



RON GRAHAM AND ASSOCIATES LTD.

10585 - 111 Street NW, Edmonton, Alberta, T5M 0L7
Telephone (780) 429-6775 Facsimile (780) 424-0004
Email rgraham@rgafinancial.com

How Can You Reduce Your Taxes?

Tax Brackets. In Canada, we have a progressive tax system. This means that the higher your income the greater your tax rate. Alberta has a flat tax system. The tax rate is the same regardless of your income. The following table shows the tax rates for 2014.

Income Level	Federal	Alberta	Combined
\$1 - \$43,953	15%	10%	25%
\$43,954 - \$87,907	22%	10%	32%
\$87,908 - \$136,270	26%	10%	36%
\$136,271+	29%	10%	39%

Your marginal tax rate is the combined tax rate of your last dollar earned. This is the cost (in tax) of earning additional income. This is also how much tax you save with tax deductions (such as pension or RRSP contributions).

Maximize RRSP Contributions. You should make your maximum RRSP contribution while you are working. You will get a tax deduction now at your current tax rate and you will be able to take the money out later when you are possibly in a lower tax bracket.

Spousal RRSP. The higher income spouse should contribute his/her RRSP amount to an RRSP for the lower income spouse. This spousal RRSP will not affect the lower income spouse's own RRSP contribution room.

Lower Paid Spouse Contributes to Own RRSP. The lower income spouse should contribute his or her own RRSP. For the purpose of income splitting, the higher income spouse can give the lower income spouse the money necessary to make the contribution. The lower income spouse's RRSP should be separate from the spousal RRSP.

We would suggest that you have a total of three RRSPs. These would be an RRSP for the higher income spouse, a spousal RRSP for the lower income spouse, and the spouse's own RRSP for the lower income spouse.

Contribute Early. Ideally your contribution should be made as soon as possible in the year in order to shelter the investment income from tax.

Rollover of Retiring Allowance. If you receive a Retiring Allowance from your employer, some or all of this amount can be transferred to an RRSP. The maximum that you can contribute is the lesser of: 1) the amount you receive; or 2) \$2,000 per year of service

prior to 1996 plus \$1,500 per year prior to 1989 when you were not a member of a pension plan. This must be contributed to your own RRSP.

Start Pension Income at 65. Income from an employer sponsored pension plan qualifies for a Pension Income Tax Credit, which effectively shelters the first \$2,000 of pension income from tax. If you or your spouse do not have qualifying pension income, when you reach age 65 you can transfer your RRSP to either a RRIF or annuity. These payments would qualify for the Pension Income Tax Credit.

Maximize TFSA Contributions. You should make your maximum contributions to your Tax Free Savings Accounts. This year (2014) you will be able to contribute \$5,500 each (this amount is periodically adjusted for inflation). You will not get a tax deduction for the contribution, but the capital can grow tax free. When you withdraw funds, you will not have to pay tax on the withdrawal (whether income or capital). Any unused contribution room (since 2009 or turning 18) is carried forward until death. Any withdrawals are added to future TFSA contribution room.

Non-Registered Investments. One way to reduce income taxes is through the type of investment income you receive. Your marginal tax rate on fully taxable income may be as high as 39%.

Interest Income. Interest is taxed at your marginal rate. In Alberta, the tax rate on interest earned below \$43,953 is 25%. Between \$43,954 and \$87,907, the tax rate on interest is 32%. Between \$87,908 and \$136,270, interest is taxed at a rate of 36%. On income above \$136,270, interest is taxed at a rate of 39%.

Rental Income. Net rental or lease income is taxed at the same rate as interest income. Against the gross rents you can deduct your direct costs as well as capital cost allowance. Significant improvements to the property are added to the cost of the property. They are not available as a deduction against other income.

Other Income. Foreign dividends and income from limited partnerships or income trusts are taxed at the same rate as interest income. Any foreign taxes paid can be used as a foreign tax credit or tax deduction.

Dividend Income. Dividends from a Canadian corporation are tax favoured. Through the dividend gross-up and tax credit, you pay tax at about one half of the rate you would if it were interest income. In Alberta, the tax rate on dividends below \$43,953 is 0% (the dividend tax credit offsets the tax on the dividend income). Between \$43,954 and \$87,907, the tax rate on dividends is about 10%. Above \$87,907 to \$136,270, dividends are taxed at a rate of about 15%. On income above \$136,270, dividends are taxed at a rate of 19%. With the personal exemption, an individual could earn about \$50,000 of Canadian dividends and pay no tax if there was no other income earned during the year.

Capital Gains. By investing in equities (or real estate) you may also achieve a capital gain (or loss) on the sale of these investments. Only one half of capital gains are taxable so that the effective tax on capital gains is one half of the rate charged for interest income. In addition, the tax is deferred until the capital asset is sold.

In Alberta the effective tax rate on capital gains in the lowest tax bracket is 12.5% and in the second tax bracket is 16%. In the third tax bracket, capital gains are taxed at 18%. In the highest tax bracket, capital gains are taxed at 19.5%.

Return of Capital. By investing in certain structured investment trusts you may receive a combination of income and return of capital payments. The income (interest, dividends or capital gains) is taxed at your marginal tax rate. The return of capital payments are not taxed in the year of receipt. The amount received is deducted from the original cost of the investment. When the investment trust is sold, a capital gain (or loss) is calculated based on the new (lower) cost base.

Some financial services companies market mutual funds where the payment you receive (usually monthly) is considered a return of capital. You do not have to pay tax on the money you receive. When you sell your units then a capital gain or loss is calculated. Each year the fund must distribute its income and realized capital gains. This distribution is usually reinvested in more units of the fund, but you will have to pay tax on the income.

Income Splitting with Spouse. To the extent permitted, your family finances should be arranged to ensure that investment income is taxable in the hands of the individuals with the lowest marginal tax rate.

If the lower income spouse has a lower marginal tax rate than the higher income spouse, the higher income spouse should pay all living expenses allowing the lower income spouse to accumulate funds for investments or future asset purchases.

This strategy includes having the higher income spouse pay for any income tax liability of the lower income spouse's as well as their RRSP and TFSA contributions as these payments avoid income attribution.

Second Generation Income. If the lower income spouse does not have any income, it is difficult to accumulate capital in their hands. If you were to gift or loan money to him or her, the income attribution rules would come into effect. These basically state that income earned on an investment must be taxed in the hands of the individual who "owns" the capital.

One exception to the attribution rules is second-generation income. If you gave the lower income spouse \$10,000 and he/she invested it at 5%, you would have to pay the tax on the \$500 of income generated in the first year. But that \$500 now actually belongs to the lower income spouse, so any income generated by investing that \$500 would be taxed as their income. Over time, this would create an investment pool in the hands of the lower income spouse that would be taxed at a lower tax rate.

Lend to Spouse for Investing. Another way around the attribution rules is for the higher income spouse to lend money to the lower income spouse. If you loan money at the "Prescribed Rate" then the income would not be attributed back to you. However, the lower income spouse would have to pay you interest on the loan at 1% (today's "prescribed rate"). This interest income must be included on your tax return. The investment income earned would be taxed in the lower income spouse's hands. Once the loan has been set up, the interest rate continues until the loan is paid off. If you are getting a higher than 3% return on your investments, it makes sense for you to lend your capital to the lower income spouse in exchange for the 1% interest payment.

Spouse with Low Income Could Borrow to Invest. A third way around the attribution rules is for the lower income spouse to borrow money for investment. Because the lower income spouse borrowed the money, any investment income will be taxed in the lower income spouse's hands. If you give money to your spouse to pay off some or all of the loan, the attribution rules do not apply, as you have not given the lower income spouse money for "investment" only for debt reduction.

Pension Sharing. Under current tax legislation you are able to “split” your qualifying pension income. Up to 50% of pension income can be transferred from (generally) the higher income spouse to the lower income spouse. “Qualifying” pension income includes employer sponsored pension payments at any age and RRIF and LIF income once you turn age 65.

There is no cash transferred from one spouse to the other, only an accounting entry on your tax returns. The amount can change each year or be stopped completely in certain years. The actual amount can be determined each year when you prepare your tax returns.

Split CPP. Once both of you are eligible to receive CPP, you can both apply to have your pension split equally between you. This way, income that would be taxed in the higher income spouse’s hands can be shifted to the lower income spouse’s and be taxed at a lower tax rate. This may reduce the tax burden of the family.

This is different than pension sharing as described above. There is an actual reduction of the higher income spouse’s CPP that would be paid to the lower income spouse. Once started, it will continue until you stop it (or one of you dies).

Income Splitting with Minor Children. To reduce the tax burden to the family as a whole, it makes sense to have the investment income taxed in the hands of the person in the lower tax bracket. Your child can also be a taxpayer. Unfortunately, Canada Revenue Agency (CRA) does not allow parents to transfer funds to children for investment purposes. If money is transferred to a minor child, and that child invests the money, CRA will attribute the investment income back to the transferor.

The attribution of the income continues until the money is transferred back. However, any second-generation income is taxed in the hands of the recipient. As an example, you could give your child \$10,000 to invest. If he invests the money at 5%, the \$500 per year of income would be taxed in your hands. The \$500 could be invested again at 5% and the \$25 of second-generation income would be taxed in his hands.

If your child invests the money in dividend paying Canadian stocks, then the first generation income would be taxed in your hands at an effective rate of 6 - 16% and any second generation income would be taxed in your child’s hands at an effective rate of 0% with probably zero taxes overall. Also, any capital gains realized by the child from this money (whether first or second generation) will be taxed in his hands.

If you loan money to your child at the “Prescribed Rate” then the income would not be attributed back to you. Your child will have to pay you interest on the loan at 1% (today’s “prescribed rate”). This interest income must be included on your tax return. The investment income earned would be taxed in your child’s hands. Once the loan has been set up, the interest rate continues until the loan is paid off.

Child Tax Benefit. Any Child Tax Benefit cheques and/or the Universal Child Care Benefit cheques received should be put in a separate bank account for the children. This way any investment income generated from this money will be taxed in the children’s hands, and as long as they do not earn over \$9,600, no tax will be payable.

The Child Tax Benefit can be used to buy term deposits, Canada Savings Bonds or mutual funds. Over the long term, a mutual fund that invests in the stock market has historically outperformed interest-bearing investments.

Income Splitting with Adult Children. Gifting to children over the age of 18 has no income tax consequences to you other than reducing your capital and therefore your future taxable income.

If they use the money to pay off debts or buy personal assets, then there would be no income tax consequences for them. If they contribute the money to their TFSA, then they will not have to pay tax on the investment income. If they contribute money to their RRSP, they will get a tax deduction and defer the tax on the investment income until retirement.

If they invest the money outside of tax shelters, your children will have to pay tax on any investment income that they receive from the capital. If they are in a lower tax bracket than you are then they will pay less tax than you and there will be more money left over to pay for current expenditures (like their education).

You may consider gifting money to your child to contribute to their RRSP. This may reduce their taxable income to a point where their tuition fees would be transferable to you.

To reduce your taxes now, and help fund your child's education, you could give your adult child some amount that they could invest. In doing so your child would pay the tax on the investment income rather than you.

As an example, if you gave your child \$20,000 which they invested at say 5%, they would have an income of \$1,000 and pay tax of about \$250 on that income (assuming little other income). This compares with your tax of about \$390 if you earned the income. The extra \$140 in tax savings can be used to fund their education.

When your child is finished his education, they can give the money back to you and you can invest it for your retirement.

Borrow Only to Invest. If you are going to borrow, it is better to borrow for investment purposes rather than for personal items. Any interest that you pay on an investment loan is tax deductible.

By accumulating funds outside your RRSP, you could make a lump sum payment on your mortgage or car loan. When these debts are paid off, you could then re-finance the loans and use the borrowed funds for investment purposes. This way the new mortgage or car loan interest would be tax deductible.

It also makes sense to save for your personal goals rather than borrowing. For the purchase of your next car, you can use your savings to pay for the vehicle then borrow to replace your savings.

Take Investment Deductions. To look at other ways of reducing your taxes, you should be aware that all expenses associated with earning investment income are tax deductible. These would include safety deposit box fees, accounting fees, or any investment counsel fees.

Employment Deductions. If your employer requires you to have an office in your home, you may deduct a portion of your utility costs and repairs and maintenance. If your employer does not reimburse you for the following expenses, they are tax deductible: motor vehicle expenses; travel expenses; parking; supplies; and salaries paid to an assistant.

Take Other Deductions and Credits. Union dues and professional association fees are tax deductible. Child care expenses (day-care, summer camps, etc.) are deductible for the lower income spouse. Moving expenses are deductible if you change working locations and you are now more than 40 kilometers close to your new work location. Alimony and spousal support are tax deductible for the payor but taxable to the recipient.

Besides the personal, married (or equivalent to married) and child exemption, there is an employment tax credit of \$1,127. There is also a new tax credit for children's sporting activities and transit passes for you or your children.

Tuition fees, books and education expenses are eligible for tax credits. Any unused credits can be transferred to a supporting parent or grandparent. Interest on student loans is also eligible for a tax credit.

Medical expenses exceeding 3% of your net income (or \$2,171 in 2014) are eligible for a tax credit. It makes sense for the lower income spouse to claim the expenses as they can usually claim more.

Other credits that may apply are the Pension Income Tax Credit, Age Exemption, Disability Tax Credit (for you, your spouse, or child), Caregiver Amount and Adoption Expense Tax Credit.

Employment Benefits. Your employer may be able to provide benefits to you that are not taxable. Some of these are: athletic, recreation or social club memberships; counselling services for mental health, re-employment or retirement; frequent flyer points used for personal travel (earned while on business); moving expenses (if required by employer); non-cash gifts up to \$500 in value; premiums paid for private health care plans; education costs (where training is primarily for the benefit of the employer); scholarship programs, professional membership fees; and low-interest loans.

There are some employer provided benefits that are taxable to you. These still result in a savings to you as you only pay the tax on the benefit, not the cost of the benefit itself. Some of these taxable benefits are: personal use of an employer owned vehicle; parking, financial counselling and tax preparation; value of gifts exceeding \$500; premiums for wage loss replacement plans; holiday trips, prizes and incentive awards; education costs (where training is not primarily for the benefit of the employer); premiums paid for provincial health care plans; group life insurance premiums; and interest-free loans.

Charitable Donations. Donations to registered charities create a tax credit of 25% on the first \$200 of gifts and 50% on all amounts above \$200 (to a maximum of 75% of your net income). You can carry forward your donations for up to five years.

If you gift your investment (stocks, mutual funds, etc.) to a charity, your capital gain will be exempt from tax but you will receive a donation receipt for the full value of the investment donated. If you are wanting to make a charitable donation, it is more tax effective to donate your investment than to donate cash.

Clawbacks at Age 65. When you turn 65, you become eligible for Old Age Security and an Age Exemption. Old Age Security is \$6,618 (in 2014) and the Age Exemption is \$6,916 (in 2014). Effectively the age exemption cancels out the tax on the OAS. If you earn too much income, you begin to lose the age exemption (at an income level of \$34,873 in 2014). This means that you will have to pay tax on your OAS. The age exemption is reduced by 15% of your income above \$34,873 until it is completely gone at an income level of \$80,980.

If you make more than \$71,592, then you will lose some of your OAS. The OAS is reduced by 15% of your income above \$71,592. It is completely clawed back at an income of \$115,712.

Once you are 65, these clawbacks increase the effective tax rate that you pay. For income earned below \$34,873 the combined federal provincial tax rate is still 25%. On income earned between \$34,874 and \$43,953 the tax rate and clawback works out to a combined rate of 28.8%. Any income earned between \$43,954 and \$71,592 is taxed at an effective rate of 35.8%. If you make more than \$71,592 but less than \$87,907, the clawback of OAS makes your tax rate about 42.2%. Income of more than \$87,907 but less than \$115,712 is taxed at an effective rate of 45.6%.

Once you have paid back all of your OAS, your effective tax rate drops back to 36% (to \$136,270) and then 39% for income above \$136,270.

The effective tax rates on investment income after 65 are as follows:

Income Range	Interest Income	Rental Income	Foreign Dividends	Canadian Dividends	Capital Gains
\$0 - \$34,873	25%	25%	25%	0%	12.5%
To \$43,953	29%	29%	29%	5%	14.5%
To \$71,592	36%	36%	36%	15%	18%
To \$87,907	42%	42%	42%	24%	21%
To \$115,712	46%	46%	46%	29%	23%
To \$136,270	36%	36%	36%	15%	18%
Over \$136,270	39%	39%	39%	19%	19.5%

If you are going to be subject to these clawbacks, you should consider withdrawing funds from your RRSPs prior to 65. You should also consider using tax effective investment income after 65 to minimize the clawback of OAS and/or the age exemption.

Tax Shelters. Tax shelters are generally designed to provide a tax deduction in the year of purchase and income in the year of sale. This process defers the tax on income until a future date (possibly when you are in a lower tax bracket). Movie and Real Estate tax shelters are an example of this. Some tax shelters are designed to convert fully taxable income to capital gains. This allows you to pay tax at a lower rate (only ½ of capital gains are taxable) and defer the tax until you actually sell the investment. Flow-through shares are an example of this tax shelter.

It is important to look at the performance of various tax shelters to find ones that have provided positive returns. There is no benefit to any tax shelter that gives you a tax deduction today but no income or capital gain in the future. If you are willing to take some investment risk, a good tax shelter may reduce your taxes and provide a positive return on your investment.

Life Insurance as a Tax Shelter. Some life insurance policies have the advantage of a tax deferral on the buildup of the Cash Surrender Value. This tax deferral becomes a tax free gain if it is paid out as a death benefit. This may be of interest to you if you do not wish to take the risk of investing in dividend and capital gain producing investments.

Tax Free Income. Scholarships to attend post-secondary education are now tax free. Other amounts that are not taxable include profits from the sale of your principal residence, death benefits from life insurance (or an employer up to \$10,000), lottery or gambling winnings, and inheritances (taxes are paid by the deceased).

Of course, getting your own money back is also “tax free”. Some annuity payments and/or systematic withdrawal plans include a portion of your own money in the monthly payments. This portion is not taxable.