Total Financial Solutions

Practical Perspectives on Tax Planning

ScotiaMcLeod™

Contents

Why is Tax Planning Important? 2

Tax Planning for Investments
- How much tax do you pay? 3
- Borrowing to invest 5
- Income splitting strategies 5
- Taxes at death 7
- U.S. estate tax 7

The Role of Insurance in Tax Planning
- Creating a tax-free wealth transfer 8
- Protecting assets against taxation 9
- Generating tax-preferred income 9
- Minimizing tax on corporate assets 10
- Minimizing tax through charitable giving 10

The Role of Trusts in Tax Planning
- Trust strategies and tax efficiency 11
- Establishing a charitable foundation 12
- Creating an estate freeze for business succession 12

Why is tax planning important?

You've worked hard to earn your money and in turn, you want to see as much of it as possible work for you. Tax planning allows you to identify opportunities now and build towards a tax-efficient solution centred on your priorities.

Building and preserving your wealth requires a detailed look at your overall financial picture, including your personal and business circumstances, the tax implications of your investments and how insurance and trust strategies can be used effectively.

The guidance of a professional tax advisor should be sought before you consider implementing any of the strategies identified here. We draw on specialists from across the Scotiabank Group who we work with to develop a customized solution within the context of your goals as part of creating your overall plan.

TAX PLANNING FOR INVESTMENTS

By structuring the right mix of investments for your portfolio, you may be able to pay less tax and help ensure you receive optimal returns. The first step towards developing a tax-effective investment plan is knowing how much tax you are paying and how much tax you pay on each type of income you may receive. This sounds obvious, but many Canadians are not sure what their marginal tax rate is.

HOW MUCH TAX DO YOU PAY?

Different types of income are taxed differently.

When selecting investments for your portfolio, it is important to know that not all investment income is taxed the same. This could have a significant impact on your after-tax returns. Interest income is taxed at the highest rate while capital gains and Canadian dividends are taxed at lower rates.

While it is after-tax income that is important when evaluating an investment, tax implications should not be the sole criteria for judging an investment. Other factors such as risk, liquidity, opportunity for appreciation and your overall goals and objectives should also be considered.

Your after-tax investment income will be dependent on several factors including: other income sources, deductions available and your marginal tax rate.

What is a marginal tax rate?

This is the rate of tax applied to each additional dollar of income you earn. In calculating your taxable income, the income you earn from investments is added to your income from all other sources. As a result, each additional dollar of investment income is taxed at the highest rate applicable to your total income.

What do I report as interest income?

Interest income is fully taxable on a yearly basis at applicable combined tax rates whether or not you actually receive the income. For example, there are certain investments (GICs, strip coupons or CSBs) where you may earn interest but not receive it until a later time. These amounts must still be reported on your tax return as interest earned. In the case of investments with terms that are one year or less, the income is reported in the year received (e.g. T-Bills). Where possible, consider structuring those investment purchases so that the maturity date is after the year end. This will effectively defer tax for another year.

How are dividends taxed?

Dividends received from taxable Canadian corporations are taxed at a lower rate than interest income. This is because dividends are eligible for a dividend tax credit which recognizes that the corporation has already paid tax on the income that is being distributed to shareholders. However, dividends received from foreign corporations are not eligible for this tax credit and are taxed in the same manner as interest income.

Please refer to the detailed insert at the back of this booklet for a current example of how a tax-payer in the top tax-bracket would be taxed on a $100 dividend, interest and capital gain.

Is there a dividend/interest trade-off?

It’s clear that when making investment decisions, it is right to be concerned with after-tax rates of return. Given that dividends are taxed at a lower rate than interest bearing vehicles, an obvious question arises: what interest rate must be achieved to be indifferent after-tax, relative to receiving dividend income?

The calculation required to determine this is the amount of money retained after-tax from dividend income divided by the amount retained after-tax from interest income.

As an example in Ontario, on an after-tax basis at the highest marginal tax rate, you must receive about $128 of interest income for every $100 of dividend income in order to have the same after-tax return.

While it takes less in dividend income to get the same after-tax return as interest income, there can be more risk when investing in common or preferred shares than in fixed income investments. However, the lower tax rate along with the growth potential of common stocks can often offset these risks for at least a portion of your portfolio.

What is a capital gain?

Capital gains result when you sell an asset for more than you paid for it (the following information relates only to non-depreciable assets). Any expenses that you incur to purchase the asset or to sell the asset would further reduce the amount of the gain or alternatively, increase the amount of the loss.

It is your net capital gains that are taxed in a particular year.

- Net capital gains are equal to your total capital gains less any capital losses within the same year.
- Half (50%) of the net capital gain is referred to as the taxable capital gain. It is this amount that is taxable at appropriate federal and provincial rates.

What is a capital loss?

A capital loss would occur when the proceeds (minus expenses) are less than what you paid for the asset. When total capital losses exceed the total capital gains, you have a net capital loss for that year.

- Net capital losses are eligible to be carried back three years and applied against gains or carried forward indefinitely to be applied against gains in a future year.

Considerations for capital losses

Superficial loss

A superficial loss occurs when an asset is sold at a loss and reacquired by you or your spouse (or a corporation controlled by either) within 30 days prior to the sale date and ending 30 days after the sale date. This type of loss is not deductible for tax purposes but does get added to the cost of the asset acquired as a result of the transaction.

Losses and transfers to your RSP account

Many people do not realize that transferring securities from their taxable account into an RRSP is a disposition of the asset for tax purposes. If these securities are worth more than their purchase price, a capital gain must be reported.

- If a capital loss occurs as a result, it is denied and can't be used to offset other capital gains.

Generally, interest bearing vehicles should be purchased to the extent possible within an RRSP. On the other hand, dividend and capital gain producing vehicles should be purchased outside registered plans to take advantage of the tax treatment of dividends and capital gains.

BORROWING TO INVEST

Borrowing to invest can work to your advantage as interest payments on loans for investments are tax deductible. However, there are some restrictions.

In the case of debt instruments, interest payments are deductible only up to the rate yielded by the security purchased.

- For example, if you borrowed funds at 6% to purchase a bond that pays interest at 4%, you are only able to deduct 4% as interest costs.
- Interest costs incurred to purchase preferred shares are deductible at 1.25 times the rate of the preferred dividend. For example, if the preferred dividend was 4%, interest could be deductible up to 5%.
- Interest incurred on money borrowed to buy common shares is generally deductible whether or not any dividends are actually received, provided the common shares you purchased with borrowed funds have the potential to produce investment income at some time in the future. For individuals in Quebec on their Quebec tax return, interest expense and other carrying charges can only be deducted against investment income reported in the year.

Borrowing can also have a negative outcome if the investment that you purchased with borrowed funds decreases in value. You may end up owning an investment that is worth less than the loan amount outstanding. Make sure that this strategy is appropriate for your risk profile.

CONVERTING NON-DEDUCTIBLE DEBT TO DEDUCTIBLE DEBT

Since interest is generally tax-deductible when you borrow for investment purposes, you can consider converting non-deductible debt into deductible debt.

- You can do this by using available cash to pay down personal loans and then reborrowing for investment or business purposes.
- If you have a portfolio and non-deductible debt, you may want to liquidate enough of your portfolio to pay off the debt and then reborrow to purchase securities.

INCOME SPLITTING STRATEGIES

Income splitting involves dividing income more evenly among family members to reduce the overall tax liability of the family.

- For example, if $1,000 of income is taxed in the hands of a family member whose marginal tax rate is 20% lower than yours, the saving is $200.

Attribution Rules: Although income splitting is allowed between family members, there are provisions in the Income Tax Act (called attribution rules) which discourage income splitting. In certain circumstances, these rules attribute income back to you, taxing it in your hands even though you did not receive it. Still, there are several strategies that can be used to legally split income among family members.

1. Income Splitting with a Spouse

There is attribution of interest, dividends and capital gains back on any money gifted or loaned to a spouse at a rate lower than the current Canada Revenue Agency (CRA)/ Revenue Quebec (RQ) Prescribed Rate.

However, there will be no attribution back to a spouse of income or capital gains from a loan where interest is charged at the current CRA/RQ Prescribed Rate.

Use of a spousal RRSP

Good retirement planning results in both spouses earning similar amounts of income at retirement to take advantage of both individual's lower marginal tax rates. Contributing to a spousal RRSP allows one spouse to split income with the other when funds are removed from the RRSP in the future.

Individuals should be aware that there will be income attribution on a withdrawal from a spousal RRSP if there has been a contribution to any spousal plan in the year of withdrawal or the previous two years.

Interest deductibility is continually under review. Check with your tax advisor to ensure you have the most recent information.

How to employ income on income

An income on income strategy is an effective method of transferring capital from a spouse in a high tax bracket to a spouse in a lower tax bracket. The attribution rules tax income earned on money transferred to a spouse back to the transferring spouse. This income, however, becomes the capital of the transferee spouse for reinvestment purposes.

The income earned on the reinvested capital (income on income) is not attributed back but is taxed in the hand of the transferee spouse. The income on the original transfer will continue to be taxed each year in the hands of the transferring spouse.

An example of income on income

Mr. Jones is in the top tax bracket so he decides to give Mrs. Jones $100,000 to invest in order to earn income for herself. Mrs. Jones invests the money and receives a 10% return each year for a ten year period. The table below shows the effect:

Year	Gift	Income Taxed to Mr. Jones	Mrs. Jones Capital	Mrs. Jones Income
1	$100,000	$10,000	$10,000	Nil
2		10,000	21,000	1,000
3		10,000	33,100	2,100
4		10,000	46,410	3,310
5		10,000	61,051	4,641
6		10,000	77,156	6,105
7		10,000	94,782	7,716
8		10,000	114,359	9,487
9		10,000	135,759	11,436
10		10,000	159,375	13,580
				$59,375

After the ten years, Mrs. Jones has accumulated $159,375 of her own capital which is comprised of the $10,000 earned each year on the original gift, plus $59,375 of income on income. Note that this example assumes that Mr. Jones pays the tax liability on the attributed income from other sources.

2. Income splitting with children

Under the age of majority

There is attribution of interest and dividend income back to a parent or grandparent on any money gifted to a minor but not on capital gains.

Since capital gains do not result in attribution to minors, you may want to consider the following strategies:

- Invest in stocks or mutual funds that only produce capital gains and pay out very little income.
- Salary could also be paid to a child from a family business but only to the extent that it is reasonable given the specific circumstances.

Age of majority or older

Monetary gifts to children at age of majority or older can be done without any income attribution. Once you have gifted the money, it is the child's to do with it as they wish.

This money could then be used to allow them to make their maximum RRSP contributions. It also allows them to earn sufficient income to absorb their personal deductions and credits and to pay for certain expenses that you might ordinarily pay out of your own after-tax dollars. This can be an effective way to fund education expenses.

TAXES AT DEATH

Tax planning plays an important role in your estate plan for a number of reasons, notably due to the deemed disposition rules that occur at death, and generally, but to a lesser extent, probate fees and U.S. estate taxes.

Deemed Disposition

In the year of your death a final tax return (or terminal return) is filed by your executor that includes all your income for the year until the date of your death. As well, on death, you are deemed to have disposed of your capital property (e.g. stocks, real estate, etc.). While the rules can be complex, particularly when you own private companies or business properties, essentially the assets are treated as if they were sold immediately prior to your death. The resulting capital gains (or losses) are included in your final tax return along with any registered assets (which are deregistered at death so that their full value is included as income in the year of death).

Taxes can be deferred by transferring your capital property in your Will to your surviving spouse. In this case, the tax would not be due until the earlier of either the actual sale of the asset or the death of your spouse. Registered assets work the same way. If they are transferred to your spouse, either by your Will or by a beneficiary designation, there would be no taxes paid on the rollover; only when funds are removed or at the death of your spouse. In the case of your registered assets, there are some special provisions to provide for dependent children or grandchildren that will also lessen the tax burden on these assets while providing support for these dependents.

There is one noteworthy exception. While still considered to be disposed at death, there is no tax on your principal residence. However, if you own a second property, only one property can be designated a principal residence.

U.S. ESTATE TAX

Canadian residents may be subject to U.S. estate tax on property situated there. U.S. property includes real property, pension plans, shares of corporations, and certain bonds and debt. Tax is levied on the fair market value of the property, not just the increase in value.

How Much Will I Pay?

For 2005, U.S. estate tax rates range from 18% on the first $10,000 of U.S. assets to 47% on the portion of the estate's taxable assets in excess of U.S. $2,000,000. Under the Canadian/U.S. Income Tax Treaty, Canadian residents are entitled to a pro-rated portion of the standard $555,880 U.S. estate tax credit that translates into a pro-rated U.S. $1,500,000 exemption equivalent.

Non-residents of the U.S. with surviving spouses can defer U.S. estate taxation by creating a qualified domestic trust that qualifies for a U.S. marital deduction with certain restrictions. Canadians can also elect an additional spousal credit, equal to the pro-rated unified credit the decedent will be allowed, which will be available only on property passing to the surviving spouse.

A Canadian income tax credit is now allowed for the U.S. estate tax in an amount not in excess of the Canadian deemed capital gains, income and profit taxes that would have otherwise been payable on the decedent's U.S. assets.

Note: The above commentary does not apply to U.S. citizens. U.S. Estate Taxes are complex and expert advice should be sought.

THE ROLE OF INSURANCE IN TAX PLANNING

Tax protection strategies can have a significant impact on the value of your estate and the wealth you leave for your beneficiaries. Typically, insurance has been used within a well-developed financial plan against the risk of future financial loss. Beyond that, a rising number of Canadians have come to rely on innovative insurance solutions to safeguard the value of their estate assets in a tax-efficient manner. Pre-tax compounding and tax-free payouts are two primary drivers in the consideration of certain insurance strategies.

THE MAJOR TAX-RELATED BENEFITS OFTEN ASSOCIATED WITH INSURANCE ARE:

1. **Creating a tax-free wealth transfer**
   Insurance is transferred to your beneficiaries outside of your estate and as such does not trigger additional taxes, probate fees or legal costs.

2. **Preserving assets against taxation**
   Insurance can be designed to provide your beneficiaries with a lump sum of cash equal to the taxes owing on the deemed disposition value of your investments.

3. **Generating tax-preferred income**
   Insurance strategies can be used to create tax-preferred retirement income streams.

4. **Minimizing tax on corporate assets**
   Insurance can provide a means to move surplus assets out of your corporation on a tax-preferred basis while enhancing the value that will be passed to your beneficiaries.

5. **Minimizing tax through charitable giving**
   Insurance will help increase the size of your gift and in most cases provide significant tax benefits.

CREATING A TAX-FREE WEALTH TRANSFER

Once you have a plan that ensures your capital will generate sufficient income and address your needs, you may want to consider shifting a portion of your assets to a tax-exempt environment. With a tax-exempt insurance policy, you can maximize the value of your estate. While saving taxes, you can pass on capital to your beneficiaries either through a policy on your life, leaving the proceeds to your children or on your childrens' lives as a legacy for future generations.

Tax-exempt life insurance can add significant value to your assets on death since they accumulate within a contract free of annual accrual taxation. Universal Life and Participating Whole Life are two types of insurance with different characteristics typically used in this way.

Part of your premium will pay for the cost of the insurance and the rest will be invested, allowing the policy's ultimate benefit to grow through the years. Tax-exempt life insurance shares certain characteristics with other types of investments, however no other asset allows for all of the following:

- tax-deferred growth, much like within your registered pool of capital
- potential for tax-free income during retirement
- tax-free distribution on death

PROTECTING ASSETS AGAINST TAXATION

If you've worked hard to build your investment portfolio, it is worth protecting it from the eroding effects of taxation. This is especially critical for registered investments like RRSPs and RRIFs that become fully taxable on the death of a surviving spouse.

Depending on the province in which you live and on your estate's marginal tax bracket and on the type of asset being taxed, the CRA/RQ may take upwards of 50% of the value of those assets. This concern extends beyond your retirement assets to other investments or valuables such as the family cottage that may be subject to capital gains tax.

Tax-free insurance proceeds are immediately available on death and provide the funds to pay taxes at the time. In the absence of using tax-free insurance, beneficiaries may have to consider either selling the estate assets or borrowing funds necessary to pay taxes owing on the estate.

GENERATING TAX-PREFERRED INCOME

In developing your financial plan and identifying how your income will be derived in retirement, consider how insurance products can play a role.

Creating an insured retirement strategy

By combining the insurance and investment components of a Universal Life or Participating Whole Life policy, an insured retirement strategy can help you meet the need for both supplemental retirement income and estate liquidity in a tax effective way.

By allocating excess capital or income into a tax-exempt insurance structure a number of years ahead of retirement, you allow the investment component to grow over time into a large pool of capital, better known as the policy's cash value. At retirement, up to ninety percent of this cash value can be pledged to a bank in exchange for a series of loans. As loans, the corresponding retirement income they create is not considered taxable income.

This approach is also a consideration for small corporations.

Shareholders can use the tax-free loan proceeds against the cash value of a corporate-owned policy to supplement their retirement income.

Securing a guaranteed income stream

Life annuities can be very useful in providing a guaranteed, lifetime, tax-preferred income. An annuity is the opposite of life insurance: instead of paying an insurer small annual amounts in return for a large amount on death, you give the insurer a large amount up front and receive small annual amounts every year until death. Each payment is a blend of interest and a return of your original capital, of which only the interest portion is taxable.

If guaranteed income is a requirement as well as maintaining your estate, it can be accomplished by insuring your original annuity deposit. The net income from this strategy is often much higher than the net income from a GIC or bond, even with the cost of the insurance.

This strategy can be considered if you own shares in a small corporation.

The concept is the same: a higher net income for the shareholder than a traditional fixed income investment through the purchase of an annuity. However, an added benefit is derived from the corporation receiving the insurance proceeds at death, which allows for a greater amount of corporate wealth to be paid out of the corporation free of tax. Additionally, the corporation reduces the value of the shares, thereby reducing or potentially eliminating capital gains tax that might otherwise be owing on the value of the shares.

MINIMIZING TAX ON CORPORATE ASSETS

A tax-exempt life insurance policy can be employed as a strategy to move surplus assets or retained earnings out of a corporation on a tax-preferred basis, significantly enhancing the value of corporate assets that are passed on to beneficiaries. This is well worth considering since annual growth on investment income inside a corporation is taxable at a higher rate than if owned personally. And when money is taken out of the corporation, it will be taxed again, most likely as a personal dividend, thereby creating double taxation.

The strategy involves shifting redundant corporate assets from a taxable portfolio to a tax-exempt life insurance policy. The proceeds of the combined death benefit and tax-deferred growth within the policy are paid to the corporation at death. This creates the ability to channel funds from the company to the shareholder's estate without tax; an opportunity not readily available with taxable investments. The mechanism for this asset flow is an account that permits Canadian controlled private corporations to pay out tax-free capital dividends.

MINIMIZING TAX THROUGH CHARITABLE GIVING

The gift of life insurance can be effective in providing a practical and affordable way to make sizeable charitable gifts to your favourite charities or private foundation. Not only will life insurance help increase the size of your gift, in most cases it will provide significant tax benefits.

THERE ARE FOUR WAYS THAT YOU CAN LEAVE A LEGACY THROUGH LIFE INSURANCE:

1. **Transfer ownership of a paid-up policy to a charity.**
   This is equivalent to an outright gift of cash in the amount of the policy's cash surrender value. The charity can surrender the policy immediately or retain it until the insured individual dies and collect the death benefit then.

2. **Transfer ownership of an existing policy in which the premiums are still being paid.**
   A policy is gifted to a charity and the person receives charitable receipts for each subsequent premium. Tax savings are received during life from donating the policy itself and subsequent premiums. The charity will receive the death benefit but no further receipt will be issued.

3. **Create a new policy and name the charity as owner and beneficiary.**
   This is an effective way to donate to a charity you are currently supporting. You receive a tax receipt for annual premiums but not for the death benefit.

4. **Designate the charity as the beneficiary of a new or existing policy so that the charity will receive the life insurance proceeds at death.**
   This will not generate any tax credit during your lifetime however the amount of the death benefit will be paid out as if it was a bequest made in your Will. In the year of death, your estate will receive a charitable receipt for the face amount of death benefit that the charity receives.

THE ROLE OF TRUSTS IN TAX PLANNING

Tax efficiency relating to the use of trusts is best considered within the context of your goals and your overall estate plan, undertaken with the help of a professional. The motivation to create a trust is usually driven by your wishes and/or the needs of your intended beneficiaries rather than for tax reasons alone. A trust is created by a person through a Will or a document known as a deed. It sets out terms of the trust and appoints a Trustee to administer it. Depending on your objectives, funds can be put in a trust during your lifetime, on your death or a combination of both.

TRUST STRATEGIES AND TAX EFFICIENCY

Once the core principles of your estate plan have been identified, a professional can identify the most appropriate tax planning strategies and give you practical perspectives reflective of the complex and ever-changing tax environment.

Key issues that trusts can address include minimizing probate fees, creating opportunities for charitable giving, establishing trusts to help beneficiaries realize tax advantages, providing for any beneficiaries with special needs and preserving family assets. Every situation is different and a tailored approach will help ensure that your individual needs are addressed with tax efficiency in mind.

The major tax related benefits often associated with trusts as part of your estate plan are:

- Deferral of tax on capital gains
- Reduction of income tax otherwise payable on death
- Splitting income between family members

Setting up a trust, establishing a private foundation and creating an estate freeze for your business are key strategies worth considering that will help ensure you continue to meet your tax obligations while taking advantage of tax saving opportunities.

SETTING UP A TRUST

1. Inter Vivos Trust

Created during the lifetime of the person who contributes property to the trust. Depending on the exact nature and purpose of the trust, there may be opportunities to defer capital gains and split income.

2. Alter Ego Trust

A variation of the Inter Vivos Trust except that it is created by a person who is 65 years of age or older, with the restriction that no person other than the contributor may receive any benefit from the trust during the contributor's lifetime. A Joint Partner Trust would allow the spouse to be a beneficiary too.

3. Testamentary Trust

Created as a consequence of a person's death under the terms of the Will. As a testamentary trust is a separate tax paying entity with its own graduated rates, there is an opportunity to split income between the trust and its beneficiaries. If a spousal trust is created under the Will, capital gains taxes may be deferred.

4. Charitable Remainder Trust

Created during the lifetime of the person who places assets in trust for the ultimate benefit of one or more charities in specified proportions. The person continues to receive the income from the assets during their lifetime and an immediate (discounted) tax receipt is issued for a future gift.

ESTABLISHING A CHARITABLE FOUNDATION

Establishing a foundation should be examined as part of a charitable giving strategy that will allow you to make a lasting contribution to your community and receive a tax benefit now or in the future. A private foundation is a registered charity with the CRA/RQ and can be created as a Federal or Provincial incorporation or through the establishment of an Inter Vivos or Testamentary Trust.

If you establish and donate qualifying assets to your foundation while you are alive, you will receive a donation tax credit, which may reduce your tax liability for the current and future years. The foundation also benefits since it can liquidate any assets it receives without incurring capital gains taxes. Working with a professional will help establish clear objectives for the foundation that conform to applicable tax requirements and may include insurance strategies.

If you leave a bequest to charity or establish a foundation under your Will, you have full use of your assets during your lifetime. From a tax standpoint, charitable donations can be used to offset up to 100% of your net income in the year of your death as well as the prior year.

CREATING AN ESTATE FREEZE FOR BUSINESS SUCCESSION

An estate freeze refers to the transfer of future growth in the value of a business, investments or other assets into the hands of subsequent generations. Typically, it is implemented to maximize the value of the estate that will ultimately be transferred.

In addition to reducing the amount of taxes arising on death, an effective estate freeze will:

- crystallize the accrued capital gain while still deferring payment of tax. This will facilitate greater certainty for the planning of future tax liabilities.
- permit future income and capital gains to be taxed in the hands of family members who may be in lower tax brackets
- protect future growth from creditors of the current business owner
- reduce probate fees that would otherwise be calculated on the value of the assets

A properly planned and implemented estate freeze will occur on a tax-deferred basis and permit the current owners to maintain control over the assets during their lifetime notwithstanding that future growth is divested for the benefit of subsequent generations.

We draw on specialists from across the Scotiabank Group who we work with to develop a customized solution within the context of your goals as part of creating your overall plan.

The information in this booklet is provided for information purposes only and is not intended to replace the advice of a lawyer or accountant and should not be relied upon as such. It is recommended that individuals consult with their own tax advisor before acting on any information contained here.