Everyone wants one, but be careful what you wish for

As a financial planner, I often get questioned about the latest “tax tip” that happens to be circulating. If you Google “tax tips”, you will find nearly four million sites offering advice on this subject. The problem is that some of these ideas may not necessarily be in your best interest and result in you paying more tax instead of less.

As an example, I’ll pick an obvious, but difficult to argue against tax tip: “Maximize your RRSP contributions each year.” Although I am a firm believer in the benefits of investing in your RRSP, I disagree with the notion that maximizing on this benefit each year (without an analysis as to how it applies to you as an individual) is beneficial. Why? The reason might be as simple as transitioning from employee status to a small business owner. An individual may decide on dividends in lieu of salary, thereby reducing the tax obligation to a point where an RRSP contribution is not worthwhile. A more complex situation may involve the anticipation of extraordinary income in an upcoming year, making the deferral of an RRSP contribution 14 per cent more effective (based on Alberta marginal tax rates).

Another example of a tax tip I see regularly is the utilization of a “tax shelter”. Many of these arrangements are aggressively promoted and should be approached with a level of skepticism. I am not saying that there aren’t good opportunities available in this area, but if it sounds “too good to be true,” it may very well be. An August 2007 Tax Alert (www.cra-arc.gc.ca/newsroom/alerts/2007/a070813-e.html) issued by the Canada Revenue Agency is called, “Warning: Participating in tax shelter gifting arrangements is likely to result in a tax bill!” This should clearly illustrate that an investor should proceed with caution.

The last example I will mention usually hits the headlines in December, although if warranted, could be implemented at any time of the year. This involves the use of “tax-loss selling”, where an investor sells a poorly performing stock or mutual fund to generate a “capital loss”. If used properly, this is an effective technique to reduce your tax bill. Incorrect use could find you facing the “superficial loss rule” with an unwelcome surprise when you file your tax return. Whatever you decide, make sure that it is a wise choice from an investment perspective first and tax benefit second.
What can a person do? To begin with, a “tax tip” should not be confused with “tax planning”. Tax planning involves arranging your affairs to pay the least amount of tax under the law. Start by making yourself aware of the alternatives that are available to you. Once these alternatives have been identified, you need to analyze which ones can be effectively implemented. Finally, you need to know how these changes will impact your overall financial status.

Many Canadians do not have a written financial plan nor do they consult with a professional when it comes to their personal finances. An in-depth study was completed by the Financial Planners Standards Council (www.cfp-ca.org/public/public_surveys_consumer2003.asp) that overviews the financial advice landscape in Canada. While some of the statistics are disconcerting, there seems to be a growing awareness of the need to plan for our financial futures.

Tax planning should be part of your overall financial plan. A specific recommendation for reducing tax should be coordinated with your investment portfolio, risk management plan, cash flow analysis and estate plan. This comprehensive approach is the basis of financial planning. It is a process that documents where you are today, verifies where you wish to be in the future and provides ongoing advice on how to reach your objectives in the most efficient manner.

Peter Murray is a Senior Financial Planner with Assante Capital Management Ltd. (Member CIPF) in Calgary, Alberta. Email questions to Peter at pmurray@assante.com or check his website at www.assante.com/advisors/pmurray. Please contact a professional advisor to discuss your particular circumstances prior to acting on the information above. The opinions expressed are those of the author and not necessarily those of Assante Capital Management Ltd.