Manulife Investments

WealthStyles®

"T" is for tax efficient

Good news! According to Statistics Canada, you're probably going to live longer[1]. This also means you may now spend up to one-third of your life in retirement. Will your retirement savings last as long as you do? Creating tax-efficient income from your retirement savings and deferring capital gains tax can help ensure that they do.

In today's low interest rate environment, traditional income-producing investments, such as bonds and Guaranteed Investment Contracts (GICs), pay rates of interest that barely keep up with inflation once tax has been factored in. To get past this hurdle, you require creative solutions to fund your retirement years. If you are looking to generate tax-efficient income and you're willing to accept the additional risks that come with mutual fund investing, T Class mutual funds may be an option worth considering when formulating your retirement income plan.

WHAT IS A T CLASS FUND?

T Class funds are a special class of a mutual fund that is designed to pay you a prescribed amount of cash flow on a monthly basis, based on a target distribution rate, typically anywhere from five to eight per cent of your mutual fund's net asset value per year. Designed to help you create tax-efficient income streams from investments in non-registered accounts (i.e. not RRSPs or RRIFs), T Class funds work like Systematic Withdrawal Plans (SWPs). However, there's an important difference:

T Class funds are designed to help defer more capital gains tax until some point further down the road.

This is accomplished through a unique structure. When you receive income from a T Class fund, no mutual fund unit redemptions are required to make the payment. Depending on the target distribution rate, the cash flow distribution that you receive could consist primarily of a return of capital, which, in essence, is a return of your original investment and is, therefore, not subject to tax. It does, however, reduce your adjusted cost base (ACB).

[1] Statistics Canada - http://www40.statcan.ca/l01/cst01/health26.htm

WHAT ARE THE BENEFITS?

T Class funds can provide a stream of tax-efficient income, while allowing you to defer capital gains taxes until a later point in time. The reason for this is simple: the monthly distributions do not require units to be redeemed and are comprised primarily of return of capital, which is not taxable.

This means that the amount of tax that has been deferred can continue to grow in your investment account and not with the Canada Revenue Agency. In addition, you have the ability to choose when to realize some of the capital gains. By triggering capital gains when you expect to be in a lower tax bracket, you may be able to reduce the total tax paid and keep more of your money.

On top of reducing the tax you pay, the tax efficiency of these payments can provide additional benefits. Lowering the income you report on your tax return can be very beneficial in terms of income-tested government benefits, such as Old Age Security (OAS) and income-tested tax credits, such as the Age Credit, which are typically clawed back as you report higher levels of income.

Once your original investment has been completely repaid to you (i.e. your ACB has been reduced to zero), any further return of capital distributions will be taxed as capital gains, of which only half is taxable. Accordingly, not only are the payments of return of capital over the near term tax efficient, but even when your ACB reaches zero, any additional return of capital distributions will remain tax efficient when compared to regular income.

DIFFERENT TYPES OF INCOME

Figure 1 illustrates how different types of income are taxed in Canada. You'll notice that income and Registered Retirement Savings Plan (RRSP) and Registered Retirement Income Fund (RRIF) payments are taxed at the highest amount. You'll also notice that the return of capital distribution is not taxed at all. This is because you are receiving your original investment back, on which you have already paid tax before it was invested.



Figure 1

TAXATION OF DIFFERENT INCOME TYPES

	Interest	RRSP/RRIF withdrawals	Eligible Canadian dividend income	Capital gains	Return of capital
Tax rate	46.41%	46.41%	24.64%	23.20%	0%
Withdrawal amount	$1,000	$1,000	$1,000	$1,000	$1,000
Taxes owed	$464	$464	$246	$232	$0
After-tax income	$536	$536	$754	$768	$1,000

For illustrative purposes only. Results are rounded to the nearest dollar.
Assumptions: Based on 2007 top individual marginal tax rates for Ontario. ACB is greater than zero.

INCORPORATING T CLASS FUNDS INTO YOUR INVESTMENT PLAN

There are a number of investment strategies using T Class funds that are worth considering. The first strategy is for investors with maturing bonds and GICs. In today's markets, bonds and GICs provide lower levels of interest and may tie up your savings for extended periods of time. If you're willing to accept the additional risk of not having a principal guarantee, rolling over a part of your GIC or other fixed-income investments into a conservative balanced mutual fund with a T Class feature has the potential to increase your level of after-tax income, while allowing the remaining investment to benefit from any market growth.

A second strategy is for investors who require cash flow and have both registered and non-registered investments. To maximize your income potential, it is often best to use non-registered assets first when withdrawing income. Using your non-registered assets first allows your registered savings to compound tax-deferred over a longer period of time. For RRIF investors, this means that you could take the RRIF minimum payment as prescribed, but then use non-registered assets to make up any income shortfalls. By following this strategy, not only are you making the most tax efficient use of your hard-earned savings, you can also help ensure that your savings last for a longer period of time.

To help illustrate this strategy, Figure 2 compares the level of after-tax income you could receive from either a GIC or bond with two different T Class funds: one that has taxable income to distribute and one that does not. As you can see, both T Class funds provide higher after-tax flow than the GIC or bond. However, the T Class fund that has no taxable income to distribute provides the greater level of tax-efficiency because its distribution is entirely made up of a return of capital, which is not immediately taxable.

Figure 2

TAX EFFICIENCY OF DIFFERENT DISTRIBUTION TYPES

GIC or Bond		T Class fund WITH income/capital gains		T Class fund WITHOUT income/capital gains	
Monthly interest payment	$2,000	Monthly distribution consists of $200 interest income, $300 eligible Canadian dividends, $100 realized capital gains* and $1,400 return of capital	$2,000	Monthly distribution that consists entirely of return of capital	$2,000
Tax on return of capital (0%)		Tax on $1,400 return of capital (0%)	$0	Tax on $2,000 return of capital (0%)	$0
Tax on $2,000 interest income (46.41%)	$928	Tax on $200 interest income (46.41%)	$93	Tax on $0 interest income (46.41%)	$0
Tax on $0 eligible Canadian dividends (24.64%)	$0	Tax on $300 eligible Canadian dividends (24.64%)	$74	Tax on $0 eligible Canadian dividends (24.64%)	$0
Tax on $0 realized capital gains (23.20%)	$0	Tax on $100 realized capital gains and dividends (23.20%)	$23	Tax on $0 realized capital gains (23.20%)	$0
Monthly cash flow after tax	$1,072	Monthly cash flow after tax	$1,810	Monthly cash flow after tax	$2,000

For illustrative purposes only. Results are rounded to the nearest dollar.
Assumptions: Based on 2007 top individual marginal tax rates for Ontario. Return of capital levels will fluctuate based on the level of income earned and distributed by the fund, as well as availability of the original capital.

* Capital gains are distributed annually; however, for the purpose of this comparative illustration we have converted the capital gains distribution to a monthly basis

SO, WHAT'S THE CATCH?

While there are many benefits associated with T Class funds, there are a number of things that you should bear in mind. First and foremost, if the financial markets experience an extended period of volatility, the market value of your mutual fund investment could fall. In addition, the monthly distributions are not guaranteed, so if the mutual fund's rate of return is less than the distribution payout rate, the value of your investment will decrease over time as will the amount of the monthly payments. For this reason, it is important that the T Class mutual fund selected has the growth potential to sustain the distribution payout rate.

To help protect you from these problems, ensure that you have other sources of income to draw upon, such as a pension plan or some other guaranteed stream of income. An additional strategy is to choose a more conservative withdrawal option that will deplete your

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savings at a slower rate. Mutual fund investing does entail risk and there is no guarantee that the underlying investment will grow in value. Seen from this perspective, T Class funds can be best used for supplementary income since the value of the investment, and the amount of income it can provide, can never be guaranteed.

The second issue to be aware of is that the ability to defer capital gains means you will realize a larger capital gain when you eventually redeem your investment or make a taxable fund switch. However, it does give you the flexibility to incur the tax liability on your timetable, not someone else's, and you'll benefit from a tax-efficient income stream until you redeem your investment or trigger a taxable fund switch. Also, while you can defer some capital gains, T Class funds, just like other mutual funds, will still distribute any taxable income and capital gains realized at the fund level during the year, which you must report on your tax return.

If, however, you hold the mutual fund for several years, any payments of return of capital when your ACB reaches zero will be taxed as a capital gain. As a result, your remaining after-tax income will be reduced.

Something else to keep in mind is the number of funds available for T Class fund accounts. Mutual fund companies do not offer T Class on every mutual fund that they provide. That being said, there are usually a number of attractive options to choose from, some of which include 100 per cent equity funds that are capable of providing long-term growth. Other common options are balanced funds, dividend funds, asset allocation funds and managed solutions. Whichever option you choose, ensure that the fund provides opportunity for long-term growth. The more growth experienced by the underlying investment, the longer your savings will last.

SPEAK TO YOUR ADVISOR

Before entering the retirement phase of your life, it is important to carefully review your future sources of income to ensure your savings will last. Always keep in mind the importance of product diversification in creating a steady income stream for your retirement years. Spreading your investments across a number of product categories that may include bonds, GICs, annuities, segregated funds and T Class mutual funds could be an effective way to establish a dependable and diversified retirement income plan.

Finding the most appropriate product diversification for your financial situation can be a difficult task, which is why it is important to sit down with a qualified advisor. He or she can discuss the various options with you to determine which strategy is most appropriate and whether T Class funds can play a role in your long-term financial plan.

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