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WEALTH MANAGEMENT

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Tax-Efficient Investing

Taxation and inflation present major impediments to growing your wealth. While we can all make some adjustments to our spending patterns, the rate of inflation is largely beyond our direct control. On the other hand we have a number of tools available to us to control the level of taxation on the income we earn. On the investment front, holding those investments likely to produce the highest tax liability in tax-sheltered registered plans such as Tax Free Savings Accounts (TFSAs), Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Funds (RRIFs) makes for an excellent start on tax efficient investing. Of course, the nature of one's investment portfolio may make it necessary to hold tax-inefficient investments outside of registered plans.

Making Investments More Tax-Efficient

One of the best ways to make several forms of investment income more tax-efficient is to utilize a number of features only available via certain mutual funds. These include funds structured as a corporate class and those with tax-efficient systematic withdrawal plans (TSWPs). The mechanics of these features are explained in more detail later in this document. These features tend to serve to convert interest income into a combination of live and deferred capital gains. The deferral of income for tax purposes is usually a considerable added benefit.

Since capital gains are taxed at half the rate of interest income, being able to receive investment income in the form of capital gains is very attractive for all taxable investors. Recipients of Old Age Security (OAS) with taxable income between $73,756 and $119,512 face an extra 15% tax rate on income in that range. Since only half of capital gains are taxable, receiving investment income in that form rather than as interest presents meaningful tax savings. For all investors with taxable incomes over $90,563 and not receiving OAS, capital gains become progressively more attractive than dividends as well. These factors are explained in more detail later in this document. The table below illustrates the taxation of different forms of investment income for typical Ontario investors, including those collecting OAS.

Taxation of $1000 of Investment Income
Ontario Resident with $75,000 Taxable Income

	Interest	Capital Gains	Dividend	Return of Capital *
Regular Tax Rate	31.48%	15.79%	8.92%	0.00%
After-Tax Income	**$685.20**	**$842.10**	**$910.80**	**$1,000.00**
OAS Clawback	$150.00	$75.00	$207.00	$0.00
After-Tax Income	**$535.20**	**$767.10**	**$703.80**	**$1,000.00**

* may be taxed on a deferred basis identically to capital gains.

A growing number of mutual funds offer one or both of these tax-efficiency improving features, thus meaningfully reducing and deferring taxes payable on the income produced by the fund while providing the investor with a desirable level of cash flow. With interest rates at historically low levels, income-oriented investors need all the help they can get in their efforts to produce adequate after-tax rates of return. Mutual funds that offer these tax-efficiency tools can make a meaningful contribution to those efforts, while also providing important risk management features.

The Details

Following is a more detailed examination of the taxation issues and investment tools available to help make investing more tax-efficient.

Taxation of Interest, Dividends and Capital Gains

When holding investments outside of registered plans, the type of income those investments produce can have a significant impact on the amount of income tax payable on that income. The table below illustrates the different tax rates on different forms of income.

2016 Ontario Income Tax Rates

						After-tax Retention of Income		
Taxable Income	Federal Rate	Prov. Rate	Combined Rate	Capital Gains Rate	Dividend Rate	Interest	Capital Gains	Dividends
$11,474+	15.00%	5.05%	20.05%	10.03%	-6.86%	$79.95	$89.98	$106.86
$41,536+	15.00%	9.15%	24.15%	12.08%	-1.20%	$75.85	$87.93	$101.20
$45,282+	20.50%	9.15%	29.65%	14.83%	6.39%	$70.35	$85.18	$93.61
$73,143+	20.50%	10.98%	31.48%	15.74%	8.92%	$68.52	$84.26	$91.08
$83,075+	20.50%	13.39%	33.89%	16.95%	12.24%	$66.11	$83.06	$87.76
$86,176+	20.50%	17.41%	37.91%	18.96%	17.79%	$62.09	$81.05	$82.21
$90,563+	26.00%	17.41%	43.41%	21.71%	25.38%	$56.59	$78.30	$74.62
$140,388+	29.00%	17.41%	46.41%	23.21%	29.52%	$53.59	$76.80	$70.48
$150,000+	29.00%	18.97%	47.97%	23.99%	31.67%	$52.03	$76.02	$68.33
$200,000+	33.00%	18.97%	51.97%	25.99%	37.19%	$48.03	$74.02	$62.81
$220,000+	33.00%	20.53%	53.53%	26.77%	39.34%	$46.47	$73.24	$60.66

Dividends are the least taxed form of income up to a taxable income of $90,563, above which capital gains become the least taxed.

Dividends can Interfere with the Collection of Old Age Security (OAS) Benefits.

It is important to realize that only $0.50 of each dollar of capital gains is counted towards taxable income while each dollar of dividends adds $1.38 to taxable income, but brings with it the dividend tax credit.

Recipients of Old Age Security (OAS) effectively face at 15% higher tax rate than the combined rate shown in the table on their 2016 income between $73,756 and $119,512. This is a result of the "Clawback" of OAS benefits for higher income individuals. For every dollar of taxable income above $73,756 an OAS recipient must repay $0.15. The full $6,863 of OAS would be repaid under this mechanism once taxable income exceeds $119,512.

For investors in the OAS "Clawback" zone, each dollar of capital gains results in the repayment of only $0.075 of OAS while each dollar of dividends results in the repayment of $0.207 of OAS. Given this reality, suitable investments that pay income in the form of capital gains rather than interest or dividends are particularly attractive for OAS recipients with taxable incomes between $73,756 and $119,512, as well as for other investors with taxable incomes above $90,563.

Tools to Convert Interest Income into Dividends or Capital Gains

Two features available on some mutual funds can provide significant tax-efficiencies. Corporate class structures and tax-efficient systematic withdrawal plans (TSWP) are features that, individually or in combination, can meaningfully enhance the after-tax return from a wide array of investments. Additionally, mutual funds provide the advantages of professional management and security diversification. This provides the potential for superior investment performance and reduces the risks inherent in owning individual securities. Some measure of tax efficiency is provided by the deduction within the fund of the costs of running the fund against the least tax-efficient income the fund produces. Still, there is room for the income the fund produces to be made more tax-efficient.

Corporate Class

One of the more common tax-efficiency measures employed by mutual funds is the corporate class structure. Traditional mutual funds are generally structured as a trust. They flow through to investors all net income in its original form (after deducting expenses). In contrast, the corporate class structure bunches together for tax purposes a number of fund mandates, each as independent classes of a single mutual fund corporation. This has several advantages:

- ❖ The corporation can net out expenses and capital gains and losses of the individual classes without affecting the rate of return of any of the individual fund classes.
- ❖ Corporate class funds generally report less taxable income.
- ❖ A greater portion of returns comes in the form of both current and deferred capital gains, meaning that a lower rate of income tax will apply to this income.
- ❖ Switches between funds that are part of the same corporate class group do not trigger the taxation of unrealized capital gains on the investment. The adjusted cost base of the original investment is transferred to the new holding, thus deferring the realization of gains until such time as one exits the corporate class structure. This feature will no longer be available after December 2016.

Corporate class funds are a superb arrangement for those not in need of a higher level of current income. For those who do require regular cash flow, a corporate class mutual fund with a TSWP (see below) can be an ideal solution.

Tax-efficient Systematic Withdrawal Plans (TSWPs)

Tax-efficient Systematic Withdrawal Plans (TSWPs) can be used to generate regular monthly cash flow from any type of mutual fund. The rate can generally be set at anywhere from 1% to potentially as high as 8% per annum and there are no withdrawal transactions to deal with because the distributions are part of the investment program. The larger the distribution rate selected the greater the portion of the distribution will tend to be categorized as return of capital. Return of capital is not taxed but does reduce the adjusted cost base of the investment, creating a growing deferred capital gain. By selecting a withdrawal rate at or below the average rate of return on the fund, you can avoid using your capital to finance distributions, while enjoying the tax deferral benefits of the TSWP.

Asset-Based Fees

Traditionally, fees for wealth management advice are funded via transaction fees and the trailer fees built into mutual funds. Transaction fees get capitalized as part of the adjusted cost base of the investment, effectively reducing capital gains reported on an investment when it is eventually sold. Trailer fees offset taxable income generated by the fund. This may be offsetting interest, dividends, capital gains or a combination of those forms of income. Asset-based fees paid for wealth management advice in relation to investments held outside of registered plans are fully deductible in the year they are paid. Choosing the asset-based fee approach in place of transaction fees and trailer fees can result in immediate tax savings that can improve the after tax return on investments.

If you have any questions concerning these matters, please feel free to give us a call or e-mail us at Graham.Tench@nbc.ca or Denis.Lheureux@nbc.ca.

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