



# TAXtalk

## The Case For Tax-Effective Investing

By Evelyn Jacks



### **First in a Series on Tax Planning Strategies using Corporate Class Funds**

*Tax-effective investing involves arranging investment affairs within the framework of the law to pay the least amount of taxes when investment income is earned and upon disposal of the underlying assets. Within that legal framework, the government has provided Canadians with a variety of "tax preferences" that are designed to encourage tax-assisted savings for retirement and within the capital marketplace to meet Canada's social and economic goals.*

#### **RRSP limitations**

The most well-known tax preference is the RRSP – an investment vehicle that should be given top priority because of its immediate double-digit tax savings and tax-deferred compounded investment growth. These accounts have their limitations, however, especially for the following groups:

- *High-Income Earners:* Tax-efficient savings opportunities must be found outside the RRSP environment once the contribution limits are reached – or in other cases, when investors reach the bottom-end limitation of 18% of earned income (See Table 1).
- *People with limited RRSP room:* Many employees are limited in how much they can invest in RRSPs because of large Pension Adjustments, which stem from Registered Pension Plan contributions made

by their employers. Some employers provide supplementary employee retirement plans to add to the retirement pot; however, these are often inefficient from a tax point of view.

- *Older investors:* Tax deferral with RRSP savings also ends for taxpayers who have reached age 70. At that time, a re-evaluation of income structure is required, to minimize tax in the absence of an RRSP deduction and in particular to avoid high marginal tax rates that will result in clawbacks of social benefits like the Old Age Security.
- *Corporate investors:* These investors, including small business owners, may face further challenges in funding Individual Pension Plans or, in the case of larger companies, in the avoidance of capital taxes in some jurisdictions.

**Table 1: RRSPs annual contribution limit – 18% of earned income to the following dollar limit:**

	2006	2007	2008	2009	2010	2011
Limit	\$18,000	\$19,000	\$20,000	\$21,000	\$22,000	indexed
Prior-year Earnings Required	\$100,000	\$105,555	\$111,111	\$116,667	\$122,222	

**Corporate class funds overcome these limitations**

For these groups and other investors who have maximized their RRSP contributions, corporate class funds (offered by CI under the name CI Corporate Class funds) are the next logical investment product. They provide an excellent opportunity for clients to:

- Maximize the tax-free growth of their assets over the long term.
- Benefit from the tax-deferral feature of RRSPs without being subject to a contribution limit.
- Make investment decisions – such as rebalancing and tactical asset allocation shifts – based on the merits of the investments rather than on tax considerations.
- Decide when to declare capital gains.
- Convert interest income earned by the funds into tax-efficient capital gains at redemption.

Combined with basic family tax-planning skills, corporate class funds provide enhanced wealth-creation opportunities for maxed-out RRSP investors on a largely unrestricted and intergenerational basis. One could say that corporate class funds play a starring role in the next tax-efficient frontier – non-registered portfolio construction.

**A close look at corporate class funds**

Corporate class funds can help clients meet all of these goals, mainly because of the advantageous tax treatment extended to mutual funds that are held within a single taxable corporation, rather than a trust.

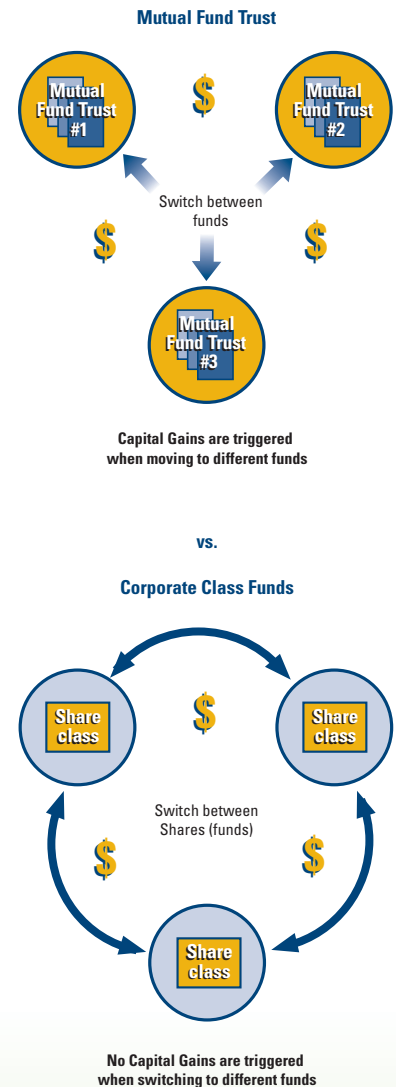
Within a corporate class structure, each mutual fund is contained within a separate class of shares.

What this means is that:

- Shareholders can switch from one class of shares to another without incurring tax consequences (See Chart 1).
- Income earned by shareholders is distributed as dividends or capital gains, which attract lower marginal tax rates than interest earnings, or withdrawals of capital and earnings from an RRSP or RRIF.
- Income distributions made to shareholders are reduced at source through a Capital Gains Refund Mechanism, which limits capital gains that flow to investors and allows the corporation to share the income and expenses of all share classes.
- The funds can be managed so that there are minimal or no annual distributions of taxable income. (This has been the case, for example, with CI Corporate Class funds since their inception.)

Remember that in a non-registered environment, the most tax-efficient way to accumulate capital is with an income-producing asset such as a business, property or investment that will generate capital gains on disposition. With an investment within corporate class funds that increases in value over time, unrealized capital gains are never taxed until redemption. Then, only 50% of the gains are taxable. Further, capital gains realized in the tax year can be offset by capital losses of the current year, or any unused losses incurred from 1972 to the present.

**Chart 1: Corporate Class Funds versus Mutual Fund Trusts**





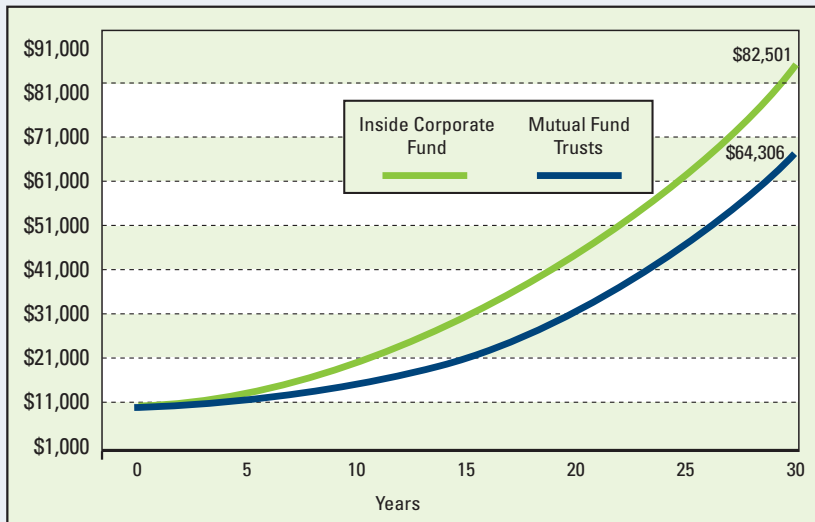
Given these features, the astute financial advisor can in fact produce stellar results over the long term for clients who have maximized their RRSPs. When you choose corporate class funds and employ

basic tax-efficient investment strategies within a non-registered account, you will be able to unleash the power of tax-deferred compounded growth.

**The Benefits of Tax Deferral in Corporate Class Funds**

Consider two investors, Bob and Sue, each in a 40% tax bracket who each start with \$10,000 invested which will grow over 30 years. Bob puts the money into a traditional mutual fund trust while Sue invests into a corporate class fund.

Sue's portfolio significantly outpaces Bob's because she can reinvest the full amount of annual growth and defer taxes.



Investors like Bob, who are paying tax on their gains every year, will see their accumulation eroded due to the annual tax bite. In the example above, Bob's \$10,000 grows to \$64,306 over 30 years.

Sue is able to reinvest all of her capital gains, paying tax only at the end of the 30-year period when she redeems out of the corporate class structure. As a result, she ends up with \$82,501, or \$18,195 more than Bob.

- Assumptions 1) 8% annual return  
 2) 40% marginal tax rate  
 3) Annual trading between funds

\*Source: CI Investments

Evelyn Jacks is the author of 30 best-selling books on the subject of personal income taxation. She is President of The Knowledge Bureau, Canada's leading professional education publisher in the tax and financial services industry, specializing in delivering courseware and information services to financial advisors and their clients. For more information call toll free 1-866-953-4769 or visit [www.knowledgebureau.com](http://www.knowledgebureau.com).



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