

THE PRUDENT CANADIAN'S  
Guide to Reducing Taxes



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WELCOME TO THE PRUDENT CANADIAN'S

# Guide to Reducing Taxes

Taxes are the one thing we all want less of. When you consider all the different forms of taxation — income taxes, payroll taxes, sales taxes, property taxes, excise taxes, investment taxes, surtaxes, license fees, and other hidden losses to the government — it's easy to get discouraged or even annoyed. Yes, we all value the services that our various governments provide, but we all have better things to do with our money.

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Added together, taxes are the largest expense for most people. Thus, to succeed financially, it is essential to take full advantage of all legal means to reduce tax. While some types of tax are impossible to avoid, like those buried in the price of gasoline, there are several strategies you can use to reduce the tax hit on income and investments. By taking time to understand a few basic concepts and strategies, the average Canadian can potentially save thousands in taxes. And the benefits can be even greater if you work

with a professional financial and tax advisor to integrate tax strategies into your overall financial plan.

## **Understand the Basics**

Since income taxes are your biggest tax and affect almost all aspects of financial planning, it is important to understand how the income tax system works. Different tax rates apply, but the most important one to know is your marginal tax rate – the percentage of tax you would

The average Canadian can potentially  
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pay on an extra dollar of income, or earn as a tax deduction on an extra dollar of RRSP contributions.

Federal and provincial income taxes are calculated separately, but in most provinces the approach is similar. After a basic exemption of \$10,382 (2010), income is taxed in progressively higher tax brackets. For example, for those in Ontario, regular income up to \$37,106 is taxed at approximately 20%. Each dollar of income between \$37,107 and \$40,970 is subject to tax at about 24%, while each dollar from \$40,971 to \$65,345 is taxed at about 31%, and so on, up to income over \$127,021 which is taxed at the highest marginal tax rate of 46.41%.

You can see how extra income could push you into a higher tax bracket, where it will be taxed more heavily. A tax deduction, on the other hand, reduces your taxable income dollar for dollar within that tax bracket, saving you tax on that amount. However, additional deductions could also drop you into a lower tax bracket, where your tax savings will be less.

### Invest Tax Efficiently

Marginal tax rates also vary depending on what kind of income you earn. Unfortunately, too many investors ignore the impact of taxes on their non-registered accounts – those that are subject to tax. For taxable accounts, you should always compare investment choices in terms of after-tax returns, according to whether they earn interest income, Canadian dividends or capital gains:

- **Interest income** from investments like GICs, term deposits and bonds is fully taxed at your marginal tax rate, just like regular income. No special treatment here.



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- **Canadian dividends** benefit from a dividend tax credit that results in a much lighter tax rate than interest income, especially for those in lower tax brackets. (Note that foreign dividends are fully taxed.)
- **Capital gains** produced by equity investments are taxed at half the rate you'll pay on interest income, and only when sold by you or your fund manager.

Thanks to the dividend tax credit, for example, a dividend yield that is lower than the interest rate paid on a GIC may actually leave more in your pocket on an after-tax basis. And capital gains generated by equities, in addition to being taxed less than interest income, may also be taxed later. If you have little or no need for investment income from your equities, you can defer tax on capital gains by using a “buy and hold” approach. One way is to make minimal changes to your portfolio so you don't trigger tax prematurely. Another is to choose funds that aim to minimize taxable distributions each year. Your IPC advisor can help identify which fund managers invest tax efficiently using a “buy and hold” philosophy.

#### Examples of Marginal Tax Rates For Different Kinds of Income

Taxable Income	Income and Interest	Canadian Dividends	Capital Gains
\$40,000	24.15%	3.96%	12.08%
\$80,000	39.41%	16.49%	19.70%
\$150,000	46.41%	26.57%	23.20%

*The example above reflects 2010 federal and provincial marginal tax rates for Ontario. The tax brackets and rates vary by province and change each year.*

#### Take Advantage of the Tax Free Savings Account

Even better than investing tax efficiently is investing tax-free. As its name implies, the Tax Free Savings Account (TFSA) is an account that will allow your savings and investments to grow without having to pay tax on any income or growth that is generated. In addition, you can withdraw funds at any time and for any reason – without any tax consequences.

Plus, withdrawals have no impact on federal income-tested benefits such as the Canada Child Tax Benefit or Old Age Security.



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Qualified Canadians 18 or older are able to contribute up to \$5,000 annually to a TFSA (contributions are not tax-deductible). Funds withdrawn can be re-contributed in a future year without affecting annual contribution room, and any unused room is carried forward. As of 2010, you could be earning tax-free income on up to \$10,000.

The TFSA is the only account  
that lets you invest  
*without having to pay tax*  
on earnings or withdrawals

TFSAs are an extremely flexible investment option. They can be used to finance short-term goals, such as a new car, a vacation, or savings for an emergency or long-term goals, such as retirement or education savings. They also come with estate planning benefits. Unlike RRSPs, the value of your TFSA will not be subject to tax on your death. TFSA assets can be transferred to your spouse or common-law

partner upon death without any tax implications or impact on the survivor's existing contribution room. Otherwise, all types of income in the TFSA from the date of death (but only income, not your original investment capital) will be fully taxed as ordinary income to the estate or beneficiary.

### Deduct and Defer with RRSPs

The immediate and best-known benefit of RRSPs is the tax deduction for the amount invested, which reduces your tax bill for the year. Potentially more attractive, however, are the tax-deferral benefits, which allow your savings to compound untaxed for what could be decades. Of course, RRSPs are fully taxable when withdrawn in retirement, but this may be when your tax bracket is lower. Here are key strategies to make the most of RRSPs:

- **Maximize contributions each year.** Although unused RRSP room can be carried forward indefinitely, you should do all you can to maximize your RRSP contributions every year. It helps establish the discipline of saving

regularly so you don't miss out on the magic of tax-deferred compounding over a longer investment period.

- **Consider deducting later.** Did you know you don't have to claim the tax deduction in the year you make the contribution? If you expect to be in a higher tax bracket next year, perhaps because you only worked part of the year, you could be better off postponing some or all of your deduction to when it may be worth more.
- **Allocate investments tax efficiently.** If you have both registered and non-registered accounts, it makes sense to first shelter investments earning heavily taxed interest or foreign dividends in your RRSP and TFSA and to keep some or all of those producing lightly taxed Canadian dividends and capital gains in taxable accounts.

### “Catch Up” to Maximize Retirement and Tax Savings

Despite their enormous appeal, many people still do not take full advantage of RRSPs. If you have unused RRSP room, you may want to capitalize on today's low interest rates and take out an RRSP loan to “catch up” on

The Canada Education Savings Grant on RESP contributions is like earning a *20% one-time bonus* on your initial investment

your retirement plan and maximize tax savings. Among the advantages is that you get a larger amount of money compounding sooner and also benefit from the “forced savings” that is naturally imposed when you start any loan. However, there are risks with borrowing. Be sure to consult a tax advisor about your personal situation.

### Make Interest Expenses Tax Deductible

If you borrow to invest outside your RRSP or TFSA, the interest may be tax deductible. Leveraging, as it's called, is especially valuable as a means of increasing tax deductions for investors with little RRSP room. In addition, it can be a powerful wealth-building strategy because more dollars



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are invested immediately with less of your own money, resulting in magnified returns. However, bad returns are also made worse with leveraging. That's why it is critical to first consult a trusted tax and financial advisor. In Quebec, interest deductibility may be limited and/or deferred.

### Split Income Whenever Possible

Spouses and families have special opportunities to reduce the overall tax they pay by "splitting income." Because each individual pays taxes separately and likely at different rates, it makes sense to plan ahead to even out taxable income as much as possible among family members so that more income is taxed in lower tax brackets and less income is taxed in higher ones. For example, an income of \$80,000 that is split evenly between two spouses instead of all in one spouse's name saves about \$6,790 in annual tax. Key strategies here include:

- **Split CPP.** Retired spouses who are in different tax brackets can arrange to "assign" or split Canada or Quebec Pension Plan payments, so that a larger portion is taxed in the hands of the lower earner.
- **Split pension.** Canadian residents can also allocate up to one-half of pension income that qualifies for the pension income tax credit to their spouse for income tax purposes. Note: these changes do not apply to Old Age Security (OAS) and CPP/QPP.
- **Use spousal RRSPs.** Couples in their working years can use spousal RRSPs to help equalize the two incomes in retirement. Generally, the spouse expecting to be in the higher tax bracket in retirement contributes to a spousal RRSP and claims the deduction, potentially at a higher tax rate. In retirement, withdrawals from the spousal RRSP are taxed to the other spouse.
- **Gift TFSA funds.** In addition to making their own contribution, an account holder may gift funds to their spouse to fund TFSA contributions, enabling couples to shelter the income earned on up to \$10,000 each year from taxation. Parents may also gift up to \$5,000 to each of their adult children for the purpose of TFSA contribution, assisting with education savings or with large purchases

(e.g. home downpayment). Keep in mind that these assets then become the child's property.

- **Other gifts and loans.** Gifting cash, placing funds in an “in trust” account, and low-interest loans between family members can also help shift income and save tax. However, if these strategies are not implemented properly, “attribution rules” may reduce or eliminate any tax benefits. Professional advice is a must. Gifting to a Registered Education Savings Plan, or RESPs, is another great way to split income with a child or grandchild (read on).

### **RESPs to Defer and Reduce Taxes**

RESPs allow you to defer taxes, while assisting with the cost of a child's post-secondary education. While the amount invested in RESPs does not result in a tax deduction, the funds compound tax-deferred like RRSPs. When the child attends school, the money is withdrawn in their name and little or no taxes would be payable if the student's income is low enough. What makes RESPs even more attractive is the 20% (and sometimes higher) grant that is earned on the first \$2,500 invested each year for each child.

### **Consider Insurance to Minimize Estate Taxes**

Canada officially has no estate taxes. However, significant capital gains taxes can be triggered on business, investment and real estate assets, which are deemed to be sold upon death. RRSPs and RRIFs that are not rolled over to a spouse become taxable as well. The last thing you want for your heirs is to have to sell assets like a cottage or business at “fire sale” prices to pay estate-related taxes.

A skilled insurance advisor can help you evaluate possible solutions for minimizing taxes and maximizing your estate to chosen beneficiaries and/or charitable causes. Life insurance can be used to guarantee that funds are available to cover taxes, funeral expenses, and probate fees. Universal life insurance plans, which flexibly combine insurance protection with a range of tax-sheltered investment options, can be designed to meet a wide variety of estate and financial planning goals.

### **Don't Overlook “Hidden” Taxes**

Payments from many government income-support programs are reduced or “clawed back” based on income level. Among the national programs subject to clawback



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are OAS and the Child Tax Benefit. What this means is that sometimes earning another dollar actually triggers “hidden” taxes. For example, the OAS benefit begins to be clawed back at around \$66,700 and is eliminated once income exceeds about \$108,000. An individual who increases income by \$1,000 to \$101,000, for example, not only pays about \$434 in tax on the income but also loses \$150 in OAS benefits, for a total tax rate of about 58%. It is therefore critical to evaluate alternatives from an after-tax, after-clawback income perspective.

Looking at the other side of the coin, strategies that reduce taxable income can produce an additional “hidden” benefit of reducing clawbacks and thus increasing your government payout. Clawbacks on the Child Tax Benefit are typically 4% for middle-income families. Contributing to an RRSP, for example, could generate a tax refund of 33% and increase the benefit by 4% as well.

### Next Steps

Taxes have a big impact on financial planning, whether your primary goal is retiring comfortably, leaving an estate, or saving for an education. Because the tax laws are com-

plex and constantly changing, it is wise to work with a professional tax and financial advisor to implement the best strategies for your unique situation. This is especially true for business owners and higher-net-worth individuals, whose situations are often complex and where a wider variety of solutions are practical. With the assistance of IPC advisors as your financial planning specialists, you can lighten your tax load and more easily achieve your goals.

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*This guide was written with the assistance of Talbot Stevens, a financial educator, speaker, and industry consultant. To learn more, visit [www.TalbotStevens.com](http://www.TalbotStevens.com).*

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