The TaxLetter®

Vol. 30, No. 12 Your Guide to Tax-Saving Strategies Single Copy: $10.00 December 2012

TAXSTRATEGY

These Corporate Class Fund strategies will help you get…

The right income

Ed Rempel CMA, CFP

The road to getting the investment income you want can sometimes lead you to a wrong turn. To stay on course, you need to first choose the investments that are right for you.

If dividends are best for you, then buy Canadian dividend-paying stocks or dividend mutual funds. If capital gains are what you want, then invest in growth stocks or equity mutual funds.

However, there are some issues with this traditional approach:

- Conservative investors usually end up paying high taxes on their investment income because they buy conservative investments such as GICs and bonds, which pay interest.

Interest is taxed significantly higher than other types of investment income. This is intentional in order to encourage more productive investments.

- Earning eligible dividends generally means you need to restrict your investments to Canada, since foreign dividends are taxed like interest. This can leave you with a poorly diversified portfolio.

- Investors wanting to earn capital gains may find themselves invested more aggressively than they are comfortable with.

Investing for income can mean you have to choose between the most appropriate investment and the most tax-efficient one.

Your investment should be the highest quality and most appropriate investment for your circumstances.

Converting investment income

If the investments you want do not pay out the most tax-efficient type of income for your particular circumstances, then use corporate class mutual funds to convert your investment income.

Corporate Class Funds are like traditional mutual funds except they allow investors to switch between investments without any tax considerations.

This efficient structure lets you to convert any type of investment into any type of investment income.

The three most common ways this is done are:

✓ Converting interest income into capital gains: This has many uses, since conservative investors often want to own bonds, but their tax would be much lower if they received capital gains.

To do this, a fund manager can purchase a forward contract on bonds that can generate capital gains income.

You do not necessarily need a corporate class mutual fund to implement this strategy, but that is mainly where this income conversion is done.

✓ Distributing only capital gains and dividends: Within a mutual fund, any taxable investment income is used to pay expenses, and then only the net taxable income is distributed to the shareholders.

If a mutual fund has a diver-

Ed Rempel, CMA, CFP has built his practice *Ed Rempel & Associates*, on solid, comprehensive financial plans. His extensive experience in tax and finance has placed him in high demand writing articles that educate the public on tax insights.
ed@edrempel.com

sified portfolio, the interest income is used to pay the expenses, so the income distributed tends to be mainly capital gains or dividends.

This strategy is most effective with corporate class mutual funds, since many mutual funds (sometimes hundreds) are all considered to be one corporation.

This allows all the taxable income from all the funds to be netted against all the expenses of the funds.

This usually results in considerably lower or no taxable income being allocated to shareholders, since the interest from bonds is allocated against the expenses, and capital gains from stocks sold within the funds are allocated against capital losses in other funds.

In addition, taxable capital gains can be allocated to investors that sold the mutual fund through a process called "capital gains refund mechanism," which reward investors who continue to own the fund.

In short, corporate class mutual funds generally result in much lower taxable distributions while you own the fund, and the distributions tend to be mainly capital gains or dividends.

Using them to provide income from a Systematic Withdrawal Plan (SWP) or T8 can make your income quite tax-efficient.

✓ Receiving tax-free return of capital income: Receiving monthly income from a SWP or T8 fund converts your income. Essentially, this is considered the same as receiving your original invested capital back.

It effectively defers capital gains tax, typically for 10-15 years, or until you sell the fund.

Corporate class advantage

Here are just a few of the creative uses of Corporate Class Funds: Note: the following strategies only work with NexGen funds (see box on page eight).

Convert interest to dividends: Conservative investors with low to moderate incomes can invest in a bond fund that pays eligible dividends, which are most tax-efficient for them.

Convert foreign dividends to Canadian dollars: Canada makes up only three per cent of the world's stock market, so proper diversification of an equity portfolio requires a significant non-Canadian allocation. You can invest in a global fund that pays eligible Canadian dividends.

Deferring dividend income: If dividends are most tax-efficient for you, but you want the lowest taxable income (perhaps you are affected by one of the clawbacks on seniors), you can invest in a diversified portfolio of bonds, and Canadian and global stocks and have it all pay you a tax-free return of capital distributions of eight per cent per year for 12.5 years.

Then, when your cost is zero, you switch to the dividend version and continue receiving monthly income that is only now taxable to you as dividend income.

Two more strategies

Preserving tax deductibility of an investment loan: If you want regular income from investments, and have borrowed to invest, you have to be careful not to use return of capital. If you use

A word on NexGen Financial

One specific mutual fund company, NexGen Financial, deserves special mention because it has by far the most tax-efficient mutual funds. It is worth noting because of all the possible, creative strategies that can only be done with their mutual funds.

All of their mutual funds are available in five versions:

☞ Registered – For RRSPs and registered accounts. Not tax-efficient.

☞ Dividends – Pays a monthly eligible dividend of four to six per cent a year.

☞ Capital gains – 100 per cent of the growth is considered to be a taxable capital gain each year.

☞ Compound growth – Zero taxable distributions.

☞ Return of capital – Pays monthly return of capital income of six to eight per cent a year with zero taxable distributions.

While the tax strategies available with mutual funds from NexGen Financial are amazing for a creative tax strategist like me, investments should never be purchased purely, or even primarily, for tax reasons. The exception to this can be extreme tax opportunities, such as dividends that are taxed at 70 per cent for low income seniors.

either a SWP or a T8 fund, part of your income is considered to be the capital invested.

Any dollar of return of capital you receive means the interest on a dollar of the investment loan is no longer tax deductible. Therefore, you can take income from the dividend or capital gains version, so that your entire investment loan remains tax deductible.

Allocating income to minors: If you invest "in trust" for your minor children, interest or dividend income is taxable to the parent, but any capital gains are taxable to the children, who likely will not have enough income to trigger tax.

Therefore, you can invest in the capital gains version and have all growth taxed to your child each year with no tax consequences.

Converting income

If the investments that you want do not provide the most tax-efficient income, there are a variety of methods to convert investment income into the most favourable type.

Most of these methods use corporate class mutual funds. ❐

How to use income conversion

Corporate class mutual funds from many fund companies have several uses for converting income.

Here are some practical examples of how you can benefit by using corporate class mutual funds to convert investment income into more tax-efficient income types.

Converting interest into capital gains: Use money market or bond funds that pay capital gains if you are a:

- ✓ Conservative investor in a high tax bracket.
- ✓ Business owner with cash or investments in your corporation or holding company and do not want to receive interest which is taxed at the highest rate inside your corporation.
- ✓ A Senior with your GIS or OAS clawed back.
- ✓ Parent investing "in trust for" your children to avoid being taxed yourself on interest income.

Distributing only capital gains or dividends: Use corporate class mutual funds for tax-efficient investing that should result in little or no taxable distributions, and any distributions are taxed mainly as capital gains or dividends, if you are:

- ✓ Growing your investments for the future and in a high tax bracket.
- ✓ Expecting to be in a lower tax bracket in the future.
- ✓ A business owner with cash in your corporation or holding company.

Converting any investment income into tax-free "return of capital": Use T8 funds (or a SWP) to receive monthly income as return of capital if you are:

- ✓ A high income earner, but expect to be in a lower tax bracket in the future.
- ✓ A senior with your GIS or OAS clawed back.
- ✓ Highly taxed and you want to defer tax for 10-15 years.

Want a low-maintenance income strategy that automatically adjusts your income every year based on how your investment performed the previous year.

– Ed Rempel