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Integrated Investment Management Can Save Taxes

Tags: investment planning [1]

High net worth investors are now sitting back and enjoying the summer weather, breathing a sigh of relief now that they are done with their annual tax filings. The work involved in assembling all of the relevant tax information is made more complicated by the fact they often deal with several investment firms.

U.S. financial research firm, Cerulli Associates, recently found that high net worth investors had, on average, 3.7 investment advisors. Ultra-affluent investors often spread their investments across many more.

The result can often lead to needless tax inefficiencies and exposure to tax penalties with a piecemeal approach to the investment strategy never mind the added paperwork of dealing with a number of investment advisors. If the client is not acting as the lead conductor and strategist then several scenarios can arise that may lead to additional and unnecessary taxes being paid.

A typical situation involves an investor using one advisor for their RRSP and another for their non-registered investments. The RRSP advisor will typically handle the account in an isolated fashion without instructions to the contrary from the client. This may result in the RRSP being invested on a balanced basis with some stocks, bonds and cash. Meanwhile, the advisor handling the taxable accounts may also include investments in bonds and, mortgage funds that generate interest income that is taxed at higher rates than capital gains or Canadian dividends.

Ideally, the fixed income assets should be held in the RRSP and the equity assets that generate capital gains and Canadian dividend income should be held in the taxable accounts. This will increase the tax efficiency of the overall investment portfolio resulting in less tax paid over one's lifetime and increasing your net worth. Equities held within the RRSP lose the capital gains treatment, whereby only 50% of the gains are taxable.

Many fixed income investments available today were issued years ago with yields of 4% to 8%.* With interest rates currently in the 2% range, fixed income securities typically trade at premiums to their maturity value. Unfortunately, interest income is often taxed at the top marginal rate while the premium paid to buy high yielding fixed income securities is only allowed as a capital loss at maturity. This mismatched tax treatment magnifies the overall tax drag of fixed income investments held in taxable accounts.

The use of a TFSA can trigger additional taxes if U.S. dividend paying investments are included in the plan. A TFSA is not a retirement or pension trust under the Canada-U.S. tax treaty and the dividends are subject to U.S. withholding taxes. This is not the case if they are held inside an RRSP. Finally the foreign tax credit for the withholding taxes paid on dividends from U.S. equities is not available for a TFSA.

Other situations that may incur additional taxes or penalties include ensuring that a low-bracket spouse uses the dividend tax credit to full advantage, the use of capital carry-forwards in a holding company and monitoring all investments across all advisors to ensure that the $100,000 foreign property reporting limit is not breached without the client's awareness. Fines for failing to file the T1135 for foreign assets can start at $25 daily to a maximum of $2,500 annually.

Give your advisor a call today to discuss your current investment strategy and to ensure it is coordinated to minimize unnecessary taxes and penalties.

* Financial Post, May 2013

Questions about your investment strategy?

Contact our office! [2]

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