Strategies for tax-smart investing

There are a number of factors to consider when making investment choices, including return potential, asset class, level of risk and portfolio diversification. But one factor that's often overlooked is the impact of taxes on investment choices.

While the tax impact is not an immediate concern for tax-sheltered savings, it's an important consideration for any savings held outside a TFSA, RRSP, RRIF or RESP because interest income, dividends and realized capital gains are all subject to tax annually.

If you earn more than approximately $135,000 a year or have a high pension adjustment amount from an employer pension plan, annual RRSP contribution limits may prevent you from saving what you need to generate an appropriate level of retirement income.

For higher-income Canadians, even modest income goals, such as replacing 70% of your pre-retirement income, may be difficult to achieve through RRSPs alone. Chances are you will rely in part on non-registered savings to maintain your desired lifestyle in retirement – and that's where the tax impact becomes significant. For non-registered savings, the after-tax return on investments is critical, as that's the money that goes into an investor's pocket at the end of the day.

Here are three strategies to help you reduce taxes, stay ahead of inflation and move closer towards achieving your financial goals:

Strategies to consider:

1. Adopt a holistic approach.
2. Optimize the investment structure for registered and non-registered portfolios.
3. Hold and defer.

1. Adopt a holistic approach.

The first step towards tax efficiency is to consider all of your assets in the financial planning process. This includes non-registered and registered savings (including TFSAs), employer pension plans, real estate, cash-value life insurance, business assets and your spouse's assets, resources and savings.

This holistic approach to planning balances the importance of different financial needs. For example, a holistic approach recognizes the effectiveness of making regular contributions to a TFSA or retirement savings plan for tax-sheltered investment growth — but also recognizes the benefits of paying off a mortgage or debt because the interest payments are not tax-deductible.

A holistic approach also means looking ahead to determine the taxes you may have to pay in retirement and taking steps now to reduce those taxes. This may include establishing a spousal RRSP or setting up a trust for the benefit of your family.

2. Optimize the investment structure for registered and non-registered portfolios.

After determining an appropriate asset allocation (cash, fixed income and equities), investments should be arranged in the most tax-optimal way. For example:

Within RRSPs or TFSAs, consider holding investments that are taxed at the highest rate or that have limited or no opportunity for tax deferral if held outside of a TFSA, RRSP or RRIF. These include:

- Regular GICs, index-linked GICs and market-linked GICs
- T-bills, regular bonds and strip bonds (which are fully taxed as interest income each year, even though no annual income is received)
- Money market funds
- Actively traded investments (note that it may be preferable to hold sector rotation, momentum and other actively traded investments within TFSAs or RRSPs so capital gains realized each year are not subject to tax. However, depending on individual circumstances and other holdings, they could be considered too risky. As well, the tax benefit of using capital losses to offset capital gains would be lost)

However, be careful about foreign withholding tax for foreign stock held within a registered account. If you hold the foreign stock in a non-registered account, you can claim a foreign tax credit against your Canadian tax payable for the amount of tax withheld. But if the foreign dividend is paid into a registered account, the foreign tax withheld is not recoverable and no credit is available. The Canada-United States tax treaty exempts U.S. dividends from withholding tax when paid to an RRSP or RRIF. But that same break does not apply to a TFSA or RESP, making U.S. dividend-paying stocks better off in RRSPs.

Outside TFSAs and RRSPs, consider holding investments that are subject to lower tax rates or that provide the opportunity for tax deferral. These include:

- Growth-oriented stocks and equity mutual funds, which produce mainly capital gains where only 50% of the gains are taxable
- Preferred shares and other investments that produce dividends qualifying for the Canadian dividend tax credit
- Regular bonds purchased on the secondary market at a significant discount, which could deliver capital gains if sold (as well as some interest income)
- Growth investments that are bought and then held for the long term to maximize tax-deferred growth (e.g., good quality growth and value-oriented equity funds)
- Income trusts, which may provide tax-deferred distributions in the form of returns of capital
- Certain mutual funds that seek to provide tax-efficient distribution through the distribution of dividends, capital gains or a return of capital
- Corporate class mutual funds that allow investors to switch funds from one corporate class fund to another without incurring an immediate tax consequence.

3. Hold and defer.

Once a well-diversified equity portfolio has been established, it should be held for the long term to defer capital gains and tax. Some of the benefits include:

- **Increase in tax-deferred compounding.** Built-up capital gains serve as an interest-free loan from the government — extra capital on which to earn more money at pre-tax rates.
- **You may be subject to lower tax rates in the future.** Not only will taxes on capital gains be postponed, but those gains may be subject to less tax in the future (if tax rates decline or if you move into a lower tax bracket).
- **Reduces the tendency to buy high and sell low.** Many Canadians are buying high and selling low, a practice that severely reduces portfolio growth. Studies have shown that market timing is generally ineffective and rarely works on a regular basis.
- **May avoid commissions and trading costs.** The only guarantee with frequent trading is increased commissions, loads in the case of load funds, and other trading costs.

The information in this article is general in nature. You should get advice from a tax expert about your individual circumstances.

For more information

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