How investors can protect their portfolio from the taxman

Even small-scale investors can benefit from tax-saving tools like TFSAs and charitable stock donations

By Sean Davidson, CBC NewsPosted: Jan 28, 2014 11:51 AM ETLast Updated: Jan 30, 2014 3:28 PM ET

Even though 2013 is behind us, there are still opportunities for the savvy investor to protect his or her portfolio from the taxman — perhaps by getting caught up on some oft-overlooked paperwork or thinking ahead to 2014 and beyond.

Boxed out

Safety deposit boxes are no longer tax deductible, starting March 21, 2013, for companies and Jan.1, 2014, for individuals. It's a very small change, but one that will affect a lot of people says Lamontagne.
Because stocks and other securities are no longer issued on certificates, investors no longer need safe places to store all that paper or the long-standing deduction that went with them.
"It was only a matter of time," says Lamontagne, before some clever government accountant thought to eliminate it.

Marc Lamontagne, a certified financial planner with Ottawa-based Ryan Lamontagne Inc., is, for instance, making sure his clients fill out their T1135 forms.

If they don't, it could lead to a "pretty harsh" penalty of up to $2,500 a year, Lamontagne said in an interview with CBCNews.ca.

The T1135, or Foreign Income Verification Statement, was reworked in 2013 as part of Ottawa's crackdown on those who hide money overseas. It applies to individuals who have more than $100,000 in non-Canadian securities — perhaps rental property in the Caribbean, or cash in foreign bank accounts, or stock in a foreign company that's traded on a foreign exchange.

"Filling out the form is the most important thing," said Lamontagne. "You don't need to give details if the interest or dividends show up on a T3 or T5, but you need to file the form."

And, surprisingly, it can't be filed online. You'll need to mail it into the Canada Revenue Agency's Foreign Reporting Unit in Ottawa.

The rules for reporting foreign holdings have, Lamontagne concedes, always been a bit confusing to some investors. But those individuals would do well to start sorting out the confusion, because the government has been cracking down.

"If you own a house in Florida for personal use, that's not a problem. But if you're renting it out, you need to start reporting it," Lamontagne said.

TFSAs a good investment vehicle

The start of a new year often sees investors putting as much money as possible into RRSPs in order to reduce their taxable income before the contribution deadline, which this year falls on March 3. But this is also a good time to think about tax-free savings accounts, since with every Jan. 1, we all get another $5,500 in allowable contributions, up from the prior limit of $5,000.

"If you have any interest or dividends or capital gains, non-registered money or even money in a savings account, put it in [a TFSA]," says Lamontagne.

Experts have long noted that TFSAs are not fully understood or exploited by many Canadians.

Some people think they are only meant for investment income; others don't understand exactly how contributions work.

"If you don't use [your contribution room], you don't lose it," says Lamontagne.

Any unused contribution amounts are carried forward into the next year and accumulate.

"For instance, this year, somebody who never made any contribution [to a TFSA] would be allowed to put in $31,000," Lamontagne said.

Someone who has that kind of money in a standard savings account would do well to move it into a TFSA, he says, where the interest and investment income it generates remain sheltered from tax.

"Why pay taxes?" Lamontagne asks, when TFSAs are "really, very flexible."

The money you put into a TFSA is not deductible for income tax purposes, but, like an RRSP, it can be invested once it's in the TFSA in a variety of ways — from high-interest savings accounts to mutual funds, equities or listed securities — and the investment income, including capital gains, it earns won't be taxed, even when withdrawn.

The advantage over an RRSP is that money in a TFSA can be withdrawn at any time for any purpose without penalty.

"If you take the money out, they actually give you back the contribution room come Jan. 1 the following year," said Lamontagne. "So, let's say you put $10,000 into a TFSA, and it grew to $11,000,

and you took out $11,000. It's still all tax free but come Jan. 1, your new contribution room is $5,500 plus $11,000."

Capital gains tax less of an issue for small investors

RRSPs and TFSAs have, for many, become the bread and butter of investing. Canadians held a total of $877 billion in assets in RRSPs and $97.9 billion in TFSAs as of June 2013, according to Investor Economics.

The more traditional approach of investing directly in the stock market and making use of tax breaks on capital gains and dividends to reduce one's taxable income is less of an issue for small-time investors, though Lamontagne says he still gets questions on that point from some of his wealthier and older clients.

"We still see clients for whom capital gains are an issue," he said.

For the 2012 tax year, roughly 1.9 million Canadians, or 7.2 per cent of all tax-filers, reported taxable capital gains, according to the CRA.

This compares to the 9.4 million (36 per cent) who had TFSAs that year — a number that has since risen to about 11.1 million, according to Investor Economics — and the roughly six million who, according to Statistics Canada, contributed to RRSPs.

A capital gain, or loss for that matter, is the difference between an asset's total cost price and its total sale price. For example, if you purchased $10,000 worth of a given stock and then sold it for $11,000, you would have a capital gain of $1,000.

In Canada, this type of investment profit is taxed more favourably than other types of income. The so-called inclusion rate is 50 per cent, meaning only half the value of a capital gain is included in the income tax calculation. Individuals also have a lifetime capital gains exemption of $750,000 (which will rise to $800,000 as of the 2014 tax year) that applies to the sale of shares in certain qualified small businesses and to some farm and fishing properties.

Turn gains into losses

Lamontagne often advises his clients to turn capital gains into losses by selling something from their portfolio that will offset the gain, even if they plan to buy it back later. A capital loss must first be applied to your taxable capital gain in the current tax year, but if you still have a loss after you do that, it can be used to offset your taxable gain in any of the three preceding tax years or any future year.

"What you do when you trigger a loss, you're not really saving taxes; you're deferring a tax bill to a future year. But hopefully, a dollar saved today is better than one tomorrow," Lamontagne said.

The rationale behind having a lower tax regime for capital property — whether that property is stocks, business capital or real estate — is based upon a simple but long-standing notion held by economists: if you cut the cost of investing, you boost the profitability of such investments and, ultimately, get more cash going into productive capital.

The economy gets more investment into important areas, so the argument goes, and individuals make more money that can be reinvested or saved.

Other tax-saving tips

If you are an investor, there's more than one way to save a few bucks on your taxes. Whether you're on the more modest or affluent end of the income spectrum, you might also want to consider the following tax-saving strategies:

Donate securities to charity — You'll both avoid paying the capital gains tax and get a charitable donation credit for your trouble if by year-end you give a publicly traded security straight to a registered charity. You can even donate one that lost value and still claim the loss.

Split your income — There are many useful income-splitting manoeuvres. Families in which one family member holds most of the income, from a family business, for example, should consider splitting that income among other relatives. The income as a whole will be taxed at a more favourable rate.

Give losing investments to one of your adult children — "Happy birthday, son. By getting rid of this failing stock, I can claim a capital loss, and, if it rebounds sometime in the future, you can both enjoy the benefits and pay the capital gains."

Defer those gains — Investors can and should defer taxation on capital gains, experts advise. "One strategy is to not trigger gains until you're retired and in a lower tax bracket," says Lamontagne. Failing that, even a few years of inflation will make what seemed like an onerous tax on one's capital gains in 2013 easier to handle in 2020.

Set up a trust — They're not just for the country club set, anymore. Whether set up to provide for one's children, a spouse or to split income, the staggering assortment of trusts recognized by the CRA has recently gained popularity among the less affluent as a tax and financial planning tool.

Mind the dividend tax credit — Investors get federal and provincial tax credits on dividends paid out by public Canadian corporations as well as Canadian-controlled private corporations, but the federal rules for the latter, known as non-eligible dividends, changed on Jan. 1, 2014, making the credit less favourable. Some provinces, such as Ontario, are also revising the way they calculate dividend tax credits. Business owners who pay themselves in dividends rather than salary might want to rethink that strategy.