



# TOOLBOX

BY

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## STRUCTURAL ADVANTAGE

Corporate class mutual funds offer tax efficiencies.

**NOT** long ago, a mutual fund wholesaler was in my office touting the benefits of his product offering to my business partner. While the two agreed on the value of the product, they agreed to disagree about its tax efficiency in non-registered portfolios.

My partner observed the product wouldn't be as tax-efficient as some of its competitors because it was structured as a mutual fund trust and not a corporate class mutual fund. Unfazed, the wholesaler politely said the corporate class issue was irrelevant because the portfolio had a very low turnover rate. These two failed to reach a consensus, but stumbled upon an important issue: tax efficiency within taxable portfolios.

Tax efficiency is the degree to which an investment avoids taxation through methods such as deferral or attraction of lower tax rates—a smaller portion of the return flows out of a portfolio to pay a tax bill, and of course, more is left behind to earn continued returns. Let's consider three portfolios:

- Portfolio A earns 8% fully taxable as interest;
- Portfolio B earns 8%, of which 4% is realized capital gains and 4% is deferred capital gains; and
- Portfolio C earns 8%, all deferred capital gains.

We'll assume tax rates are equivalent to the top tax rate in Ontario of 46.41%, and that the portfolios were not liquidated at the end of the year. Each portfolio is left with the following return:

- Portfolio A, 4.2872%
- Portfolio B, 7.0718%
- Portfolio C, 8%

Assuming this relationship holds, portfolio C will be able to compound at a rate of 8% versus the lower rates for A and B, and in turn result in the largest before- and after-tax values. That brings us to the three factors which impact efficiency within a portfolio: Type of income, turnover and dividend yield.

### Income Type

There are three types of investment income: interest, dividends and capital gains. All attract their own tax rates. In Ontario the top rates for each income type are: 46.41% for interest; 23.96% for dividends issued by public corporations; and 23.21% for capital gains.

Based on these rates, it's clear capital gains yielding investments are more tax-efficient than other forms of return. But we still have to consider the inherent risk associated with these types of investments. Capital gains also provide the distinct advantage of not being taxable until time of sale.

### Turnover

Portfolio turnover measures how often assets within a portfolio are sold, and then used to buy new assets. The most common measurement tool is called a turnover ratio, which equals the value of the turned-over assets divided by the total assets in the portfolio. So, a turnover ratio of 25% tells us that the portfolio manager on average will sell and purchase 25% of the portfolio's dollar value in one year.

Portfolio turnover affects tax efficiency by causing the investor to realize deferred capital gains and in turn pay tax on them, thereby re- **continued on page 10**

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continued from page 9    ducing the dollar value of the investments.

## Dividend Yield

The last factor affecting portfolio efficiency is dividend yield, which is unique to stocks. A dividend yield is measured as the total dividends paid to shareholders in a given year, divided by the dollar value of the stock/portfolio.

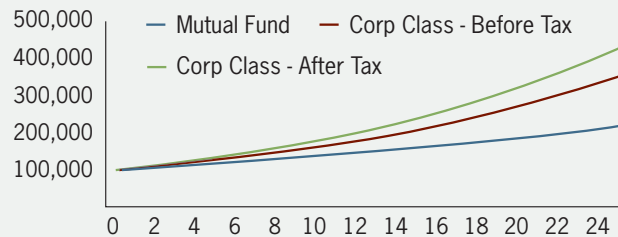
When measuring the total return for a stock/portfolio in any given year, this yield is included. For instance, if a portfolio returned 8% with a 2% dividend yield, it means 2% of that 8% came from dividends while the other 6% came from capital gains. Dividends are taxable in the year they are paid to the shareholder, and that's significant for efficiency management because the higher the dividend yield, the more taxes will be due in a given year.

## A Question of Risk

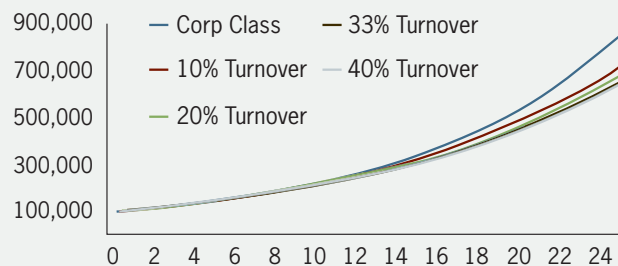
It might be tempting to conclude the most tax-efficient way to invest money within a taxable account is to place 100% of the assets in non-dividend paying stock funds with no turnover. While that may be true, from a risk standpoint it's inadvisable. Stocks that pay no dividends are historically higher risk, and are certainly much riskier than bonds. So, even though low turnover is more tax-efficient, the only time a manager should sell an investment is when the fundamentals make sense.

A common solution is to hold investments that attract higher tax rates and generate income (such as bonds or dividend-paying stocks) in tax-sheltered portfolios, while keeping lower-yielding stocks in non-registered accounts. Another is to seek out portfolio managers with low turnover. Or, as my partner so adamantly insisted, corporate class funds provide an excellent alternative.

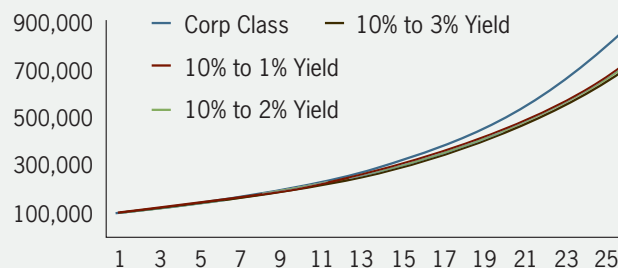
## Class Comparison



## Turnover Totals



## Yield Curve



## Going Corporate

Corporate class mutual funds are just like the more common trust-structured mutual fund, except for one important difference: they're organized as corporations. The resulting benefits are significant and include:

- Switching among funds within the

same family without triggering a disposition;

- All taxation is deferred until time of sale (assuming 0% distribution); and
- All gains at time of withdrawal are taxed as capital gains, regardless of the asset class the funds were invested in.

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**continued from page 10** Every advisor must examine the mechanics of these funds before making recommendations to clients. Let's look at some of the ways the benefits of these funds affect their tax efficiency.

First, the ability to switch between funds without triggering a disposition is a huge advantage to investors. With trust-structured funds, the switch from one mutual fund to another would trigger a disposition and the investor would realize deferred capital gains. This isn't the case with corporate class funds. The deferred gains are carried over to the new fund, and disposition only occurs when withdrawing funds from the account. This is also useful for investors in various wrap programs, which often rebalance on a monthly to quarterly basis, triggering small dispositions each

time. In a corporate class structure, all of this would be deferred.

Generally, taxation of gains is deferred until the time of withdrawal. If the fund has to make a distribution during the year, the proceeds of the fund would be taxable. But at least there's potential that investors will not have to pay taxes on their gains for as long as they remain invested within the structure, thereby increasing their rates of compounding.

Gains are, however, consistently taxed as capital gains; even if the client's money were in a money market, bond or dividend fund. All gains still convert into deferred capital gains and that's a significant advantage when investing in fixed income. Since fixed income generates interest income, which is fully taxable, investors in the top tax bracket

can lose almost half of their annual return. However, in a corporate class structure, they wouldn't pay any tax until withdrawal, and, even then would pay the much lower capital gains rate. Let's consider the following example: An investor buys \$100,000 in a trust structure bond fund and \$100,000 in the corporate class version of that fund (see "Class Comparison," page 10). Both funds earn 6% and the investor pays a 46.41% tax on interest income.

Due to the higher rate of compounding, the corporate class fund on a pre-tax basis ends up more than doubling the value of the trust-structured fund over 25 years. And, on an after-tax basis, it still ends up providing significantly more return. Clearly when holding fixed income in a taxable portfolio, corporate class funds are the winners.

## Portfolio Turnover

Now, just how much of an impact can portfolio turnover have on a taxable account's value? Let's examine the following:

- A 10% turnover portfolio;
- A 20% turnover portfolio;
- A 33% turnover portfolio;
- A 40% turnover portfolio; and
- A corporate class fund portfolio.

Each portfolio was examined for a 25-year period and compares what the after-tax value of each portfolio would have been if it had been liquidated at the end of that year (see "Turnover Totals," page 10). The initial investment in each portfolio was \$100,000, all of them returned 10% with a 0% dividend yield, and all were taxed at a capital gains rate of 23.21%.

Even the portfolio with a turnover rate as low as 10% delivered more than \$125,000 less than the corporate fund class over the 25-year period. And, it seems the cost benefit trade-off on portfolio turnover follows the law of diminishing returns. The gap between 0%, 10%, 20%, 33%, and 40% gets smaller each time. In fact, while the difference between 10% and 20% turnover is approximately \$44,000, the gap between 20% and 40% is only \$26,000. The inefficiency associated with portfolio turnover decreases when portfolios with higher turnover rates are compared. So, when comparing managers with high turnover rates, realize those respective rates become less important.

## Dividend Yield

Last, consider dividend yield using the following illustration:

- A 10% turnover portfolio with a 1% dividend yield;
- A 10% turnover portfolio with a 2% dividend yield;
- A 10% turnover portfolio with a 3% dividend yield; and
- A corporate class fund portfolio.

Once again, we'll assume a total return of 10%, a capital gains tax rate of 23.21%, and a dividend tax rate of 23.96% over 25 years, and examine only the after-tax values in each year. A 10% turnover is a reasonable benchmark, since it would have been unrealistic to assume a 0% turnover ratio—the most conservative assumption was made in order to limit its impact on the illustration (see "Yield Curve," page 10).

While dividend yield had an impact, it was far less pronounced than the varying turnover ratios. These small differentials show that while dividend yield does have an impact on efficiency, it is far less than turnover ratio. It's crucial for advisors to remember the only thing that truly matters to most investors is net dollars, not gross. To maximize this net-return benefit to a client, we must keep portfolio efficiency, and the factors that affect it, in mind when making recommendations. <sup>AE</sup>

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