FINANCE

TAX TALK

Smart ways to secure your financial future.

BY MIKE MAGREEHAN

Ensure financial security through effective tax planning and investment strategies.

Taxes are inevitable. The amount of tax you pay is often your highest lifetime expense. With inadequate planning, Canada Revenue Agency can become the largest beneficiary of your hard-earned dollars.

In my years of experience working with wealthy families, including chiropractors, naturopathic doctors and business owners, there is a cardinal error that has proven costly on the long-term success of an otherwise well-crafted investment plan: thinking in pre-tax instead of after-tax returns.

Many affluent investors fail to integrate their investment and tax-planning strategies in a manner that optimizes after-tax returns. This error is committed with great frequency when there are solutions that can be easily implemented.

The good news is that there are strategies to alleviate tax and ways to structure your investments in a way that offers compelling advantages.

Successful business owners and high-income earners can accumulate substantial wealth over their working lives. Returns from non-registered investments are often taxed at your highest marginal rate. Additionally, returns on investments inside your corporate Holding Company are diminished by annual taxation as well.

CORPORATE CLASS FUNDS

One powerful advantage of a registered plan, such as a registered retirement savings plan (RRSP), tax-free savings account (TFSA), insured retirement program (IRP) or pension, is the tax-deferred compounding of income that occurs inside these plans over time. These accounts are limited by strict annual contribution limits and the penalties for over-contributing are severe. As a result, many affluent families accumulate a sizeable non-registered nest egg, which is subject to annual taxation. For these assets, investors should consider corporate class funds for their many tax advantages, which can be substantial over your investment lifetime.

To set the stage, there are two broad fund categories. Traditional mutual funds are structured as trusts, and therefore each year you must declare any capital gains/losses and investment income received. This income is taxed at your highest marginal tax rate. Additionally, if you switch from one fund to another, as investors often do in order to rebalance portfolios, you will trigger a taxable disposition that must be declared on your tax return that year.

The other fund category is corporate class funds, where funds are structured under a corporate umbrella. This simple distinction is what makes corporate class funds so attractive.

Corporate class funds have been growing in both practicality and popularity. They look and feel a lot like regular mutual funds, but provide investors certain tax benefits which traditional funds do not offer.

Under the corporate class umbrella, investments can grow tax-free and be rebalanced among other class funds offered by the same fund company without triggering a capital gain or loss. Tax is ultimately realized once you redeem funds from the umbrella, but is treated as a capital gain (only half

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taxable). Investors can plan when to take the gain, providing more control over after-tax returns. This is especially advantageous as you transition from pre-retirement to retirement, when most investors are looking to rebalance their portfolios toward more conservative assets.

Further, investors looking to maximize current after-tax cash flow should consider distributions in the form of return of capital (ROC) as paid by corporate class funds. ROC distributions are tax-free until such time the investment is sold (or your adjusted cost base becomes zero, at which time further distributions are treated as capital gains). In this manner, you defer tax that you would otherwise pay on a regular stream of income distributions.

Operating fees for many corporate class funds may be slightly higher, so one should ensure that the tax advantages outweigh any incremental costs. Certain corporate class structures are superior to others in achieving tax efficiency.

A corporate class strategy can work well alongside other fully funded tax-advantaged options, including RRSPs, TFSAs and IRPs. Contribution limits do not apply to class funds, and as such, are a suitable tool to tax-shelter investment income and create the means for tax-effective portfolio rebalancing and tax-deferred compound growth.

Accumulating wealth takes effort, and preserving your wealth takes discipline. Wealthy investors are wise to fully fund their tax-sheltered plans, and should consider other deferral opportunities to maximize after-tax returns, such as corporate class funds.

As is the case with most areas in life, if you are looking to maximize your success, it is best to surround yourself with a qualified team. Not only is this true when it comes to your personal health, but it is also true for your financial health. An advanced team of financial professionals will equip you with the tools and knowledge you need to make informed decisions that enhance your portfolio success and, ultimately, your quality of life.

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