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Smart Money: It's not what you make, it's what you keep

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Brad Brain: "I was going to write about tax planning this week. But then I had some conversations with some different people, only one of which was directly related to taxation." | Getty Images

This week I was going to write about tax planning. The bottom line is that it it's not what you make that matters; what matters is what you keep.

Here's what I mean. What would you rather have: A Guaranteed Investment Certificate that pays you $1000 per year in interest income, or a Canadian stock with a $800 annual dividend?

Many people will look at this and say $1000 is more than $800, give me the GIC. But let's think this through.

The GIC will produce interest income, which is 100% taxable at your full marginal tax rate. This means you could easily pay 30% tax on the $1000, leaving you with only $700 after tax.

Dividend income is far more attractive. Someone in a 30% tax bracket might be paying closer to 5% in tax on qualifying dividend income. So, if you pay 5% in tax on $800 of dividend income you get to keep $760.

You make $1000 on the GIC, but you only keep $700. Or you make $800 in dividends, but you get to keep $760. Its not what you make that counts, its what you keep.

So, as I say, I was going to write about tax planning this week. But then I had some conversations with some different people, only one of which was directly related to taxation.

The first conversation was with a client who was inquiring about an insurance policy that he owned. He was thinking that the reason he bought the policy may have changed and he was wondering if it still makes sense to fund the insurance strategy.

The second conversation was with a lady in her early 50s who has made some very attractive returns in a growth-focused retirement portfolio and was concerned about future market volatility.

The third conversation was with a client who is winding down his company and is wondering if he should take money out of his company as wages or dividends, and how that will affect his Individual Pension Plan.

These three conversations may appear to be unrelated. They aren't. It's not what you make, its what you keep.

For the insurance client, he has more money than he will ever spend in his lifetime. The insurance strategy will allow him to grow money tax sheltered, and then transfer it tax-free and with no probate fees to his family and favourite charities, rather than see large chunks of the family fortune lost to taxes upon his death. Arguably, he could "make" more if he invested outside the insurance strategy, but he and his family would not keep more.

For the investment client, she will need money for the rest of her lifetime, which will probably be another four decades or so. She could reduce the equity exposure of her retirement portfolio and potentially avoid some short-term volatility, but she would also reduce her future purchasing power. Long story short, changing her asset allocation will affect her inflation protection. Maybe in the short term she "makes" more, but she wouldn't keep more in the long term.

For the business owner, the details of the Individual Pension Plan don't really add to the story here, so I will leave them out for now. The salient point is that there are different corporate and personal tax consequences on whether he takes income as wages or as a dividend. My advice was to minimize his total tax bill. It's not what he makes, its what he keeps.

Here is the point of my three stories. In each case, there was some decision of the day that distracted the client's attention and took focus away from the long-term objective.

The question is not, 'Can I grow money outside of an insurance policy?'; Or, 'Will there be short-term volatility in the equity markets?"; Or even, 'Do I need more earned income in the current tax year?' The real question is: 'Am I doing what I need to in order to meet my objectives?'

It's not what you make, its what you keep.

Brad Brain. CFP, R.F.P., CIM, TEP is a Certified Financial Planner in Fort St John, BC. This material is prepared for general circulation and may not reflect your individual financial circumstances. Brad can be reached at www.bradbrainfinancial.com.

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