Finance

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Making your portfolio more tax-efficient

Corporate class funds can translate into major tax savings for many investors, but they come at a cost.

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Looking to save some taxes? Well, starting next year, you'll be allowed to invest up to $5,000 in the new tax-sheltered Tax-Free Savings Account.

You won't pay taxes on any investment gains, and you can withdraw the money without penalty at any time you chose. Although it's a relatively small amount, it's still a pretty good deal for tax-sensitive investors looking beyond RRSPs.

And, many investors, particularly those who have generous corporate pension plans that leave them little or no RRSP contribution room, are finding that non-registered investments actually form an increasingly significant chunk of their retirement funds.

And, for them, taxes then become a major consideration, especially if they're looking to unwind a position in the face of these volatile markets. Every decision to sell has to be weighed against the impending tax hit.

Realizing this, most fund companies now offer more tax-efficient setups, known as corporate or switch funds, which allow investors to move out of one fund and into another without any immediate tax consequences. Vendors like these arrangements because they tend to keep people loyal to a particular fund family. Investors like them as well because they really do offer potential tax savings, providing you understand how they work.

In general, funds get hit with taxes at two levels: the tax you pay directly every time a fund unit is redeemed, and that which is triggered as the fund manager buys and sells securities.

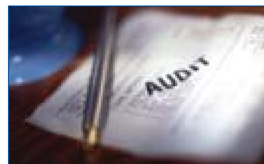
Most original funds are set up as trusts where income flows directly through to unitholders in annual distributions where they then pay the tax. Although the ins and outs are complicated, the overall tax bill will generally be lower if the fund pays out all of its income this way.

A mutual fund corporation, however, is essentially a family of funds within a single taxable corporation. Picture an umbrella with a number of spokes beneath it. Each series of funds is considered a mutual fund corporation, and each fund within the series is considered a different share class.

Selling one corporate class fund will not create a tax liability as long as you roll over the profits into another corporate class fund, staying under the umbrella. Think of these funds as RRSPs in disguise. You're only taxed on the increase in value when you sell out totally for cash down the road.

If you're an everyday buy-and-hold investor, however, these funds aren't going to be of much use to you since you're not actually doing much switching. In fact, you may even end up paying more for something you don't use.

More on taxes:



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Corporate class funds sometimes have management expense ratios that are slightly higher than the original funds on which they're based. The MER on the AIC Diversified Canada Fund is .03 per cent less than its corporate cousin, for example.

But, even this isn't always the case. The cost for the IA Clarington Canadian Equity Fund, for instance, is the same regardless of which type you buy.

Still, for some - particularly conservative, fixed-income investors - any extra cost may be worthwhile since the corporate class option has the ability to turn what is normally interest income into capital gains.

You see, even if your money is in a money market or bond fund, any gains you make within the umbrella are converted into deferred capital gains. This means you're converting at least a portion of the interest you earn, which is fully taxable, into capital gains, which will endure a lower tax bite.

How much of a difference will this make? Consider the following example, courtesy of Jason Pereira, an advisor with Toronto-based Woodgate Financial Partners/IPC, and, Advisor's Edge, a financial industry trade publication.

Say you're in the highest tax bracket, paying 46.4 per cent tax on interest income, and you invest $100,000 in a garden variety bond fund and $100,000 in the corporate class version of that fund, with both funds earning 6 per cent.

Since you'll have more money working for you and enjoy a higher rate of compounding as a result, the corporate class option on a pre-tax basis ends up nearly doubling the value of the trust-structured fund over 25 years ($220,604 v. $429,187). And, on an after-tax basis, it still ends up providing significantly more return ($220,604 v. $352,799), Pereira estimates.

In fact, an investor only has to earn 4.2 per cent pre-tax in a corporate class bond fund to equal a 6 per cent return in a regular bond fund, he points out.

The umbrella approach can also prove attractive to those who rebalance on a regular basis to maintain a specific asset allocation strategy and keep their portfolio on track. Several fund companies offer wrap programs that periodically restore your portfolio to its initial target asset mix without charge and, under these corporate class programs, without immediate tax.

Of course, corporate class costs will vary among companies. So, consider the MER charged by the fund and how much higher it may be compared to the fund you might otherwise use if you weren't bedazzled by the potential tax savings.

As always, any final decisions about tax-related strategies should be checked out with a qualified tax advisor.

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