Tax Planning for the Private Investor

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1 › Introduction

Canada continues to be one of the highest taxed countries in the world. The average Canadian pays taxes on almost half of their income each and every year. These taxes represent a major obstacle to many private investors seeking wealth accumulation.

Tax planning is an ongoing process that should be reviewed every year to ensure your tax minimization and wealth preservation goals are met. Your advisor at RBC® can link you to tax strategies that may reduce the amount of taxes you pay, thereby making funds available to allocate toward your long term goals. You should discuss these tax strategies with your own professional tax or legal advisor to determine their appropriateness for your individual circumstances.

RBC has prepared this publication as an informational guide concerning various areas of taxation for the private investor. Please note that this publication has been prepared based on the current and proposed tax law in effect as of the date of this publication. See back cover for date.

2 › Personal tax planning calendar

This calendar provides important tax dates and tax-friendly strategies to help maximize tax savings.

January

- **15th**—Deadline for an employee to inform employer of any deferred stock option benefits related to a stock option exercise from the previous year.
- **30th**—Deadline to pay interest for the previous year on a family loan at prescribed interest rates.
- Consider making a maximum lump-sum RSP contribution for the current year.
- Consider making a $2,000 lifetime RSP over-contribution.
- Consider making the maximum $5,000 lump-sum contribution to a Tax-Free Savings Account.
- Review your personal financial plan, including your estate plan, to ensure it is still appropriate.

February

- **28th**—Deadline for employers (even for those employing a nanny or babysitter) to send in T4 Summary to the Canada Revenue Agency (CRA). A copy of the T4 slip must be mailed or delivered to the employee by February 28th. (February 29th in leap years.)

March

- **1st**—RSP contribution deadline. If it is a leap year, the deadline is February 29th. This deadline applies to regular RSP contributions, retiring allowance RSP contributions, and Home Buyers’ Plan and Lifelong Learning Plan RSP repayments.
- **1st**—Labour-Sponsored Fund contribution deadline. If it is a leap year, the deadline is February 29th.
- **15th**—First quarterly Canadian tax instalment is due.
- **31st**—Inter-vivos/living trust tax return deadline. If it is a leap year, the deadline is March 30th.
- If you are expecting a tax refund, consider filing your personal tax return early—but only after you have received all your necessary tax information.

April

› **15th**—U.S. resident tax return or four-month extension request deadline. Deadline for extension request for non-resident aliens who are subject to withholding tax. Deadline for the balance owing to avoid interest charges.

› **30th**—Deadline to file your Canadian personal tax return and pay any balance owing to avoid paying interest and a late filing penalty.

› Consider the impact of the new federal and provincial budgets on your personal finances.

June

› **15th**—Second quarterly Canadian tax instalment is due.

› **15th**—Deadline for filing Canadian tax return if you or your spouse has self-employment income. However, if there is a balance owing, the tax must be paid by April 30th to avoid underpayment interest charges.

› **15th**—Deadline for filing U.S. tax return for U.S. citizens living in Canada and non-resident aliens not subject to withholding tax. However to avoid interest charges, any balance owing of unpaid taxes must be paid by April 15th.

September

› **15th**—Third quarterly Canadian tax instalment due.

October

› If you expect significant tax deductions next year, consider applying now for a tax waiver to the CRA on Form T1213 to reduce withholding taxes at source on employment income.

November

› Consider the use of an investment tax shelter to reduce your current year taxes payable.

December

› **15th**—Fourth quarterly Canadian tax instalment is due.

› Consider selling securities with accrued losses that no longer meet investment objectives to offset realized capital gains. Ensure that the trade settles in the current calendar year and superficial losses are avoided.

› To obtain a tax deduction in the current year, pay your deductible expenses and make charitable donations before the end of the year. If you plan on making a large donation to reduce your tax liability for this year, consider an in-kind donation of appreciated securities since this results in no tax on the accrued capital gain. You can also reduce your employment benefit on the exercise of stock options where the shares are donated to a qualifying charity within 30 days of exercise and in the same year as exercise.

› If you turn 71 during the year, make your final RSP contribution before the end of the year. Contributions to your RSP cannot be made after the end of the year in which you turn 71 as your RSP has to be converted to an income stream by the end of the year you turn 71. If you are over age 71 and still have unused RSP contribution room, you can make your RSP contribution to a spousal RSP if your spouse is age 71 or under.

› Consider delaying purchasing new mutual funds in non-registered accounts to avoid prepayment of tax on year-end distributions.

› **31st**—RESP contribution deadline.

Note: when a due date falls on a Saturday, a Sunday or a public holiday, your payment is considered to be paid on time, or your return is considered to be filed on time, if CRA receives it or if it is postmarked on the next business day.

3 › Canadian income tax system

The Canadian personal income tax system is based on progressive or graduated tax rates. This means that there are increasing tax rates that apply to increasing levels of taxable income (except for provincial taxes in Alberta, which are based on a flat tax for all levels of income).

AVERAGE VERSUS MARGINAL TAX RATES

Your average tax rate (also referred to as your "effective" tax rate) is the percentage calculated when the total tax paid is divided by your taxable income. Your marginal tax rate is generally the percentage of tax paid on the final dollar of taxable income. There is a difference between the two rates because, as mentioned above, Canada has a system of progressive tax rates. The average tax rate is always equal to or less than the marginal tax rate.

Figure 1 shows the marginal tax rate for each of the major tax brackets. Some provinces have tax brackets that may slightly differ from those indicated in Figure 1. The rates are based on the federal and provincial tax rates. The illustrated provincial tax rates are based on an average of all the provincial tax rates.

CALCULATING YOUR TAX LIABILITY

In order to estimate how much tax you will have to pay, you must first calculate what your taxable income will be for the year.

To start, add up all your various types of income (e.g. salary, interest, grossed-up Canadian dividends, taxable capital gains, etc.) and subtract the various deductions such as RSP contributions, investment management fees and deductible interest expense. The total income less deductions represents your taxable income.

The total federal taxes payable can then be calculated by multiplying the taxable income amount by the appropriate federal tax rates. Then various tax credits (e.g. basic personal credit, donation credit, dividend tax credit, foreign tax credit, etc.) are subtracted from the federal tax calculated to arrive at a net federal tax amount.

The method of calculating provincial taxes has significantly changed for all provinces (with the exception of Quebec). In the past, provincial and territorial taxes were calculated as a percentage of basic federal taxes. Under the new tax-on-income (TONI) system, provinces and territories now are able to set their own tax brackets and tax rates based on taxable income, similar to the federal government, to meet their needs and priorities. Quebec already has a system of setting their own tax brackets and tax rates based on taxable income.

However, under the TONI system, individual taxpayers will not have to file a separate provincial tax return like Quebec taxpayers. Instead, the new provincial tax calculation will continue to be calculated on one harmonized federal and provincial tax return administered by the CRA.

As a result of the TONI system, a similar set of calculations has to be completed to determine the taxable provincial income and then the provincial taxes owing.

FIGURE 1

Marginal Tax Rates

Taxable Income*	Up to $41,000	$41,000 to $81,000	$81,000 to $126,000	More than $126,000
Federal Tax	15%	22%	26%	29%
Provincial Tax	9%	12%	15%	15.5%
Combined Tax	24%	34%	41%	44.5%

* As the marginal tax brackets are indexed to inflation, these values are subject to change each year. All amounts are approximate.

The net federal tax plus the provincial taxes owing are added together to determine the total tax payable. Credits, such as tax withheld at source and tax instalments paid during the year, are subtracted from the total tax payable to determine any refund or balance owing at the time the tax return is filed.

Note that Canadian residents are required to report their worldwide income for Canadian tax purposes. In the majority of cases, this means that all taxable income, regardless of where in the world it is earned, must be reported for Canadian tax purposes. Canadian citizenship is generally irrelevant in determining one's obligation to pay Canadian tax.

The Canadian tax system requires taxpayers to declare income based on the honour system, whether the CRA has a trace to the income or not. If taxable income is not reported for Canadian tax purposes, there can be penalties to the individual taxpayer.

4 › Investment income

It is important to recognize that different types of investment income are not taxed in the same manner. For example, capital gains and Canadian dividends are taxed at more favourable rates than interest income and foreign income.

Since various types of investment income receive different tax treatment, you should look beyond the investment's pre-tax rate of return and consider the after-tax return.

This assessment of investment rates of return should be done on an individual basis, taking into consideration your income level and marginal tax rate, as well as any other tax benefits that may be available.

While evaluating investments based on their after-tax return is important, you should also consider such other factors as the investment's risk, the opportunity for capital appreciation, liquidity and so on.

It is important to note that in most cases, you will retain more after-tax income from capital gains and eligible Canadian-source dividends than either Canadian-source non-eligible dividends or interest income. Figure 2 illustrates how much income you will keep from an additional $1,000 of interest, Canadian-source eligible dividends and capital gains, relative to each tax bracket.

INTEREST INCOME

Interest income is fully taxable within each tax bracket at the applicable combined tax rate. Figure 3 illustrates the amount of interest income you keep after tax.

Interest income can be paid at varying frequencies during the year, such as semi-annually or monthly, and is taxable in the year it is received. It is also possible that you may not actually receive interest income in the year but will still be required to declare this "accrued" interest on your tax return.

FIGURE 2

Investment Income:
How Much You Keep After Tax Per $1,000

Taxable Income*

- Up to $41,000
- $41,000 to $81,000
- $81,000 to $126,000
- More than $126,000

Interest and Foreign Income

$760

$660

$590

$555

Dividends from Canadian Corporations

$1000

$919

$828

$775

Capital Gains

$880

$830

$795

$777

* All amounts are approximate.

For investments made in 1990 and later years, accrued interest is required to be reported annually. Investments that require the annual accrual of compound interest include compound Canada Savings Bonds, strip coupons and compound GICs.

For investments where the term is not more than one fiscal year (e.g. T-bills), income should be reported in the year the interest is received.

In the year that a compound-interest-paying investment matures, the taxable amount in the year is equal to the amount of interest received less the amount of interest declared in prior tax years. This ensures that the interest income is taxed only once. If this investment is sold prior to maturity or was purchased at a premium or a discount, a capital gain or loss may have to be recognized in addition to the interest income.

TAX PLANNING TIP

Structure T-bill purchases so maturity dates are after the end of the current calendar year. This can defer tax for up to 16 months.

DIVIDEND INCOME FROM CANADIAN CORPORATIONS

Since the beginning of 2006, it is now possible to receive both eligible and non-eligible dividends from Canadian corporations. Generally, eligible dividends are dividends paid after 2005 by a Canadian corporation to Canadian resident individuals where the dividend has been designated as an eligible dividend. Eligible dividends are subject to an enhanced dividend gross-up of 45% and a federal dividend tax credit of approximately 19% of the grossed-up dividend. The 2008 federal budget decreases the enhanced dividend gross-up from 45% to 44% in 2010, 41% in 2011 and 38% in 2012. In addition, the dividend tax credit will also be decreased to 18% in 2010, to 16.5% in 2011 and to 15% in 2012. There is also a provincial dividend tax credit available, which differs for each province.

FIGURE 3

Interest Income: How Much You Keep After Tax Per $1,000

Taxable Income*	Up to $41,000	$41,000 to $81,000	$81,000 to $126,000	More than $126,000
Interest Income	$1,000	$1,000	$1,000	$1,000
Combined Tax	$240	$340	$410	$445
Amount You Keep	$760	$660	$590	$555

*All amounts are approximate.

Non-eligible dividends are subject to a dividend gross-up of 25% and a federal dividend tax credit of approximately 13% of the grossed-up dividend. Again, there is also a provincial dividend tax credit that varies for each province.

The ability to pay an eligible dividend is different for public corporations and Canadian Controlled Private Corporations (CCPC). In general, all dividends paid after 2005 from a public corporation are eligible dividends (however, there may be exceptions). A CCPC can only pay eligible dividends to the extent that its active business income is taxed at the high general corporate tax rate. It can also pay eligible dividends to the extent of eligible dividends it receives. Although investment income is taxed at a high rate in a corporation, this type of income cannot be paid out as eligible dividends. Investment income includes interest, taxable capital gains and non-eligible dividends.

Eligible dividends are effectively taxed at a lower rate than interest income due to the dividend tax credit that is applied to the federal and provincial tax payable. The use of a tax credit is meant to recognize that the Canadian corporation paying the dividends has already paid tax on its earnings, which are now being distributed to its investors.

The tax payable on eligible dividend income is calculated by grossing up the actual dividends received by 45% (i.e. actual dividend x 1.45); net federal tax payable is calculated using this grossed-up amount and deducting a federal dividend tax credit of 27.5% of the actual dividend received or 18.97% of the grossed-up dividend. Provincial tax is then calculated using the provincial tax rates and a provincial dividend tax credit rate. See Figure 4 for an illustration of this calculation.

FOREIGN INCOME

Foreign income is fully taxable at the applicable marginal tax rate. Dividends received from foreign companies are also taxable at the same marginal tax rates as interest income. That is, dividends from foreign corporations do not receive the dividend tax credit that is available for dividends from Canadian corporations. Therefore, dividends from foreign corporations are taxed at a higher rate than dividends from Canadian corporations.

RETURN OF CAPITAL

There are instances when an investment will distribute a non-taxable payment to you called a "return of capital." Real estate investment trusts (REITs), royalty income trusts, as well as some mutual funds are typically the types of investments that distribute return of capital. Return of capital distributions reduce the adjusted cost base (ACB) of the investment for income tax purposes. As a result, although the distributions are not taxable currently, the reduced ACB results in a larger capital gain or smaller capital loss when you dispose of the investment in the future. Therefore, return of capital distributions can be thought of as tax-deferred income.

FIGURE 4

Eligible Dividend Income: How Much You Keep After Tax Per $1,000

Taxable Income*	Up to $41,000	$41,000 to $81,000	$81,000 to $126,000	More than $126,000
Dividend Income	$1,000	$1,000	$1,000	$1,000
Gross-up (45%)	$450	$450	$450	$450
	$1,450	$1,450	$1,450	$1,450
Federal Tax	$218	$319	$377	$421
Less Dividend Tax Credit	$275	$275	$275	$275
Net Federal Tax	$0	$44	$102	$146
Net Provincial Tax	$0	$37	$70	$79
Combined Tax	$0	$81	$172	$225
Amount You Keep	$1,000	$919	$828	$775

* All amounts are approximate.

THE DIVIDEND/INTEREST RELATIONSHIP

It is important when evaluating investments to compare the after-tax returns on various types of investments. A factor can be calculated to compare the after-tax return on interest and eligible Canadian dividend-paying investments. The current range is between 1.32 and 1.40, and will vary somewhat among provinces.

For example, for the tax bracket greater than $126,000, the eligible dividend/interest ratio is calculated as follows:

$$= \frac{\text{After-tax dividend}}{\text{After-tax interest}} = \frac{\$775}{\$555} = 1.40$$

In other words, an interest rate would have to be approximately 40% higher than a dividend yield for after-tax returns to be similar, assuming all other factors are equal. Remember, however, that the risk associated with receiving dividend income will, in all likelihood, be different from the risk associated with receiving interest income.

Figure 5 shows the interest yields that would provide the same after-tax income as the corresponding dividend yields for an investor in the top marginal tax bracket.

FIGURE 5

Interest Yields Required To Provide the Same After-tax Income as the Corresponding Dividend Yields
(in the Top Marginal Bracket)

Dividend Yields	4%	5%	6%	7%
Interest Equivalents	5.6%	7%	8.4%	9.8%

TAX PLANNING TIP

- You can elect to include all of your spouse's taxable Canadian dividends in your income if the election will increase your spouse's or common-law partner's credit. This election can provide tax savings if the increased spouse or common-law partner credit exceeds your increased tax liability.
- Ask your advisor at RBC about a dividend reinvestment plan (DRIP) that allows investors to reinvest their dividend income in additional shares of the corporation.

CAPITAL GAINS AND LOSSES

Note: this information relates only to non-depreciable assets.

A capital gain will occur upon the sale of an asset for proceeds in excess of the cost base of the asset. The capital gain is further reduced by any costs incurred to sell the asset (e.g. transaction fees).

Taxable Capital Gains

To determine what amount of capital gain will be taxable in the year, you must first calculate the net capital gain recognized in the year. This is calculated by summing your total capital gains and subtracting your total capital losses. A taxable capital gain is equal to half of the net capital gain. It is taxable at the marginal tax rate applicable in the year. See Figure 6 below for an illustration of this calculation.

FIGURE 6

Capital Gains: How Much You Keep After Tax Per $1,000 *All amounts are approximate.

Taxable Income*	Up to $41,000	$41,000 to $81,000	$81,000 to $126,000	More than $126,000
Capital Gain	$1,000	$1,000	$1,000	$1,000
Taxable Portion	$500	$500	$500	$500
Marginal Tax	$120	$170	$205	$223
Amount You Keep	$880	$830	$795	$777

Superficial Loss Rule

A common year-end tax planning strategy is tax loss selling. However, if you sell an investment at a loss, but wish to reacquire that same investment (due to long term potential), be careful of the superficial loss rules.

A superficial loss will occur when both of the following conditions are met:

i) A security (including mutual funds) is sold for a loss and an identical security is acquired during the period beginning 30 days before the disposition and ending 30 days after the disposition of the original security; and

ii) At the end of the above period, the taxpayer or a person affiliated with the taxpayer owns or has a right to acquire the property.

According to the Income Tax Act, a person "affiliated" with a taxpayer is essentially their spouse or a corporation controlled by the taxpayer or their spouse. An RSP or RIF is also considered affiliated with the taxpayer because the taxpayer is the majority-interest beneficiary of the RSP/RIF. Therefore, based on this definition of "affiliated," some tax loss selling opportunities arise since a child or parent is not considered to be affiliated with the taxpayer.

If the superficial loss rules are triggered, the capital loss will be denied. The denied capital loss will be added to the ACB of the substituted investment. Therefore, the net effect of triggering the superficial loss rules is that the capital loss cannot be immediately claimed for tax purposes. However, by adding the denied capital loss to the ACB of the substituted investment, the tax benefit of this denied capital loss may be realized in the future when the substituted investment is ultimately sold and the superficial loss rules do not apply at that time.

Note that if you delay your repurchase until after the 30-day period, the superficial loss rules will not apply and the capital loss can be claimed.

Using Capital Losses To Offset Capital Gains

Realized capital losses must first be used to offset capital gains realized in the same tax year. If a net capital loss is remaining, it can be carried back and applied against capital gains in any of the three previous calendar years. If a net capital loss still remains, it can then be carried forward indefinitely and used to offset capital gains in future years.

TAX PLANNING TIP

- If an individual has no other income, they can receive up to $50,320 of eligible Canadian dividend income or $40,600 of non-eligible Canadian dividend income with no federal income tax to pay (however, there may be provincial tax payable). It is essential that this calculation be done for your specific province.
- Generally speaking, Canadian dividends should be received outside an RSP or other tax-sheltered vehicles in order to take advantage of the dividend tax credit.
- The mix of assets in your portfolio should be examined to take advantage of the lower tax rates applied to eligible Canadian dividend income and capital gains.
- Prior to the end of the calendar year, consider selling investments to recognize a capital loss. This loss can be used to reduce other capital gains recognized in the year. If you intend to repurchase the investment, ensure that you do not invoke the superficial loss rules.

5 › Borrowing to invest

When interest rates are low, you may be attracted by the strategy of borrowing to invest, also known as leveraged investing. This section will explain the issues that you should be aware of before using leverage.

WHO SHOULD CONSIDER LEVERAGING?

Unfortunately, when deciding whether to use leverage, many people simply consider the current interest-rate environment and past market performance without evaluating their complete financial situation. Borrowing money to purchase investments is definitely not a strategy for the faint of heart. Along with higher potential gains, leveraging carries the risk of magnifying potential losses. It may not be suitable for all investors. It involves significant resolve as well as various factors that should be considered and adhered to. These factors include:

- **Risk tolerance**—Most investments have some degree of risk associated with them. Your risk tolerance is a measure of how comfortable you are with taking risk in the hope of earning greater returns on your investments. Diversification of your leveraged assets will help reduce the volatility of the investments.
- **Time horizon**—The use of a leverage strategy requires a commitment of approximately 10 years. Collapsing this strategy early increases the chance that a loss may result.
- **Cash flow**—You must have sufficient surplus cash flow (i.e. after-tax income less expenses) to tolerate fluctuations in the borrowing costs incurred on the investment loan or margin account.

One of the primary reasons that leveraging does not work is that one does not adhere to a long investment time horizon. A long investment time horizon creates two benefits in a leveraging strategy. These benefits are:

- Increased probability that your total investment assets will exceed their loan plus interest costs; and
- Potential of lower volatility on investment returns.

In order for you to increase your chances of having a successful leverage strategy, you should:

- Be prepared to accept the risks associated with leveraging investments;
- Be prepared to invest the borrowed assets for a long time horizon regardless of intermediate volatility—if the investment fundamentals continue to remain strong;

TAX PLANNING TIP

Always repay non-deductible debt before you repay tax-deductible debt. If you have a non-deductible mortgage and a portfolio, consider liquidating your portfolio to repay your mortgage —then re-borrow sufficient funds to repurchase your portfolio. Note that the liquidation of your portfolio could create immediate capital gains. Consult with your qualified tax advisor before proceeding with this strategy.

- Be willing to diversify the leveraged assets in order to reduce investment risk; and
- Be comfortable that you have adequate surplus cash flow based on your expected income sources to cover any increase in borrowing costs or margin calls.

INTEREST DEDUCTIBILITY ISSUES

Another major attraction of leveraging investments is the deductibility of the interest expense for personal income tax purposes. This deductibility allows you to increase your after-tax rate of return on your investment. Some of the more important issues regarding interest deductibility that you should be aware of are as follows:

- A Supreme Court of Canada case (i.e. Ludco case) has increased confidence that interest expense is generally deductible if the purchased investments have the potential to pay taxable interest or taxable dividends, and the borrowed monies are used directly to purchase non-registered investments. It could be argued that investments purchased with borrowed monies that are expected to generate only capital gains also could have

the potential to pay dividends in the future and therefore are eligible for the interest expense deduction.

- If leveraged investments are sold at a loss, the proceeds may not be adequate to pay off the outstanding investment loan balance. In this case, the CRA's position is that the interest expense on the remaining loan generally continues to be deductible as long as the original loan was used to purchase portfolio assets.
- Interest paid on an investment loan continues to be fully deductible even when the property originally purchased with the borrowed funds is replaced with property of a lesser value. As long as you can trace the cost of the replacement property to the entire original borrowed amount, the full amount of the interest expense is deductible.
- If a portion of the leveraged investment is transferred to an RSP, then the portion of the interest expense that's related to the transferred investments will not be deductible for tax purposes.
- If the investment generates a return of capital (ROC), the ROC must be reinvested to ensure all of the interest continues to be tax-deductible. Otherwise, a pro-rated interest expense calculation is required to determine the amount that may be tax-deductible.

The interest deductibility tax rules are currently under review by the CRA. You should consult with your qualified tax advisor before proceeding with a leverage strategy to ensure the tax rules have not changed.

6 › Income splitting

Income splitting is the reallocation of income among family members to reduce the total amount of tax paid by the family unit. The shifting of income from a family member in a high tax bracket to one in a lower tax bracket will result in greater after-tax income retained by the family. The use of income splitting with family members is recognized as an acceptable tax planning method; although, the use of these strategies is restricted by the income attribution rules.

ATTRIBUTION RULES

Under the income attribution rules, income earned on capital that has been transferred as a loan or gift to family members may be "attributed" to (or taxed in the hands of) the individual that gifted the capital. Figure 7 provides a detailed summary of these rules.

For example, if Mrs. Smith were to gift capital to either Mr. Smith or their minor children, any income (except for business income or capital gains/losses recognized by the children) would be taxed back or attributed to Mrs. Smith.

If income splitting is achieved by transferring appreciated property to a family member, the accumulated capital gains or losses must be recognized as of the date of transfer and declared on the transferor's tax return. However, a capital loss cannot be recognized at the date of transfer for property transferred to a spouse due to the superficial loss rules.

Although the income attribution rules restrict the number of income-splitting opportunities available, there are still a number of effective ways of splitting income with family members.

Note: to ensure the desired results are achieved, income splitting methods should be discussed with a qualified tax advisor prior to implementation.

FIGURE 7

Summary of Income Attribution Rules: Relationship to Transferor (i)

Method of transferring capital	Spouse (includes common-law partner)	Minor **(ii)**	Adult child or other adult non-arm's-length individuals **(iii)**
Capital transferred as a gift **(iv)**	Income/loss and capital gains/losses are attributable	Income/loss is attributable; capital gains/losses are not	No attribution of any type of income
Capital transferred as a loan **(v)**	Same as above	Same as above	Income/loss is attributable; capital gains/losses are not

(i) The transferor is the individual that is gifting or lending the capital to the related party.

(ii) A minor is a non-arms length individual or a niece or nephew of the transferor that is under the age of 18 throughout the taxation year.

(iii) This includes an individual connected by blood relationship, marriage or common law partnership or adoption such as a child, grandchild, parent, brother, sister,brother-in-law, sister-in-law, etc.

(iv) Gifted capital must be made with no restriction as to its use or requirement of future repayment.

(v) This assumes that the capital has been lent to the individual as a low- or no-interest loan. If the CRA prescribed rate (set each quarter) or a fair market rate of interest is charged, the attribution rules do not apply (see Prescribed Rate Loan discussed later).

INCOME SPLITTING WITH YOUR SPOUSE

Invest the Earnings of the Lower Income Spouse

To establish investment capital in the hands of the lower-income spouse, their employment earnings should be kept separate from the family's finances and invested in their name. This will allow the investment income earned to be taxed at the spouse's lower tax rate. The earnings of the higher income spouse should then be used to pay all living expenses for the family as well as the family's tax liabilities.

Contribute to a Spousal RSP

One objective of income splitting is to equalize the spouses' income in retirement. In order to ensure equal retirement income, the higher-income spouse should make RSP contributions to the spouse with the lower expected retirement income.

In the future, when the funds are withdrawn from the spousal RSP, the income will be taxed in the hands of the spouse. Income attribution to the RSP contributor will not occur provided a spousal contribution to any spousal plan did not occur in the year of the withdrawal or the previous two years. Minimum RIF withdrawals are also not subject to the attribution rules.

Loans to a Spouse Used To Finance a Business

Business income is not attributable; therefore, any business income earned will not be taxed in the hands of the spouse that provided the capital.

Pay Your Spouse a Salary

For individuals who own a business, it is possible to pay a salary for the work the spouse performs. The amount of salary paid to a spouse must be reasonable in relation to the duties they perform. This will put income into the hands of the lower-income spouse, which will be taxed at their lower rate. Also, this will allow your spouse the opportunity to contribute to the Canada or Quebec Pension Plan and to their own RSP.

Income on Income

Although the income earned on property transferred to a spouse is attributed back to the transferring spouse, this income does become the recipient spouse's capital for reinvestment.

The income earned on the reinvested capital will be taxed in the recipient spouse's hands, hence the term "income on income." The income earned on the original loaned capital will continue to be attributed back to the lending spouse.

Over a number of years this method can result in the accumulation of substantial capital in the hands of the lower-income earning spouse.

For example, Mrs. Smith gifts $100,000 to Mr. Smith, the lower-income spouse, who invests the capital at 5% (interest and dividend income). Each year $5,000 of income is taxed in Mrs. Smith's hands, but becomes Mr. Smith's capital for reinvestment.

TAX PLANNING TIP

For parents who are supporting their children's education costs, there may be a more tax-effective method of providing this support and reducing capital requirements by up to one half. If you are currently paying $5,000 per year for your child's education and you are paying this expense with income from your investments, you require approximately $120,000 of capital to produce $5,000 after tax (assuming a 7% investment return and a marginal tax rate of 40%). If instead you were to gift your $72,000 to your adult child, they could invest the capital, which would provide approximately $5,000 of after-tax income, assuming they have little or no other income.

Figure 8 illustrates the capital accumulation that would occur over a 10-year period.

FIGURE 8

Income-on-income Capital Accumulation over 10 Years

Year	Gift Amount	Income Taxed to Mrs. Smith	Mr. Smith's Capital*	Mr. Smith's Income
1	$100,000	$5,000	$5,000	—
2	$100,000	$5,000	$10,250	$250
3	$100,000	$5,000	$15,763	$512
4	$100,000	$5,000	$21,551	$788
5	$100,000	$5,000	$27,628	$1,078
6	$100,000	$5,000	$34,010	$1,381
7	$100,000	$5,000	$40,710	$1,700
8	$100,000	$5,000	$47,746	$2,036
9	$100,000	$5,000	$55,133	$2,387
10	$100,000	$5,000	$62,889	$2,757
TOTAL				$12,889

*This assumes that Mrs. Smith will pay any tax liability incurred by Mr. Smith. Based on the stated assumptions, Mr. Smith could accumulate $62,889 by the end of the 10th year.

Prescribed Rate Loan

When the higher-income spouse loans money to the lower-income spouse at an interest rate at least equal to the CRA's prescribed rate for these loans, income attribution can be avoided. This means that all of the income and capital gains earned by investing the borrowed funds will be taxed in the hands of the spouse who borrowed the money. The higher-income spouse must declare the interest received on the loan, but this income should be less than the amount of income earned by the lower-income spouse to make this an effective income-splitting strategy.

In order for this strategy to work, a formal written loan agreement must be in place and payments of interest must be made each year or by January 30th of following year. If the interest payments are not made within this time limit, attribution will apply for current and all future years and this income splitting strategy will no longer work.

Splitting Canada Pension Plan (CPP)/Quebec Pension Plan (QPP)

CPP/QPP retirement pensions can be shared between spouses based on the length of the time the spouses have lived together. The application to share the CPP/QPP can be made only once the younger spouse is old enough to receive a retirement pension. The benefit of splitting the CPP/QPP retirement pensions is that a portion of the higher-income spouse's CPP/QPP can be received by the lower-income spouse and taxed in the lower-income spouse's hands without the attribution rules applying.

Splitting Pension Income or RIF Income with a Spouse

Effective January 1, 2007, qualifying retirement income may be split with a spouse. The introduction of these new rules is particularly good news for couples where the primary recipient of the qualifying retirement income is subject to a tax rate that is significantly higher than that of their spouse. Any amount between 0% and 50% of the qualifying retirement income may be allocated to a spouse for income tax purposes.

Only certain types of income may be split under these new rules. The types of income that qualify depend on the age of the person who is the primary recipient of the income. The age of the spouse to whom the income is allocated (generally the lower-income spouse) is not relevant for the purposes of the new pension income-splitting rules. However, their age is relevant for eligibility for the pension income tax credit for certain qualifying pension income.

In most cases, a primary recipient who is under 65 years of age during the entire tax year will be able to split only the income that is paid to them directly from a defined benefit pension plan. A primary recipient who is at least 65 years of age during the tax year will have more types of income that are eligible to be split with their spouse.

The following summarizes the main types of income that may be split with a spouse, depending on the age of the primary recipient:

For primary recipients who are under 65 during the tax year:

- Periodic payments received directly from a defined benefit pension plan; and
- Certain types of annuity income received as a consequence of the death of a previous spouse or common law partner.

For primary recipients who are 65 and older during the tax year:

- Periodic payments received directly from a defined benefit pension plan;
- Payments received from a RIF, LIF, LRIF, PRIF, or RLIF;
- Payments received from annuities purchased with the proceeds of an RSP, RIF, LIF, LRIF, PRIF, or RLIF;
- The taxable portion of payments received under certain types of annuity contracts purchased with non-registered funds (typically prescribed annuity contracts); and

- Periodic payments received from a money purchase (defined contribution) pension plan in the same manner as permitted under a LIF. *Note: Only some money purchase pension plans are designed to allow these types of payments.*

INCOME SPLITTING WITH YOUR CHILDREN

Age 18 and Over

Since the income earned on capital transferred as a gift to adult children is not attributed back to the donor, any outright gift will achieve family income splitting.

Low-interest or no-interest loans to adult children result in the attribution of income on the loaned capital back to the lender. Only the capital gains/losses earned on the loaned capital will not be attributed back to the lender.

Under Age 18

Since the income earned on capital transferred as a low- or no-interest loan or a gift is attributable to the transferring family member, with the exception of capital gains and losses, income splitting opportunities are restricted to the following strategies:

Canada Child Tax Benefit (CCTB) and Universal Child Care Benefit (UCCB)

A parent may gift the monthly CCTB and UCCB payments to a minor child for their investment. Income earned on the gifted payments is taxed in the hands of the minor child.

Growth Stocks

Since capital growth recognized on capital transferred as a gift or a loan is taxed in the child's hands, the purchase of growth-oriented investments may avoid attribution.

Other Opportunities

If you own a business and you employ your children in that business, it is possible to pay a salary for the work they perform. The amount of salary paid to your children must be reasonable in relation to the duties they perform. In addition, if they invest the salary they receive, the income earned on the salary is not attributable to the parent.

The use of the income-on-income strategy (discussed in the spousal income-splitting section) can also be used with minor children to accumulate capital in their hands.

7 › Tax-free savings account

The 2008 federal budget introduced the Tax-Free Savings Account (TFSA) for Canadians effective January 1, 2009. The TFSA appears to have elements of both a non-registered account and a registered account.

It is similar to a registered account because the funds within the TFSA can grow sheltered from tax, the account is subject to the same qualified investment rules and the account is subject to a similar concept of contribution room. It is similar to a non-registered account in that TFSA contributions are not deductible. This means your investment will be made with after-tax dollars, but the income earned inside the TFSA will be sheltered from tax. What is completely new is that your withdrawals will never be subject to income tax, even the growth on the original investments. Since your withdrawals will not be subject to tax and will not be considered as taxable income, it will not impact your income-tested benefits and income tax credits such as Old Age Security and Employment Insurance, and your entitlement to the age credit.

CONTRIBUTION ROOM

All Canadian residents age 18 and older will earn $5,000 of contribution room each year, indexed to inflation, regardless of income. The CRA will determine and track your TFSA contribution room as you file your tax return each year. Unused contribution room will be carried forward indefinitely. Amounts withdrawn from the plan, including the tax-free growth, will be added back to your contribution room for the following year, which means you will be able to withdraw amounts and reinvest those same amounts as you choose without losing any contribution room. This type of "revolving" contribution room will help you meet your financial planning goals throughout your lifetime since you will be able to save funds in this account and withdraw funds as necessary without losing your ability to reinvest in this account for future goals.

INCOME SPLITTING OPPORTUNITY

Since the income earned within the TFSA is not taxable, contributions made by a taxpayer to their spouse's TFSA will not be subject to the income attribution rules. Unlike conventional income splitting strategies that consider the source of the invested funds, this account allows you and your spouse to both earn tax-free investment income, regardless of whose money is invested. Also, relative to traditional income splitting strategies, your TFSA will also allow for greater tax savings, thus greater investment growth, in a shorter time frame.

FINANCIAL PLANNING OPPORTUNITIES

The various attributes of the TFSA, including the tax-free investment income, the ability to invest in your spouse's plan without triggering attribution, the revolving contribution room and the fact that the withdrawals do not effect any income-tested benefits or clawbacks, can provide you with greater flexibility for savings and investments throughout your lifetime. Though the TFSA may add to the overall complexity of your financial situation, it will also provide you with more flexibility with regard to choosing which sources of income to draw upon during retirement.

The TFSA is an ideal complement to a retirement savings plan (RSP), especially if you are able to make the maximum contribution to each of these two plans each year. Since the investment income earned within the TFSA is not taxable, any interest paid on funds borrowed to invest in the TFSA will not be deductible for income tax purposes. However, there will not be any constraints with respect to using your assets within your TFSA as collateral for a loan.

8 › Education funding

Registered education savings plans (RESPs), formal trusts and in-trust accounts are the three main types of accounts that many individuals consider to save for their children's or grandchildren's post-secondary education costs.

REGISTERED EDUCATION SAVINGS PLANS

An RESP is a tax-deferred savings plan designed to provide a tax-effective method of saving for a post-secondary education. Contributions to the RESP are not deductible for tax purposes and are limited to a lifetime maximum per beneficiary of $50,000. Contributions to an RESP must be made within the calendar year (i.e. December 31st deadline) to take advantage of the annual Canada Education Savings Grant (CESG). Grant room can be carried forward where contributions have not been made each year. All investment income earned within an RESP is sheltered from tax until it is withdrawn.

Multiple Beneficiaries Within a Family RESP

While it is possible to establish an RESP for individual beneficiaries, it may be more effective to establish a single plan with multiple beneficiaries (a family RESP). The main advantage of setting up a family RESP is that the funds in the plan do not have to be shared equally among the beneficiaries. More income from the RESP can be directed to the beneficiaries who have higher educational expenses at the discretion of the plan's subscriber (i.e. the person that set up the plan). Prior to 2008, a family plan may not have been a good option where the beneficiaries have a significant age difference since the plan could not have remained open for longer than 25 years and contributions were limited to the first 21 years of the plan being open. However, starting with the 2008 calendar year, the 2008 federal budget increases the life of RESPs to 35 years and allows contributions for the first 31 years. This significantly improves the flexibility of family RESPs where the beneficiaries have large age differences.

In order for a family plan to have multiple beneficiaries, all of the beneficiaries must be connected to the subscriber by blood relationship. This means that children, grandchildren, brothers, sisters and adopted children and grandchildren can be included in a single family RESP. Note that nieces and nephews are specifically excluded from being a beneficiary of a family plan. Furthermore, family plans will not allow any individual to become a beneficiary if the individual is 21 years of age or older at the time they are added to the plan. Although the 2008 federal budget allows contributions for beneficiaries up to age 31, it does not extend the age for adding a beneficiary to age 31.

The Canada Education Savings Grant (CESG)

The CESG is a government grant of 20% on the first $2,500 contributed to an RESP per eligible beneficiary per year. An RESP beneficiary is eligible to receive the CESG only if they are turning no more than age 15 in the year, have a social insurance number (SIN) and are a resident of Canada. The maximum lifetime CESG a beneficiary can receive is $7,200.

Beneficiaries who are turning 16 and 17 years old in the year may also qualify for the CESG if the following criteria are met:

- A minimum of $2,000 of RESP contributions were made in respect of the beneficiary before the year in which the beneficiary turned age 16; or
- A minimum of $100 in annual RESP contributions were made in respect of the beneficiary in any of the four years before the year in which the beneficiary turned age 16.

One of the features of the CESG is that eligibility can be carried forward for use in future years if a $2,500 contribution for the beneficiary is not made in the present year. Note that the maximum CESG that can be received in any one year is $1,000.

Contributions made starting on January 1, 1998, are eligible for the CESG. The CESG will not count towards the annual or lifetime contribution limits as described above.

Education Assistance Payments

Once a beneficiary is enrolled in a qualifying educational program at a post-secondary educational institution as a full-time student, or in some cases as a part-time student, they are eligible to receive funds from the RESP in the form of Educational Assistance Payments (EAPs). The EAPs are paid at the direction of the subscriber for the benefit of the beneficiary. EAPs may consist of accumulated income and CESG.

Note that a beneficiary can even receive EAPs if they are attending an educational institution outside Canada, provided the course being taken is at a post-secondary level and lasts at least 13 consecutive weeks. However, in order to receive any CESG as part of an EAP, the beneficiary must be considered a resident of Canada at the time that the EAP is received.

EAPs are taxable to the beneficiary student; however, with the student's basic federal personal exemption as well as tuition and education credits, there is generally little or no income tax to pay on the EAP amounts received.

For plans opened after 1998, a maximum $5,000 in EAPs is allowed in the first 13 weeks of enrolment in the educational program. Thereafter EAP payments to the beneficiary student should be reasonable. Each time an EAP is requested from an RESP, proof must be supplied that the beneficiary is enrolled in a qualifying educational program at a post-secondary educational institution as a full-time student.

In addition, the 2008 federal budget provides a grace period to allow beneficiaries to receive EAPs for up to six months after they have ceased to be enrolled in a qualifying post-secondary program. Although payments must still qualify under the rules for EAPs, this could give students more flexible access to funds to pay late-occurring expenses and accommodate a wider range of personal circumstances. This applies to RESP beneficiaries who cease to be enrolled in a qualifying education program after 2007.

If the Beneficiaries do not Pursue Post-Secondary Education

It is possible for a subscriber to receive the income from an RESP, called "Accumulated Income Payments" (AIP), if all of the following conditions are met:

- The RESP must have been open for at least 10 years;
- The youngest beneficiary of the plan must be at least 21 years of age and no longer eligible to receive EAPs; and
- The subscriber must be a resident of Canada.

When all these conditions are met, the AIP withdrawn from the RESP is included in the taxable income of the subscriber in the year it is withdrawn, and is taxed at the subscriber's marginal rate of tax. In addition to being included in taxable income, the income withdrawn is also subject to an additional 20% tax. Consequently, if a subscriber were subject to a top marginal rate of tax of 46%, the total tax on the AIP withdrawn from an RESP would be 66%.

To avoid this potential tax hit, original subscribers are permitted to contribute up to $50,000 of accumulated RESP income to an RSP, provided that the subscriber has sufficient regular RSP contribution room available. Joint spousal subscribers are permitted to contribute up to $50,000 each of AIPs for a total of $100,000 if they each have the respective unused RSP contribution room. Only the portion of the RESP income that is contributed to an RSP avoids current taxation and the 20% additional tax. Only original subscribers or the surviving spouse of a deceased original subscriber is permitted to transfer up to $50,000 of AIPs directly to an RSP if they have the unused RSP contribution room.

The CESG received by the RESP may have to be returned to the government if the beneficiary does not pursue post-secondary education.

FORMAL TRUSTS AND IN-TRUST ACCOUNTS

Typically, a trust (formal trust or an in-trust account) is established by a parent or other relative to save money for a child, often for education purposes. The trust offers a unique opportunity to split investment income among family members so the family can benefit from a lower overall tax cost.

The donor of the assets to the trust is called the "settlor" or "contributor". The person that has legal ownership and manages the assets is called the "trustee" (except in Quebec where the trust maintains legal ownership of the assets and the trustee manages the assets like an owner of the assets). With the managerial responsibilities of the trustee comes a duty of care (fiduciary duty) that is owed to the beneficiaries of the trust.

In-trust accounts or standard formal trusts at financial institutions often have standard documentation that cannot be customized. Trusts established by an external lawyer/notary can be customized to reflect your wishes. RBC Dominion Securities offers a few types of standard formal trusts. Speak to your advisor at RBC if you are interested in setting up a trust to split capital gains with low-income children and/or grandchildren, which would also allow you to fund not only the children's education but anything for their benefit.

RBC offers both family trust and formal trust solutions. These solutions, based on standardized trust deeds, are structured primarily for the purpose of splitting investment income with low-income family members to minimize the overall tax burden on the family. The RBC Family Trust can be used to fund your children's education and expenses while providing a mechanism for income splitting. The RBC Dominion Securities Formal Trust is used primarily for gifting smaller amounts to a beneficiary for income splitting. The main difference between the RBC Family Trust and the RBC DS Formal Trust is that amounts contributed to the RBC DS Formal Trust are irrevocable gifts to a beneficiary, while with the RBC Family Trust, you have the option to loan or gift monies to the trust. If you are interested in learning more about the RBC Family Trust or RBC DS Formal Trust, speak to your advisor at RBC.

Taxation of Trusts

When there is a related minor beneficiary (includes child, grandchild, niece and nephew), the answers to the following two questions will generally determine who must declare the investment income in the trust:

- Who contributed the funds to the trust?
- Is the trustee a different person than the donor?

The related person who contributed the funds to the trust (i.e. donor) must always declare the interest and dividends earned where there is a minor beneficiary. If the donor is also the trustee, then the donor continues to control the asset after it is gifted. If this is the case, our tax rules state that the donor will have to also declare the capital gains realized in the trust. Therefore, if the donor and trustee are the same person, it is possible that no income splitting will be achieved. However, if the trustee and donor are different people, then you can avoid the attribution rules with respect to capital gains, and thus, the minor beneficiary may declare the capital gains realized in the trust for tax purposes.

If the monies in the trust came from the beneficiary through such sources as Canadian Child Tax Benefit (CCTB) payments, Universal Child Care Benefit (UCCB) payments, their own employment income or an inheritance, then all investment income (interest, dividends and capital gains) is taxed in the beneficiary's hands.

Furthermore, if the beneficiary is an adult and the donor and the trustee are two different individuals, interest, dividends and capital gains may be taxed in the adult beneficiary's name.

RESPS COMPARED WITH TRUSTS

Prior to the 1998 federal budget, the preferred method of saving for a child's or grandchild's education was through the use of an in-trust account or a formal trust. Since the 1998 budget announcement that the government will contribute up to $400 (increased to $500 by the 2007 federal budget) per year per beneficiary to an RESP, interest in RESPs has grown considerably.

The major differences between RESPs and trusts are:

- Income earned in an RESP is tax-deferred until withdrawn, while income in a trust is taxable each year;
- Lifetime contributions to an RESP are limited, while there are no limits on the amount that can be contributed to a trust;
- Permitted uses for RESP funds are limited to post-secondary education, while as long as the amounts are used for the beneficiary's benefit, there is no restriction on the use of funds in a trust. (It is possible to specifically limit the use of the funds in a trust by documenting restrictions in the trust agreement);
- The life span of an RESP is limited to 35 years (prior to 2008 it was 25 years) and contributions can only be made to family plans until the beneficiary's 31st year (prior to 2008 it was the 21st year). A trust does not have a maximum life and contributions can be made at any time. However, there is a deemed disposition at fair market value of all of the assets in a trust every 21 years;
- Income from the RESP may be taxed in the hands of the beneficiary if the beneficiary pursues post-secondary education; otherwise the income is taxed in the subscriber's hands (see the exception on the next page). In a trust, interest and dividends are taxed in the contributor's hands (attribution rules) if the beneficiary is under age 18; however, capital gains may be taxed in the beneficiary's hands if the trust is properly structured;
- When the RESP is wound up by the subscriber, if any unused RESP income remains and if certain criteria are met, the unused income can be returned to the subscriber (but not CESG) and is taxed at their marginal tax rate plus an additional 20% unless the original subscriber has adequate unused RSP contribution room;
- Capital gains and Canadian-source dividends do not receive beneficial tax treatment when withdrawn from the RESP, while in a trust, only 50% of a capital gain is taxable, and Canadian-source dividends receive the dividend tax credit;
- RESPs can receive matching grants of up to $500 per year per beneficiary, while trusts do not receive any money from the federal government; and
- The contributions in an RESP belong to the subscriber; while in a trust, those contributions belong to the trustee for the benefit of the beneficiary. However, it is possible to loan funds to the trust instead of gifting funds to the trust so that the loan capital can be returned to the lender. It is important to note that in this scenario, if the loan is a low-interest or no-interest loan, then the attribution rules will apply to dividend and interest income, attributing them back to the lender regardless of the beneficiaries' ages. Capital gains can be taxed in the hands of the beneficiaries assuming the trust is properly structured. To avoid the attribution rules on dividend and interest income, the loan must be a prescribed rate loan (i.e. interest is charged at the CRA's prescribed rate). However, this would reduce the income splitting tax advantage since you, as the lender, would have to pay tax on the interest income earned on the loan to the trust. Speak to your advisor at RBC if you are interested in this type of a trust to save for your child's education.

CONCLUSION

As demonstrated above, the rules regarding RESPs make these accounts more restrictive than the rules governing trusts. In comparison, trusts have a broader range of potential uses and are considered a more flexible alternative.

Subscribers who set up family plans with multiple beneficiaries have an advantage over subscribers who set up RESPs for a single beneficiary. Multiple beneficiaries give some insurance of getting the income taxed in a beneficiary's hands because the chance of a beneficiary pursuing post-secondary education may be increased if there are more potential beneficiaries to choose from. This is important because if the beneficiary of an RESP does not pursue post-secondary education, all of the income could be taxable in the hands of the subscriber, and the CESG may have to be returned to the government. It should also be noted that if it is the subscriber who

withdraws the income from an RESP, the total taxes on that income earned in an RESP may or may not be higher than the total taxes on that same income had it been earned in a trust.

From a tax perspective, RESP accounts are much easier to maintain than trust accounts because amounts from an RESP are only taxable when they are withdrawn. As well, income attribution rules are not a concern with RESP accounts, while these rules must be actively considered with trusts.

For all of the reasons listed in this section, it is vital that the benefit of the new maximum $500 per beneficiary per year CESG be weighed against the potentially higher tax cost and decreased flexibility of an RESP before making the decision to choose an RESP over a trust.

9 › Registered investments

There are numerous types of registered investment vehicles available: retirement savings plans (RSPs), retirement income funds (RIFs), locked-in retirement accounts (LIRAs), life income funds (LIFs), locked-in retirement income funds (LRIFs) and registered education savings plans (RESPs). Of the available registered vehicles, the RSP is by far the most utilized tax planning tool. This section will serve only to outline the basic details of RSPs. For further information on RSPs, speak to your advisor at RBC.

RETIREMENT SAVINGS PLANS (RSPs)

RSP Contribution Limits

Deductible RSP contributions are limited to 18% of the prior year's earned income to a maximum dollar limit. The dollar limit is $20,000 in 2008, $21,000 in 2009 and $22,000 in 2010. The dollar limit will be indexed thereafter.

Contribution limits will also be reduced by the prior year's pension adjustment (PA) factor or may be increased by a pension adjustment reversal (PAR).

"Earned income" generally includes employment income, net self-employment income, net rental income, taxable alimony or child support payments received and CPP/QPP disability pensions. However, earned income is reduced by deductible alimony or child support payments paid, rental losses and most deductible employee expenses. Note that earned income does not include investment income, pension benefits, RSP/RIF income or retiring allowances.

An RSP offers a double advantage in saving for retirement—a tax deduction, and thus a tax savings in the year the contribution is deducted, and the tax-free compounding of income on the contributions.

TAX PLANNING TIP

- Make RSP contributions early in the year to maximize the deferral of income.
- Consider making an over-contribution of up to $2,000 to your RSP. However, you must ensure that the $2,000 over-contribution is eventually deducted or you will effectively be double-taxed on the $2,000.
- If you are over 71, make RSP spousal contributions as long as you have earned income and your spouse is 71 or under.
- If your income is unexpectedly low in a particular year, make a contribution but defer taking a deduction until a future year when income is higher.
- RSP contributions can be made for individuals who have no earned income in the current year, but who did have earned income in the prior year (e.g. retirees).
- Consider holding investments yielding Canadian dividends and capital gains outside the RSP and interest-bearing securities inside the RSP.

RSP Contributions Calculations

- **Non-members of an employer pension plan**— 18% of earned income from the previous year to the maximum dollar limit.
- **Member of a Deferred Profit Sharing Plan or a defined contribution pension plan**— 18% of earned income from the previous year, to the maximum dollar limit, less the previous year's PA.
- **Member of a defined benefit pension plan**— 18% of earned income from the previous year, to the maximum dollar limit less the previous year's PA less a past service pension adjustment (PSPA) if applicable.

10 › Tax shelters

In an attempt to reduce the amount of tax that is paid each year, many investors consider the use of a tax shelter to reduce their tax liability. A tax shelter is simply an investment that provides significant deductions against your other taxable income.

By taking these deductions, you can reduce your total taxable income and thereby reduce the amount of tax payable to the CRA.

Investors generally view the reduction in taxes payable as a tax savings, but it is more accurately viewed as a tax deferral, since ultimately income derived from either the investment or the sale of the investment will result in a tax liability.

TAX PLANNING TIP

Tax shelters are generally only appropriate for investors in the top marginal tax bracket, since the value of any tax deduction is maximized. Consult a qualified tax advisor prior to purchasing a tax shelter to ensure it is appropriate in your situation.

EVALUATING TAX SHELTERS

Although the main selling feature of a tax shelter is the tax deduction, it is important that it be evaluated based on its investment quality—not just the potential write-offs.

In order to assess a tax shelter's investment quality, investors should assess both the risk involved in the venture itself as well as the likelihood of continued cash flow once the deductions have been taken.

The tax shelter structure should also be considered when evaluating these investments. Most tax shelters are set up as either a limited partnership or as a flow-through share.

Limited Partnerships

With a limited partnership, only the amount invested is at risk should any partnership liability arise. Since the limited partner's risk exposure is limited to their investment, this also tends to limit the amount of deductions available to the amount invested or the at-risk amount.

This amount is generally defined as the limited partner's investment plus or minus any income received or expenses deducted.

Flow-through Shares

A flow-through share is a share that allows you to claim resource exploration expenses incurred by resource companies. The resource expenses simply flow through the company and are deductible against your other income.

The expenses that flow through also serve to reduce your cost base, which results in a zero, or in some cases, a negative cost base. Any time a negative cost base occurs, a capital gain has to be recognized in the year to bring the cost base up to zero.

Upon the sale of these flow-through shares, you may incur a capital gain.

Potential Problems

As a result of the substantial deductions that occur with a tax shelter, the investor must remember that they may become subject to the Alternative Minimum Tax (AMT).

The large tax deductions may also result in a positive cumulative net investment loss (CNIL) balance should the investor's cumulative investment expenses exceed their cumulative investment income. A positive CNIL balance will restrict the investor's access to their $750,000 qualified small business or qualified farm property capital gains exemption.

It is also important to recognize that for most tax shelters there is a very limited secondary market for these investments, especially once the tax deductions have been taken. Therefore, investors should generally view a tax shelter as a long term investment.

Once the investor is comfortable with the risks involved in the investment and has consulted a qualified tax advisor to ensure its appropriateness, the use of a tax shelter can be an effective tax-deferral vehicle.

11 › Alternative Minimum Tax (AMT)

Alternative Minimum Tax (AMT) is designed to target high-income individuals who have significant deductions (e.g. over $40,000) such as the write-offs from tax shelters. To determine whether AMT applies, the taxpayer must do two calculations—their regular tax calculation and an AMT calculation. The AMT calculation can be complicated. If the taxes calculated for AMT are greater than the regular tax calculation, then the difference is the AMT amount that is payable in the year.

Items that can lead to an AMT liability include stock option deductions, limited partnership losses and capital cost allowance claimed on tax-sheltered investments.

Note: RSP contributions no longer impact the AMT calculation. Thus, large RSP contributions, including retiring allowance rollovers, will not cause an AMT to be payable.

If you are subject to minimum tax, the excess of minimum tax over the regular tax payable is identified as a minimum tax carryover.

This carryover can be carried forward for seven years and credited against tax payable in future years to the extent that regular tax exceeds the minimum tax calculation.

Note: there is also a provincial AMT calculation that varies from the federal calculation.

TAX PLANNING TIP

- Both deductible-interest expenses and business losses do not affect the AMT calculation. Consider using these deductions to reduce your taxable income without triggering AMT.
- One exception is that deductible-interest expenses related to tax shelters do affect AMT.

12 › Investing through a holding company

Years ago, earning investment income inside a Canadian corporation (generally referred to as an "investment holding company") was considered an attractive tax planning technique. In the past, the use of a Canadian investment holding company allowed for both the deferral of taxes and the payment of less total tax compared to holding investments personally in a non-registered account. The combined corporate and personal tax rates on interest, dividends, foreign income, rent, royalty and taxable capital gains income ("investment income") were, in many cases, lower than personal tax rates on such income. It was therefore possible to save taxes by investing through an investment holding company. Furthermore, since corporate tax rates were lower than personal tax rates, a tax-deferral opportunity was also available through investing and retaining income in the investment holding company.

As a result of changes to the Canadian tax system, the tax advantages associated with investment holding companies have all but been eliminated. It is generally no longer possible to defer taxes through an investment holding company. In most provinces, the combined corporate and personal tax rates on investment income slightly exceed the personal taxes paid on the same income.

A high corporate tax rate is initially imposed by the Canadian tax authorities on income earned by an investment holding company to prevent the use of an investment holding company to defer tax. There are no progressive tax rates and brackets for an investment holding company like there are for personal taxes. There is simply one high tax rate applied to all income earned in an investment holding company. However, similar to individuals in the highest tax bracket, Canadian dividend income and capital gains received in a corporation are taxed lower than interest or foreign income. The 50% inclusion rate for capital gains also applies to capital gains realized in a corporation.

A portion of the corporation's taxes paid on investment income is refunded when the holding company pays a taxable dividend to its shareholders. An investment holding company should therefore consider distributing its income to its shareholders in the same fiscal year that it is earned to minimize the net amount of corporate taxes paid for the year.

Even though the potential for tax deferral has been for the most part completely eliminated, investing through an investment holding company can provide some benefits. The following paragraphs illustrate some of the potential advantages.

Income Splitting

It may be possible to split income with adult children through the use of an investment holding company. Assets can be transferred to the holding company on a tax-deferred basis and the adult children can subscribe for shares of the company. Dividends can then be paid to the adult children and taxed in their hands at lower tax rates.

Estate Freeze

An investment holding company can also be used in a tax planning strategy called an "estate freeze." The goal of an estate freeze is to freeze a company's share value for the original shareholders, while ensuring that future increases in the fair market value of the company pass to the next generation or to other desired individuals. This way, the amount of income taxes at death and probate tax can be minimized. Another use of an estate freeze may be to crystallize the $750,000 enhanced capital gains deduction on the sale of qualifying small business corporation shares. It should be noted that shares of holding companies that are used only to hold investment portfolio assets do not qualify for the $750,000 enhanced capital gains deduction since the company is not engaged in an active business.

U.S. Estate Tax

Another reason for using a bona fide Canadian investment holding company is to hold U.S. situs investments in order to shelter a Canadian resident shareholder (non-U.S. citizen or green-card holder with a U.S. domicile) from U.S. estate tax. That is, U.S. estate tax may not be applicable to a Canadian resident shareholder that has U.S. situs assets in a bona fide Canadian corporation. The pros and cons of using a Canadian corporation to avoid U.S. estate tax are complex (particularly when U.S. real estate is held in a Canadian corporation), and you should seek advice from a professional tax advisor well versed in this area.

Conclusion

Due to the lowering of personal tax rates compared to corporate tax rates on investment income over the last several years, the use of a holding company to earn investment income may actually cause the prepayment of taxes and the ultimate payment of extra tax.

However, there are certain benefits in using an investment holding company that still exist and may outweigh the additional income tax and professional costs incurred. Furthermore, if you currently have an existing investment holding company; although there is a potential disadvantage in earning investment income in the company, winding up the corporation may not be in your best interest as it may result in a realization of previous tax deferrals. You should consult with a qualified tax advisor to determine if an investment holding company should be set up, or an existing one should be dissolved.

13 › Tax-exempt Life Insurance

Tax-exempt Life Insurance

Do you have surplus non-registered assets that you think you will never need but would like to pass on to your heirs when your estate is settled? If so, it probably does not make sense to continue exposing the income from these assets to your high marginal tax rate. If there's an insurance need or a desire for life insurance for other purposes, such as to cover your tax liability on death or to maximize the size of a charitable donation at death or the size of your estate left to your beneficiaries, consider speaking to your advisor about putting these highly taxed assets (typically interest-bearing) into a tax-exempt life insurance policy where the investment income can grow on a tax-free basis. This way, the amount of tax that would normally be paid to the CRA on the income earned on these surplus assets could instead be paid to your beneficiaries in the form of a tax-free death benefit.

If you need to access the assets within the life insurance policy, you can do so either directly (which would have tax implications) or through borrowing against the value of the insurance policy. The loan would be repaid after your death with a portion of the death benefit. While you may incur borrowing costs under this strategy, the use of the money is on a tax-free basis. Note that it may also be possible to use tax-exempt life insurance inside of your corporation depending on your objectives. Speak to your advisor at RBC if this strategy interests you.

14 › Investing in the United States

Generally, Canadian residents are taxed in Canada on income earned from their worldwide sources, including income received from U.S. sources. Prior to receiving U.S.-source income, a withholding tax is applied to income received from certain debt obligations, most shares of U.S. corporations and U.S. real estate.

To prevent U.S. income from being taxed twice (i.e. withholding tax paid in the U.S. and fully taxed in Canada), a foreign tax credit is applied to the tax payable on the investor's Canadian tax return, thereby recognizing the foreign tax paid.

INTEREST AND DIVIDENDS

Unlike dividend income received from Canadian corporations, U.S.-source dividends are not subject to the dividend gross-up and tax credit that result in a lower effective tax rate. Therefore, U.S.-source dividends and interest income are taxed at the same rates in Canada.

When declaring U.S. interest or dividend income on a Canadian tax return, this income should be converted at the CDN/U.S.-dollar exchange rate in effect at the date of payment or the average exchange rate for the year. However, the taxpayer should be consistent with the method of conversion used throughout that year's return.

Note: it is also important that the taxpayer is consistent from year to year in the use of an exchange rate method on the same investment.

CAPITAL GAINS

Capital gains on U.S. assets are treated in the same manner as capital gains on Canadian assets. When calculating the capital gain/loss on the sale of a U.S. investment, the cost and proceeds must be converted to Canadian dollars at the exchange rate applicable on the transaction dates.

WITHHOLDING TAX

Under the terms of the Canada/U.S. income tax treaty, dividend income from a U.S. source is subject to a withholding tax of 15%.

Changes to the Canada/U.S. income tax treaty have eliminated withholding tax on interest income received from a U.S. source.

Generally, tax is not withheld on capital gains recognized on U.S. investments with the exception of real property (i.e. real estate).

REAL ESTATE INVESTMENTS

Upon the sale of U.S. real estate owned by Canadian residents, the recognized capital gain is subject to tax in both the U.S. and Canada.

U.S. Tax Implications

A vacation property in the United States is regarded for tax purposes as an investment, and the disposition of such a property, if at a gain, will be subject to U.S. tax in most circumstances.

A withholding tax of 10% is generally levied based on the proceeds of the sale of the property. However, this withholding tax may be reduced or eliminated in certain circumstances. A U.S. non-resident tax return (a 1040NR) should be filed with the Internal Revenue Service (IRS) reporting the disposition, with any withholding tax applied against the actual tax payable.

Many states also require a tax return to be filed when real property located within the state is sold.

Canadian Tax Implications

To avoid double taxation, tax paid in the United States as a result of the sale of U.S. real property can be applied as a foreign tax credit against the tax payable in Canada.

U.S. ESTATE TAX

For Canadian residents (non-U.S. citizen and non green-card holders) with assets in the United States, estate tax is calculated on the fair market value (at the date of death) of all U.S. situs property including real estate, shares of U.S. corporations, U.S. debt obligations (with certain exceptions) and other tangible property such as vehicles, boats and art. U.S. situs property means any property that is considered to be situated in the United States.

The tax is calculated on the value of U.S. situs property, reduced by certain expenditures and deductions, such as an apportionment of funeral expenses, foreign taxes paid on U.S. property and certain indebtedness.

Deductions are then pro-rated based upon the value of U.S. assets in relation to worldwide assets. (For most Canadians facing U.S. estate tax, this pro-rating will result in only a minor deduction.)

How Much Do I Owe?

For Canadian residents that are not U.S. citizens (or U.S. green-card holders), U.S. estate tax is only potentially applicable if the value of your U.S. situs assets exceeds $60,000 US and your worldwide estate exceeds $3,500,000 US (in 2009).

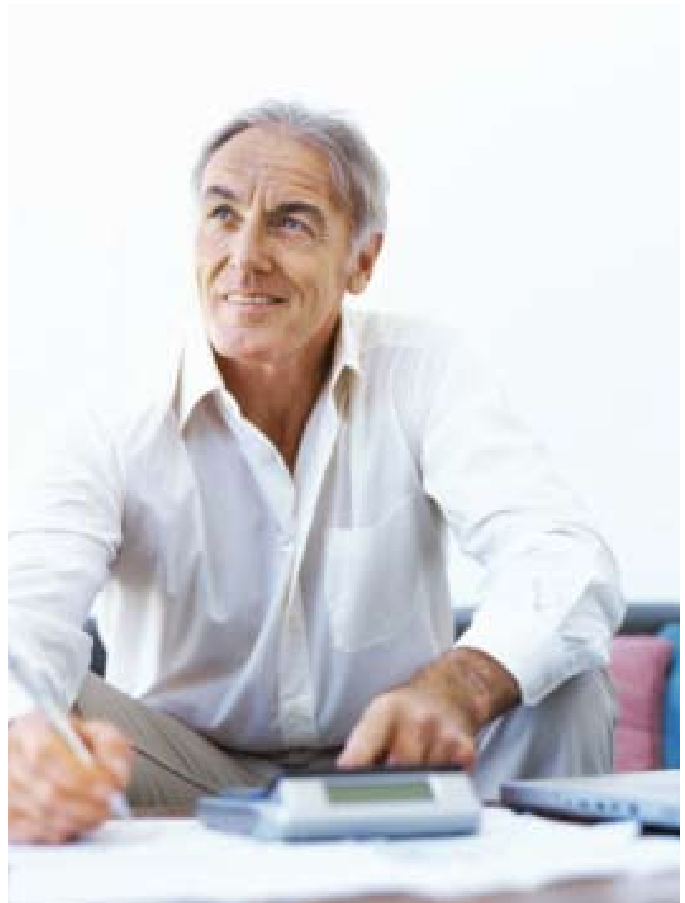
The tax rates imposed on the value of the U.S. situs assets range from 18% on taxable estates of $10,000 US up to a marginal rate of 45% for estates with values greater than $3,500,000 US.

The estate tax imposed on Canadians with U.S. situs property may no longer result in a double tax since the U.S. estate tax paid can now be used as a credit against Canadian income taxes payable at death (related to U.S. situs assets).

The U.S. estate tax is calculated by first applying the U.S. estate tax rates on the value of the U.S. situs assets less a U.S. estate tax “unified” credit. The unified credit for 2009 is $1,455,800 US, which is pro-rated based upon the value of U.S. assets in relation to worldwide assets.

TAX PLANNING TIP

- Consider gifting intangible assets such as U.S. stocks to avoid the gift and estate tax.
- Ensure that gifts of other U.S. property to any one individual do not exceed $13,000 US per year, and gifts to spouses do not exceed $133,000 US per year.



U.S. GIFT TAX

In addition to estate tax, the U.S. tax system also levies a tax on gifts of tangible property situated in the United States (e.g. U.S. real estate, art and automobiles.)

Gifts of intangible U.S. property such as stocks and bonds are not subject to the gift tax as long as the donor is not a citizen or resident of the United States. Otherwise, any gift of tangible assets in excess of $13,000 US per year (2009 value) to an individual will be subject to the gift tax.

Gifts made to a spouse who is not a U.S. citizen are exempt from the gift tax if the gift is not in excess of $133,000 US per calendar year (2009 value).

If in any year a gift exceeds the outlined annual gift limits, then a gift tax is levied on the excess. The gift tax rate applied is based upon the graduated tax rates of the estate tax system.

Although transferring assets by gift may avoid or defer U.S. estate tax, the gifting of assets is considered a disposition for Canadian tax purposes and could result in a Canadian capital gains tax liability where the person receiving the asset is someone other than your spouse.

For further information regarding the tax implications of investing in the United States, speak to your tax advisor.

15 › Conclusion

When you invest, you should understand the various types of investment income and the way each type of income is taxed in Canada. Being aware of and using the different opportunities and strategies available can help you build and protect your wealth. Some of these strategies include using different investment approaches, leveraging, income splitting, various registered investments, tax shelters, legal structures and insurance-based solutions. Working with your advisor at RBC and your qualified tax advisor will allow you to make decisions on these opportunities and strategies that are appropriate to your own personal situation.

In this publication, we have summarized some of the key considerations and strategies for Canadian private investors. If you are also a U.S. citizen or green-card holder, there may be other considerations and complications that may make some of the opportunities and strategies discussed inappropriate in your circumstances. You should consult with a qualified tax advisor familiar with both tax jurisdictions.

If you would like more information on any of the opportunities or strategies discussed in this publication, either for yourself, your family or someone you know, we would be pleased to help. Please contact your advisor at RBC for more information.

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