Income Tax Considerations for Investors

When evaluating the performance of their portfolio throughout the year, many investors focus on the total return of their portfolio and do not consider the tax implications. It is only as the Registered Retirement Savings Plan (RRSP) deadline approaches that most investors start to pay attention to tax savings opportunities. Unfortunately, it is often too late to do anything about the year that has just passed.

However, consider for a moment the total tax burden of the Canadian Taxpayer. After paying federal and provincial income tax, health care premiums, CPP contributions, employment insurance, retail sales tax, municipal property taxes, license and user fees, disposal fees and airfare taxes the average Canadian is left with less than 40% of their income. Given this, it is prudent for all investors to consider tax efficient investment strategies year-round.

As investment professionals, we are often asked: Should I make an RRSP contribution? Should I contribute to a Tax-Free Savings Account (TFSA) or should I pay down debt? Unfortunately there is no simple answer. Everyone has a unique situation and many factors need to be considered. While tax planning can be a complex task, there are three issues that all investors should think about.

Registered Retirement Savings Plan Contributions

For many investors the use of an RRSP is an effective tax deferral strategy. Contributions are tax deductible in the year they are made, but more importantly, they grow and compound on a tax-free basis within the plan. Eventually an RRSP will have to be converted to a Registered Retirement Income Fund (RRIF), which requires minimum annual withdrawals and is treated as taxable income. Whether one should contribute to an RRSP or pursue an alternative investment strategy is dependent on one's personal situation. Some of the factors to consider include age, marital status, retirement plans, current income, marginal tax rates and current debt load.

Self-employed taxpayers may want to explore the alternative of a Personal Pension Plan. These plans are more complex than merely contributing to an RRSP so those interested in exploring this option should consult with a Financial Advisor.

Use of a Tax Free Savings Account

The second issue that investors should consider is the use of a TFSA as a means to build retirement funds in a tax efficient manner. Individuals 18 years and older can contribute up to $5,000 per annum to a TFSA. If less than $5,000 is contributed in any given year, the difference is carried forward and added to the following years' contribution limit. These plans first became available in 2009, so those who have not opened a TFSA can contribute up to $15,000 to a plan in 2011. Any withdrawals from a TFSA can be replaced in the following calendar year or any time thereafter. As the ceiling of these plans increase and contributions grow, the amount of potential tax-free income for every Canadian will increase substantially. Consider the example of a married couple, each contributing $5,000 per annum to their TFSAs for a period of 15 years. Given 5% compounded growth, they will end up with a total of $227,000. Any income this generates or any withdrawal of principal will be tax-free. In their retirement years this will have no effect on their Old Age Security (OAS) eligibility.

Securities Held Inside and Outside of Registered Accounts

Advance planning for investors with funds both inside and outside of registered accounts can be advantageous. Different forms of investment income include interest, Canadian dividends and foreign dividends. The efficient distribution of stocks, bonds and mutual funds among an investor's registered and non-registered accounts can mitigate both current and future taxes payable. Generally, assets producing income with the highest rate of tax, which includes interest and foreign dividends, should be placed into registered accounts. Conversely, assets producing income that is taxed at lower rates, such as Canadian dividends, should be placed in non-registered accounts. It does need to be kept in mind that each portfolio and investor is unique and asset distribution plans need to be developed on a case-by-case basis.

In summary, income taxes significantly impact the net income a Canadian Taxpayer will receive from their investment portfolio. In addition to balancing risk and return, minimizing taxes should be an important part of their overall investment strategy.