
# Four pillars of tax-efficient investing

Tax-efficient investment solutions are likely to become more crucial in the near future. We know it's highly important in the context of non-registered accounts, simply because these accounts are not tax-sheltered. We also know that it's not merely a question of selecting investments that incur the least amount of tax. Otherwise, people would simply hide their savings under their mattresses.

We define tax-efficient investing by looking at the added after-tax value of an investment attributable to its tax characteristics for a given risk profile. In other words, what's the value-added tax component? We also have to consider the high-net-worth (HNW) investor's particular investment objectives: a tax-efficient solution, even if it matches an investor's risk profile, isn't worthwhile if it doesn't meet the investor's objectives.

With that in mind, there are four basic tax-efficient strategies.

**1. Tax-efficient growth:**

This is minimizing taxable distributions to facilitate compound growth.

"Corporate Class Funds" can minimize current taxes and promote tax-efficient growth by grouping a family of funds within a single mutual fund corporation (MFC). A MFC, which is treated as a single tax entity, consolidates all income and expenses realized by its classes for tax purposes. This allows the corporation to effectively use expenses to offset income generated by the structure that would otherwise produce a tax liability, thereby allowing greater compounding of the investment.

To optimize this tax saving strategy, the MFC's board of directors must ensure that income does not exceed expenses within the structure. One way it can achieve this is to limit interest income-generating investments within the structure.

After the interest and foreign income is offset, the balance of expenses can be applied against capital gains, and possibly Canadian dividends, to help minimize the class fund's taxable distributions.

An MFC can also utilize available capital losses across all investment classes to help eliminate capital gains. Any remaining net realized capital gains are then typically allocated back to the class fund that generated them in the first place.

The capital gains refund mechanism (CGRM) is another important tool to minimize distributions within a MFC. A mutual fund can use the CGRM to shelter a portion of the distributions from realized gains that would otherwise be paid to investors. MFCs can then retain these gains without incurring a tax liability.

**2. Tax-efficient switching:**

This is making strategic or tactical shifts in a portfolio's allocation without triggering a taxable event.

At some point, investors need to rebalance their portfolios in response to changing market conditions, either because of considerations under the know-your-client rule or for tactical reasons.

In either case, a MFC provides investors with the flexibility to switch and rebalance non-registered investments without triggering taxable dispositions. Given that MFC is viewed as a single tax entity, a taxable disposition only occurs when the investor redeems or switches out of the corporation altogether. Consequently, switches within the corporation are not deemed to be a taxable event, and unrealized gains are left inside the account to continue to grow.

This compares favorably to mutual fund trusts, which produce a current tax liability when gains are realized as a result of a switch.

**3. Tax-efficient cash flow:**

This is generating a desired level of cash flow while mitigating current tax.

A more recent MFC innovation, the introduction of a return of capital (ROC) service on class funds allows for the tax-efficient generation of cash flow. The ROC service defers the triggering of capital gains from regular monthly withdrawals. It does this by reducing the adjusted cost base (ACB) of the investment by the amount of ROC distributed instead of redeeming units. ROC is considered after-tax, so there is no tax liability on this cash flow.

Unfortunately, this doesn't mean there won't be any taxable distributions from a mutual fund corporation. There can still be reinvested taxable dividends or capital gains dividends. However, these dividends are likely to be less than the amount that would otherwise be generated in the same fund within a mutual fund trust structure, and won't include interest income.

The return of capital process can continue for many years until the account's ACB is reduced to zero, at which time additional withdrawals will be treated as capital gains. However, these later withdrawals would still be tax-efficient because capital gains are only subject to a 50% inclusion rate.

For example, the tax on the cash flow once the ACB is drawn down to zero is taxed at half the rate of an interest-bearing security or a withdrawal from a RRSP or RRIF account.

The life of an investment's ACB in a class fund depends on the payout option you choose and the return on investment, but typically the average ACB life ranges from 10 to 20 years.

**4. Tax-efficient estate planning:**

This is planning for spousal, inter-generational and charitable transfers of wealth in a tax-efficient manner.

New federal charitable gifting rules allow investors to eliminate capital gains tax and receive tax credits for in-kind donations of publicly traded securities, including mutual funds, to registered charities and foundations.

These rules dovetail perfectly with the ROC service on class funds discussed above, by allowing investors to separate their original capital from their capital gains. When a class fund's ACB reaches zero, the investor is then left with an investment that consists entirely of capital gains. At that point, investors can then make in-kind donations to charitable organizations, consisting of 100% capital gains, and take full advantage of the zero inclusion rate.

Using a ROC service on class funds (mentioned above) can be better than making an in-kind donation of shares. Typically with an in-kind donation of shares, investors are donating a portion of after-tax original capital as well as pre-tax capital gains. With the ROC service, investors can either keep the after-tax original capital or give it to heirs while donating some or all of the pre-tax capital gains to charity.

ROC services on class funds (also known as T-SWP Class or T-Class) are now one of the most compelling strategies for making charitable transfers. More broadly, it can be an indispensible solution for implementing a tax-efficient estate plan.

***Adrian Reynolds and Greg Taylor are Wealth Optimization Specialists with DentalWealth - a Multi-Family Office that caters to successful dentists and high net worth individuals in the dental industry. They can be reached at: www.DentalWealth.ca***