PLANNING MATTERS

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Whose Money is it Anyway? Taking Ownership of Your Investments

All investors, whether they make investment decisions themselves, work with an Investment Advisor or delegate the day-to-day decision making to a Portfolio Manager, should periodically review their portfolio to ensure they are taking advantage of opportunities to maximize their portfolio efficiency. Even those who work with a Discretionary Portfolio Manager need to speak with their manager and understand if and how they are on track to meet their investment goals. With the tax filing deadline looming, now is a good time to review a few planning basics that can reduce taxes, as well as other costs, and allow you to take ownership of your investments.

Registered Retirement Savings Accounts (RSP)

RSP accounts allow Canadians with employment income to shelter up to 18% of their income to a maximum annual contribution limit ($22,000 for 2010) and allow the investments inside the plan to grow tax free until taken out – hopefully in retirement — when they are at a lower marginal tax rate. There are many off-shoots of the RSP such as Locked-In plans and Life Income Funds, but the same basic principles apply to all. At their core, registered plans allow Canadians to create their own individualized pension plan making it a sound retirement strategy for most individuals.

Tax Free Savings Accounts (TFSA)

TFSAs are increasing in popularity as Canadians realize their tax-sheltering benefit. As a result, TFSAs will play an important part of investors' future investment strategies. The beauty of a TFSA is its simplicity. Unlike a RSP, you do not need earned income to accrue contribution room. If you remove money from your TFSA you are allowed to put it back the next year with no tax implications. So what product wins in the RSP vs. TFSA debate? The answer is highly dependent on each client's specific situation. The best strategy, if possible, would be to maximize both. Like RSPs, TFSA contribution room accrues if it is not used, so you can catch up if you haven't contributed to one yet. In terms of what you can own in a TFSA, a good rule of thumb is if you hold an asset in your RSP, you can own it in your TFSA.

Investment Management Fees

Investment management fees should be considered when working towards your investment goals. No one likes to pay fees – particularly exorbitant ones that are often charged by various service providers in the investment industry. We feel that if you pay active management investment fees, your investments should look and act distinctly different from the market – how else could they beat the market? But there are ways to minimize the effect of these fees. Much like accounting fees, investment management fees charged directly to a client in a taxable account could be tax deductible at your marginal tax bracket effectively reducing this cost. For mutual fund clients, although fees charged to the fund are not deductible by the client directly, clients do benefit as the fees charged reduce the amount of taxable distributions paid by the funds and therefore, their taxable income from the fund. The end result is typically similar to the benefits one achieves if fees are deducted by the client directly. This issue of deductibility comes with some pretty stringent caveats, however. For example, not all fees are tax deductible. If you pay investment management fees directly on investments held within your RSP, you cannot deduct these fees. Sound practice would be to consult with a tax professional and examine how your fees are currently being paid.

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Tax Implications of Asset Allocation

Tax considerations should be secondary to your investment principles and considerations. That said, once an appropriate asset allocation is determined, there are ways to structure a portfolio to minimize taxes. Improvements to taxes payable on realized capital gains and eligible dividends over the last decade have widened the gap between tax on interest from fixed income investments. Taxes payable on realized capital gains are half of those payable on interest income, while dividend taxes payable fluctuates depending on the taxpayers' marginal tax rate but could be even more tax effective than realized capital gains. Therefore, an easy improvement to your portfolio structure is to hold fixed income investments (which generate interest income that is taxed at the highest rate) in your tax sheltered accounts, like your RSP or TFSA, while holding tax efficient equities in your non-registered accounts. Furthermore, a husband and wife can structure their combined assets to transfer the larger tax liability generating asset to the lower income earning spouse through a loan or asset swap.

Income Splitting

Recently, the government has made it possible for spouses over age 65 to split up to half of their pension income (not Canadian Pension (CPP) or Old Age Security (OAS)) allowing couples even more opportunities to save on taxes. Even money drawn from a RIF is eligible to be split between spouses.

Foreign Investments

Investors should keep in mind that although realized gains on foreign equities owned in a taxable account attract the same low capital gains tax rate as a Canadian equities, the treatment of dividends is not nearly as good because there is no dividend tax credit on foreign equities. As a rule of thumb, view the tax implications of dividends received on foreign equities similar to interest income.

A further consideration for the high net worth private clients investing in individual U.S. securities or property is the U.S. Estate Tax. The Internal Revenue Service (IRS) can levy a tax on your estate based on the value of U.S. holdings (not merely their gain) even if (1) you were neither an American citizen nor resident, (2) you predeceased your spouse and held such investments in joint names and (3) you held such investments in a registered or tax deferred account which the IRS does not differentiate from a non-registered account. The departed U.S. Republican Administration thought this tax was unfair, as it unevenly taxed those with larger estates and tried to eliminate it. The estates of those who die in 2010 may possibly avoid it; however, the tax returns next year. Due to the complexities of these issues, it is prudent to discuss how they might affect you with a tax professional. For most Canadians, avoiding U.S. investments is not realistic as the U.S. market offers opportunities for Canadians to diversify outside of the narrow Canadian market. The simplest strategy is to own such investments on an indirect basis through a mutual/pooled fund, trust or holding company to eliminate the potential for U.S. Estate tax.

Turnover

The next consideration would be the rate at which securities are bought and sold, called 'turnover'. The manager that trades infrequently or has low 'turnover' allows for the compounding of money on a pre-tax basis. The high turnover strategy consistently sells winners, pays taxes and leaves less money to re-invest. Therefore, the compounding of money is hindered by taxes, commissions and market impact and can be a material impact on returns.

Charitable Giving

Government support for issues affecting you and your community are falling while private donations have been on the rise. If you are supporting a registered charity, keep your donation receipts. They are highly effective in reducing your income tax. However, not all 'giving' can be applied. Spending to play golf in a charity tournament for which you receive a personal benefit cannot be used. Neither can the expense of buying an auction item at a charitable event.

Conclusion

Although simple, these are highly affective strategies that investors should be aware of to take ownership of their investments. Whether investing on their own, working with an Investment Advisor or even a Portfolio Manager, we recommend investors review these strategies with a tax advisor.

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