



CESTNICK

TAX MATTERS

It pays to invest with the taxman in mind

I have a good friend who's a personal trainer. He often talks to me about proper nutrition. Last time we spoke he was singing the praises of eating 25 grams of fibre daily. I'm actually very good about eating properly. In fact, I ate so much fibre yesterday that I'm a little concerned I might pass wicker furniture if I'm not careful. Proper nutrition is not something you have to focus on. But if you ignore it, you'll suffer for it later.

Active tax management (ATM) around your investment assets is much the same. I spoke last week about the value you can add to your investments over time through the minimization of taxes. ATM is not something you have to focus on, but if you ignore it, you'll suffer later.

I shared last week that studies have shown you can potentially add 2 to 3 per cent to your after-tax returns annually through proper ATM.

All of this raises the question: What ATM strategies are available to add those after-tax returns I've been talking about? The list is extremely long, but let me focus on five important strategies:

1. Determine the proper asset allocation

Remember that different types of income are subject to different tax rates. A person in the highest marginal tax bracket in Canada today will face taxes, on average, of about 45 per cent on interest income.

Eligible Canadian dividend income is next, facing taxes of about 25 per cent (foreign dividends are taxed like interest income), and capital gains are most tax-efficient with a highest marginal tax rate of approximately 23 per cent (rates vary by province and income level). The bottom line? Equities are more tax-efficient than fixed income or cash investments when held outside a registered plan, where taxes matter.

2. Pay attention to asset location

Asset location refers to where you hold certain investments (in a registered plan, taxable account, holding company, trust, in your hands, in a family member's hands, onshore, offshore, etc.).

Different people, entities and jurisdictions face different types and rates of tax (including U.S. estate tax), and you'll want to minimize the tax to which your assets are subjected, always keeping in mind that the money to live on needs to eventually end up in your personal hands.

One simple example of proper planning is to ensure your highly taxed interest-bearing investments are held inside your RRSP, RRIF or TFSA to the extent possible.

Also, see my article from March 12, 2009, at waterstreet.ca on shifting assets to a spouse to save tax.

3. Minimize portfolio lock-up

When you buy and hold investments for a long period of time, the fair market value of your assets over time can end up substantially higher than their original cost, ensuring a large tax hit when you eventually sell.

This can result in portfolio "lock-up" where you, your adviser, or money manager might feel handcuffed into holding investments longer than you should.

This problem can be solved in several ways, but the simplest idea is to regularly trigger capital losses by selling assets that have dropped in value.

This will create a tax shelter to offset capital gains.

Those gains should be realized regularly with sale proceeds being reinvested. This will "bump up" your cost amount and can avoid a large tax hit later.

4. Properly assess your tax cost hurdle

Before selling an investment you should consider the tax cost "hurdle," recognizing that any new security chosen as a replacement must perform well enough to recover the taxes paid from the disposition, and then outperform the original investment, for that transaction to add value.

In the case of marketable securities, this will typically require the new investment to outperform the original investment by 2 to 4 per cent annually.

5. Utilize the capital gains reserve

There's a provision in our tax law that will allow you to sell assets for a profit and pay tax on the capital gain over a period as long as five years. If you've decided to liquidate an asset, paying tax over five years will allow use of those tax dollars in your hands longer.

To make this work, you have to collect your sale proceeds over more than one year to defer the tax, but there are ways to structure this so that you can gain the benefit of collecting your sale proceeds today.

These strategies just scratch the surface of possibilities. I'll share more over time.

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