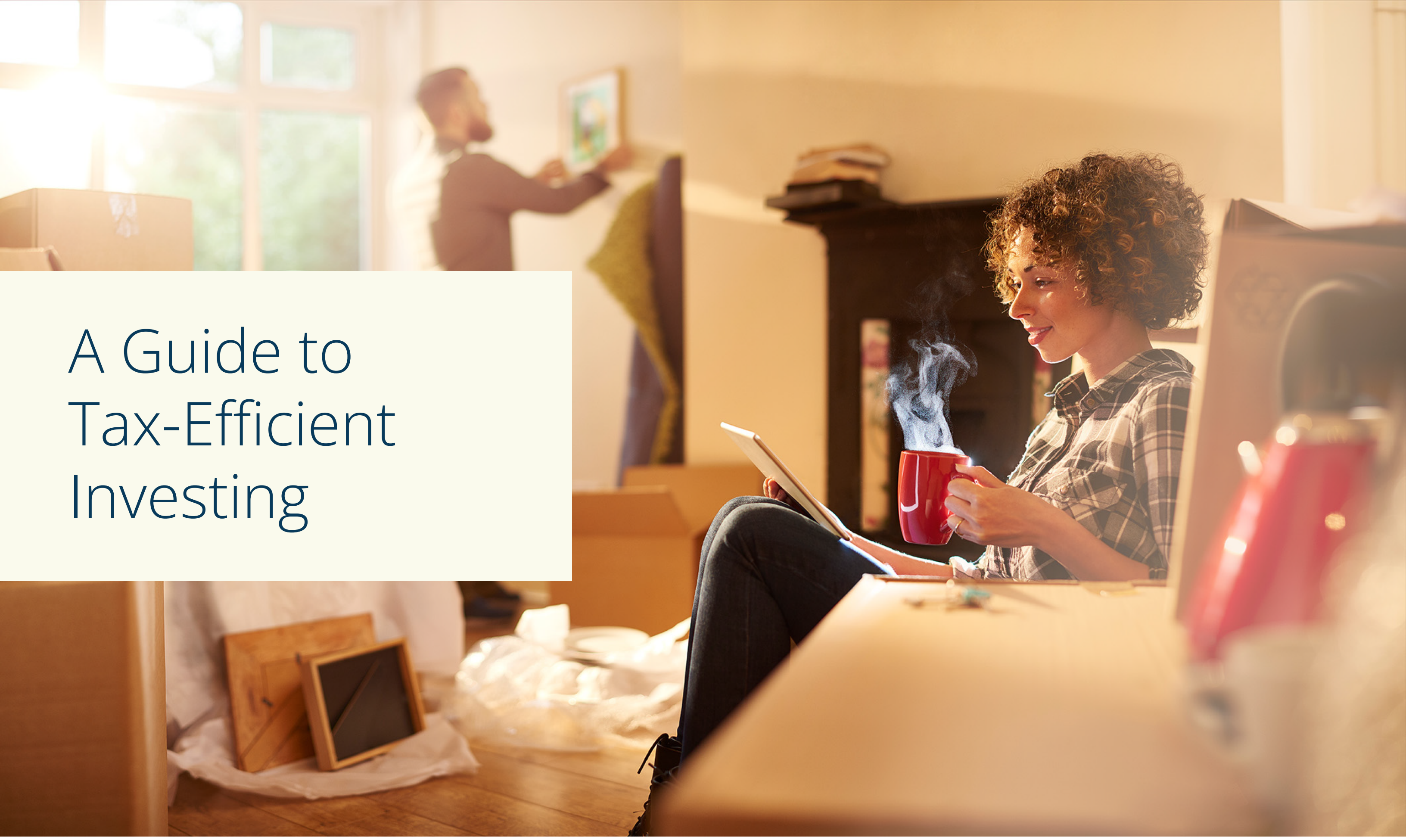
A Guide to Tax-Efficient Investing



WHAT YOU NEED TO KNOW

This guide provides general tax information related to the purchase and sale of investments in registered and non-registered accounts.

The goal is to help you gain a better understanding of how you can reduce or defer the tax you pay on your investment growth, thereby allowing you to grow your investments faster and reach your retirement savings goals.

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Taxes are inevitable, but there are steps you can take to lower your tax burden.

When it comes to the taxes on your investment growth, you can reduce your tax bill by strategically making tax-efficient investment decisions. It starts by understanding that the amount of tax you pay on non-registered investments can vary according to the type of income or growth your investments generate.

Make no mistake, by implementing a tax-efficient investment strategy suited to your needs, you can make a significant difference in your long-term returns and the amount you save for your retirement years.

How investment growth is taxed

Investment income can be divided into three main areas, each of which is treated differently by Canada Revenue Agency.

1

Interest and other income

The highest rate of tax is paid on interest income, which is generated when an investor loans money to a person or an organization. Investment vehicles that generate interest income include GICs, bonds, mortgages and bank savings accounts.

2

Dividend income

Through dividend payments, a company can share its profitability with its shareholders, without the shareholders needing to sell shares. Dividend income is taxed at a lower rate than interest income.

3

Capital gains income

This form of income refers to the difference in the amount you pay for an asset and the price at which you sell it (assuming a positive return). Of the three types of income discussed here, capital gains income is taxed at the lowest rate.

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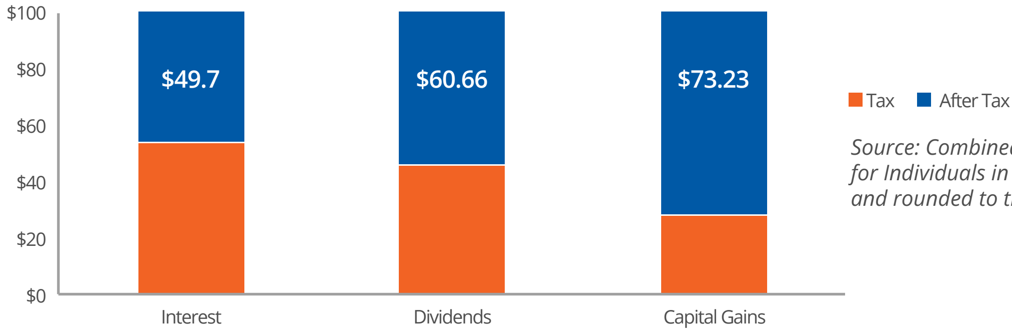
It’s Not What You Earn, It’s What You Keep

When your investment generates $100 in growth, here’s what you’ll have in your pocket after paying tax (assuming you’re in the highest tax bracket).



Source: Combined Top Marginal Tax Rates for Individuals in Ontario, 2023, and rounded to the nearest dollar.

Understanding Registered Vs. Non-Registered Accounts

Registered Accounts

For most investors, the most tax-efficient approach is to use up all the contribution room in your “registered” accounts before putting funds into “non-registered accounts.” That’s because Canada's federal and provincial governments have created registered savings programs that provide tax advantages and incentives for Canadian investors.

The registered savings plans available to Canadians are as follows:

- Registered retirement savings plan (RRSP)
- Registered retirement income fund (RRIF)
- Tax-free savings account (TFSA)
- Registered education savings plan (RESP)
- Registered disability savings plan (RDSP)
- First Home Savings Account (FHSA)

These registered plans allow you to either defer or avoid paying tax on your investment income or growth — whether it’s generated through interest, dividends or capital gains.

Non-registered Accounts

Registered accounts have various restrictions, such as how much money you can contribute and how long the account can stay open. Conversely, non-registered accounts have no contribution or time limits.

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Typically, the income generated in non-registered accounts is fully taxable in the year it is earned. That's why it makes sense to ensure non-registered accounts are as tax efficient as possible. When investing in a registered account like a tax-free savings account (TFSA), you don't have to be concerned about the nature of the income earned. That's because investment income is not taxed when earned inside any of these accounts.

However, once you've maximized your contributions to your registered plans, or if you want additional flexibility in accessing your money, you may wish to invest in a non-registered account.

Strategies for Deferring and Reducing the Taxes You Pay on Non-Registered Investments

Corporate Class Investment Funds

A corporate class fund is designed as a holding corporation, set up by a fund company to invest in a group of mutual funds within the corporation. The result is that corporate class funds tend to pay out distributions that are more tax efficient to the investor. Plus, as long as your money remains invested in a corporate class fund, the tax payable on any gains is deferred. This allows your money to grow faster and more efficiently through the power of compounding.

Corporate class funds are generally used by investors who have reached their contribution limits in tax-free savings accounts and registered retirement savings plans. The appeal of this fund class is that it represents yet another option for tax-efficient investing.

What to consider when choosing a Corporate Class Fund

When choosing a corporate class fund family, look for one with a wide variety of available funds. Ideally, it should include Canadian, U.S., global equity, sector and money market funds, as well as offering differing management styles.

For the right investor, corporate class funds can be a great way to make your portfolio more tax efficient. And, over the long term, tax-efficient investing can have a positive impact on the value of your portfolio.

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How can you benefit from using a Corporate Class strategy?

When compared to standard mutual fund trusts, corporate class funds give you an opportunity to pay less tax on income earned inside of a corporate structure. Because corporate class funds can manage the taxable income and deductions generated by all the funds under its corporate umbrella, the losses or expenses in one fund can be used to shield taxable income in another. This is how corporate class funds can help reduce the taxable distributions you receive. Over the long run, you benefit from tax deferral and compound growth.

When your investment is eventually redeemed out of the corporation, you'll pay tax on any gains realized – just like any other investment. However, you could structure a monthly redemption payment using a T-Series option giving you the ability to further defer tax payments by paying out all or some of your withdrawal amounts in the form of return of capital (ROC).

Important Tax Change Notification

As of January 1, 2017, Corporate Class Funds have lost some of their tax advantage. The 2016 Federal Budget told us that exchanging units of one corporate-class fund for another would no longer be tax-deferred. This change has eliminated the ability of investors to switch between funds in corporate class investments without paying capital gains tax.

T-Series Investment Funds

Corporate class funds can help you reduce the taxes you pay while you're building your savings, but what can you do to reduce or defer taxes when you need to take money out of your savings to fund your retirement?

A good strategy is to invest using the "Series T" option of your mutual funds. Series T is not a mutual fund itself, but rather an option that a mutual fund may offer. Investing in the Series T option of a mutual fund can help reduce the tax you pay on your initial withdrawals/distributions by paying out all or some of your withdrawal amounts in the form of return of capital (ROC).

This form of distribution is not taxed until your original investment capital is depleted. In other words, not until the adjusted cost base (ACB) reaches zero or the units are sold. In some mutual funds with a T-Series option, the ROC distribution makes up all or most of the expected return, enabling you to maintain your original investment in the fund.

A fund that gives you control over when you incur a tax liability, allowing you to defer taxes, can be beneficial in several ways. You will benefit from higher after-tax income and the compounding effects of a larger investment. Plus, you may also be able to reduce the amount of tax you pay in the future, due to lower marginal tax rates or lower capital-gains inclusion rates.

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What to consider when choosing a T-Series Fund

When considering T-Series Funds, look at payout rates, as they vary. Also look for funds with the T-Series option that make investment sense: Poor returns will result in smaller monthly distributions. Some funds are designed so that the ROC distribution takes up all or most of the expected return, enabling you to maintain your original investment in the fund and defer your tax bill.

Is a Return of Capital Strategy Right for You?

By implementing a return of capital strategy, you can realize some of the financial outcomes that offer peace of mind in retirement: more cash flow, less tax and less tax risk (which results in capital preservation).

There are two specific situations when a return of capital strategy, using a T-SWP structure in particular, can be most beneficial:

1

When you need cash flow, but not taxable income

The return of capital approach creates cash flow but not taxable income. A key consideration here is your exposure to clawback zones. You want to ensure that when cash flow is supplemented with a return capital, you don't lose important government income benefits.

2

When market cycles are volatile

Historically, market volatility has increased on a cyclical basis before falling to more normal volatility levels. During these higher volatility cycles, you may consider using this withdrawal option to generate a consistent level of cash flow. But since your net invested capital will be reduced over time, you probably don't want to keep a T-SWP in place over the longer term, because you generated a deferred capital gain.

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When planning for the right amount of cash flow, you must pay attention to the following:

1

Sources of income

Determine whether the most tax-efficient income sources have been used to obtain the require cash flow results.

2

Tax liabilities

Evaluate the overall taxes paid, the average and marginal rate of tax, the government benefits received and the claw-back zones. If any of these need to be improved, you may wish to change your mix of income sources.

3

Time

Determine how to supplement earnings with a return of capital. This planning should focus on the length of time capital will last, and the income taxes payable now and in the future as a result of the return on investment.

Finding the right investment vehicle for the right investor is part of the art of financial management. The flexibility and convenience of T-Series Funds could be ideal for you.

Here's where we can help!

We first prepare and review a comprehensive investment plan to help you reach your goals. Then we help you decide on the best options for investing and building your portfolio.