Strategies to Minimize Tax

In our industry so much attention is paid to driving top-line performance that an investor's after tax return is often overlooked. At Milestone, we develop a comprehensive investment plan for each client and distribute the assets in the most tax-efficient manner possible. As a result we deliver results where it really counts – at the bottom line. Below we present several strategies we use to ensure the highest after-tax return is achieved in client portfolios.

Strategies for Taxable Accounts

- **Promote Low Portfolio Turnover.** Turnover is defined as the part of a portfolio which is sold and replaced by new holdings each year. Since the average equity mutual fund has a turnover rate as high as 80%, the capital gains resulting from such activity means the CCRA takes a sizeable chunk from taxable profits every year. Over time, these taxes resulting from a high turnover strategy drastically erode the value of a client's portfolio. We utilize a low-turnover strategy which allows capital gains to accumulate inside the portfolio, giving it a significant boost through time.

- **Hold Tax-Efficient Assets outside an RSP.** This includes dividend-paying Canadian corporations and preferred shares which enjoy the benefit of the dividend tax credit.

- **Maintain an Equity Bias.** Stocks not only provide superior rates of return over time compared to cash, bonds and GICs, they are even better after tax. For example, in Ontario, the highest tax bracket for interest income (bonds, GICs and cash) is 46%, but for dividends and capital gains (stocks), it is only 31% and 23%, respectively.

- **Buy Discount Bonds.** This allows a portion of the bond's return to be taxed as a capital gain at maturity.

- **Use Joint Accounts in 'His and Her' and 'Her and His' Names.** This allows us to implement a customized tax strategy for couples. Each portfolio is structured so as to minimize overall taxes by taking advantage of the separate and often different marginal tax brackets attributable to each spouse.

- **Take Advantage of Capital Losses.** Year-end tax planning is critical to the success of any investment plan. Crystallizing any losses to offset gains realized earlier in the year or even deferring gains until the next tax year can help reduce or defer taxes. Over time, the bottom-line saving is significant.

- **Loan Money to Lower Income Spouse.** This strategy is especially effective in the current low-interest rate environment. Money may be loaned at 3% (CCRA sets it quarterly) and carried forward indefinitely at this rate. Carrying costs of the loan are attributable to the high-income earner, but the proceeds of the loan are invested in the hands of the low-income earner. The benefits of income splitting in this manner are substantial over time.

- **Hold Stocks with Dividend Income.** Dividend income is taxed much more favourably than interest income. In addition, in the case of spouses, additional strategies are possible. For example, if one spouse earns only dividend income, the first $30,000 is tax-free. Alternatively, CCRA allows the lower income earner (of a couple) to transfer any dividend income to the higher income earner. This may enhance the spousal tax credit if such individual's income is below $6,900 per year.

Strategies for Registered Accounts

- **Shelter the Highest-Taxed Assets inside an RSP.** For clients with taxable and non-taxable portfolios who do not require income, we place interest-bearing investments, to the extent possible, in the RSP/RIF to minimize tax. We also allocate equity investments with higher turnover rates and capital gains distributions in the RSP/RIF to defer tax. These typically include small cap and emerging market stocks which by their nature tend to have more volatility and higher capital gains distributions.

- **Use the Tax-Sheltered Account as the 'Swing' Portfolio.** Where possible we conduct strategic asset-mix shifts (adjusting the portfolio allocation between stocks, bonds and cash) in a client's tax sheltered account, thereby reducing or eliminating the tax costs of realized capital gains.

- **Realize a Loss in a Taxable Portfolio and Simultaneously Buy the Same Security in a Tax-Sheltered Account.** Since a tax-sheltered plan is a legal Trust, it is considered a separate entity from an individual's taxable portfolio. Current tax legislation permits crystallizing capital losses and buying the same security in a registered plan without having to wait the usual 30 days. This eliminates the risk of the stock appreciating in value during the waiting period and potentially eliminating the value of the strategy. Capital losses may be carried backwards for three years and forward indefinitely.

- **Utilize Spousal RSPs.** This shifts future income to the lower-earning spouse, thereby helping to equalize retirement income and reduce taxes.

- **Open RESPs.** These help clients save for their children's post-secondary education in a tax-advantaged way. In addition, the federal government currently provides an annual grant of 20% on the first $2,000 contribution per child.

It's clear that managing a client's wealth in a tax-sensitive way adds significantly to the bottom-line return over time. At Milestone, we pay close attention to each client's tax situation because, in fact, the only return that matters is the one achieved after costs, after fees and - after taxes.

Milestone Investment Counsel Inc.

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