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-
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