiary's eligibility for support under the program. In most cases, RDSP payments do not affect provincial disability support so RDSPs can be a good way to save and income split with the beneficiary.

Tax-Free Savings Account (TFSA)

The TFSA enables you to earn tax-free investment income and capital gains. Funds can be withdrawn tax-free

TFSAs can be used as a means of income splitting. If you have a spouse or adult children who have unused TFSA contribution room, consider making a gift to them so they can invest in their TFSA.

at any time but you don't need to withdraw or take income from your TFSA until you are ready to do so. This means that a TFSA can be used for a wide range of goals – from emergency savings, to renovations and other special purposes, or to supplement your retirement income.

Contributions to a TFSA are not tax deductible. Your TFSA contribution room limits the funds that you can invest in a TFSA. You can determine your contribution room by adding together the annual limits set by the government for every year during which you are eligible to contribute. You then subtract the contributions you make to a TFSA to calculate your remaining room. If you make a withdrawal from your TFSA, the amount you withdraw will be added back to your TFSA contribution room for the following calendar year.

The following are some tax planning strategies that involve TFSAs:

- The funds you withdraw from your TFSA are not subject to income tax so any withdrawals you make will not have an impact on any income-tested government benefits you may receive, such as Old Age Security and Employment Insurance. If you require funds and do not want to affect your income-tested government benefits, consider making a TFSA withdrawal.
- The TFSA can be an ideal complement to an RRSP, especially if you are able to make the maximum contribution to each of these two plans each year. You will continue to earn TFSA contribution room throughout your life, regardless of your age, even when you are no longer eligible to contribute to an RRSP and even if you no longer have earned income with which to generate RRSP contribution room.
- The investment income earned inside your TFSA is not taxable, so if you borrow funds to invest in a TFSA, you will not be able to deduct the interest you pay for income tax purposes. You can use the assets in your TFSA as collateral for a loan, subject to the requirements of lenders. It is important to note that using borrowed money to finance the purchase of securities involves greater risk than a purchase using cash resources only. Should you borrow money to purchase securities, your responsibility to repay the loan as required by its terms remains the same even if the value of the securities purchased declines.
- TFSAs can be used as a means of income splitting. If you have a spouse or adult children who have unused TFSA contribution room, consider making a gift to them so they can invest in their TFSA. The attribution rules will not apply to the income earned in the TFSA.

Summary

The Canadian tax system is very complex. Different types of income are taxed in different ways and a number of government-assisted programs exist to help taxpayers save. Speak with a qualified tax advisor about the programs and strategies described in this article to determine they make sense in your circumstances

Please contact us for more information about the topics discussed in this article.

Wealth Management

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