Planning to retire

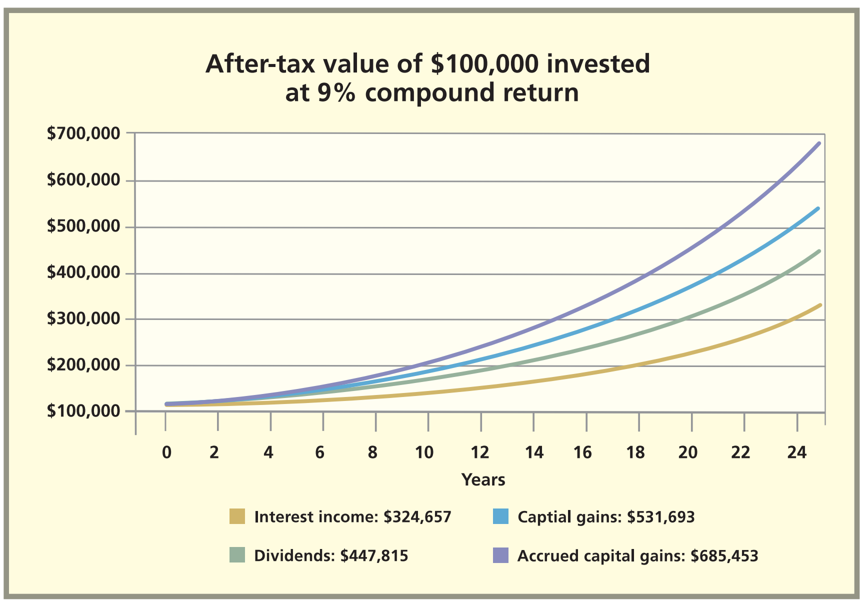
HALF OF ALL CANADIANS INVEST OUTSIDE THEIR RRSP IN AN OPEN ACCOUNT — BUT ARE THEY DOING IT WISELY?

Retirement is a major event, yet many people are not prepared for that time of their lives. According to two Ipsos-Reid polls released this year, six out of 10 Canadian adults feel they began saving for retirement much too late in life and nearly 30% of investors do not own an RRSP. It appears Canadians are not saving enough to achieve financial independence in their retirement years.

Determining the amount of capital someone will need at retirement is the most basic of financial planning analyses. Imagine a client earns $100,000 a year and would like to retire at age 65, with a retirement income of $75,000 before tax. To do so, he or she will need about $1 million in capital. A prerequisite for both retirement and estate planning is that a sufficient pool of assets be accumulated. But many clients (particularly the private sector) are not saving enough to enable them to fulfill their retirement lifestyle goals. In the public sector, invested capital per person is about $500,000 — the source deductions for defined benefit pension plans in the public sector are significant and mandatory. There is no equivalent in the private sector (while 40% of private-sector employees are in pension plans, the majority are in defined contribution plans). Furthermore, the average RRSP is $50,000 and only one-third of eligible Canadians contribute to RRSPs.

So, how does one build a nest-egg in middle age? To increase nonregistered (open) retirement savings, clients must get their money working for them, in a tax-efficient way, as fast as possible. The most basic financial planning strategy, after paying yourself first, is to reduce income taxes. CAs understand the importance of after-tax returns. Income tax is the single biggest drag on investment returns.

As the investing public looks for higher yields, they need to be made aware of the benefits of after-tax yields. In addition to building a diversified portfolio with greater-than-average growth or income potential, careful consideration of tax consequences is required to ensure that potential savings are maximized. This is where a mutual fund corporation (MFC) can help.



When it comes to open accounts, investors usually focus on two issues — the volatility and growth of their investments. Though these considerations are worthwhile, the tax liability that investments generate in an open account shouldn't be overlooked. Tax implications can severely hamper the overall success of a financial plan. Unlike a registered account such as an RRSP or RRIF, interest and dividends earned on investments in an open account are taxable in the year they are earned. Also, securities sold in an open account may generate taxable capital gains. Corporate-class mutual funds are extremely tax-efficient vehicles that can simplify tax planning and potentially lower long-term tax liability.

In essence, an MFC is a family of funds contained within a single taxable corporation. This is different from typical mutual fund trusts that are structured as a single fund unit. MFCs are organized so that each mutual fund is a different class of shares of the same corporation and the shares are convertible from one class to another on a tax-deferred basis. By utilizing a rollover provision in the Income Tax Act, the share conversion is deemed not to be a disposition for tax purposes and consequently no taxable gain is realized on the switch. For example, an investor can move his or her money from a blue-chip fund to a dividend fund without realizing capital gains. In this manner, investors can reallocate asset classes without triggering tax consequences. Clients need financial flexibility to readjust their portfolios to suit lifestyle and financial planning goals. Accordingly, MFCs can provide one-stop shopping to investors looking for flexibility in changing their asset mix over time. The tax-deferred conversion provision that underpins these funds is only available with respect to the shares of corporations, not the units of trusts.

At year-end, all mutual funds generally distribute taxable income to investors; however distributions are often lower under an MFC than they would be in a mutual fund trust. Within an MFC, only one corporate tax return is filed for the entire corporation, notwithstanding the fact that there are many classes of shares. The corporate structure allows capital losses in one fund to offset capital gains in another fund with a benefit to investors because there would be less in the way of mutual fund distributions to investors subject to tax.

As with other mutual funds, MFCs can reduce taxable capital gains through the use of the capital gains refund mechanism. The CGRM reduces double taxation because it allows some or all of a mutual fund's realized capital gains for the year to be effectively exempt from tax. The CGRM is intended to shelter the portion of capital gains realized by the mutual fund that approximates the gains realized by investors who redeem units or shares during the year. The mutual fund can retain those gains rather than distribute them. This practice has the effect of minimizing capital gains distributed to shareholders while at the same time avoiding any corporate tax in the corporation on capital gains.

One factor that has a positive correlation with the amount of capital gains that can be retained is the proportion of the fund's shares or units redeemed in the year. In general, the higher this number, the lower the capital gains distribution. Canada Revenue Agency is of the view that a shareholder converting shares of one fund into another fund doesn't constitute redemption for purposes of the CGRM. However, within certain mutual fund corporations, the existence of some unique individual funds within the structure work to further enhance the efficiency of the CGRM.

Corporate fixed-income investors have been strongly attracted to some MFCs. There are some corporate bond-like funds designed to attract investors for relatively short periods as a place to park uninvested funds and receive a tax-efficient return. Furthermore, these funds are attractive to institutional investors for short-term parking of funds at year-end because an investment in a corporation is deductible for capital tax purposes. The corporation realizes higher redemptions as a result of the increased volume of corporate investors. Generally, the higher the redemptions in the year, the higher the CGRM and the more realized gains that can be retained in the corporation. This is of benefit to shareholders because the greater the amount that can be retained in the corporation, the less that needs to be distributed to them for inclusion in their tax return.

Planning strategies using MFCs

MFCs can be used as a solution to a number of Canadian individual and corporate investment and tax-planning issues.

Individual investors Net capital losses realized in a given year may be carried back to any of three preceding taxation years or forward indefinitely to offset future taxable capital gains. By investing in corporate-class mutual funds, an investor can crystallize capital gains to coincide with capital losses or to increase income during low-income years.

It is possible to transfer accrued capital losses between spouses. As a rule of thumb, if the spouse with the higher marginal tax rate is invested in a corporate-class mutual fund, they can crystallize a capital gain to take the best possible advantage of a tax strategy that utilizes the lower-income spouse's accrued capital losses.

Now that only half of a capital gain gets taxed, some investors wonder if it's better to skip RRSP contributions and invest instead in an open account. RRSP investments must be turned into a taxable income stream after age 69 — even if a client doesn't need the money for spending. The RRSP income creates an extra tax bill and can reduce income-tested government benefits. Therefore, open-account investing in a tax-efficient MFC may be advantageous in certain specialized cases that involve income-tested government benefits.

Pensioners with incomes in excess of $60,804 (2005) must begin to repay part of the Old Age Security benefit through the tax system. This repayment is commonly known as the clawback. Dividends are preferentially taxed due to the dividend tax credit; however, they do result in higher clawback amounts than otherwise would occur with other forms of income. And, 125% of the cash amounts of Canadian dividends in income must be included — the 15% clawback rate is applied to this gross amount. Therefore, consider MFCs as part of a pensioner's nonregistered asset mix. Gains are not taxed until the investor redeems from the corporate-class structure and at that time, only 50% of those gains need be included in income. Investors have full control over the timing and amount of withdrawals from their accounts.

One of the most significant opportunities in the attribution rules applies to capital gains and minor children. Unlike income-producing assets, capital gains realized on the disposition of property by a minor does not attribute to the transferor. It is therefore advantageous to invest in assets, such as MFCs, that generate realized and unrealized capital gains as opposed to income-producing assets.

If a client moves to another country and ceases Canadian residency, he or she may have a deemed disposition on certain

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assets (excluding for example RRSPs and RRIFs). The client may wish to leave his or her investments in Canada if the client plans to return in the future. However, while he or she is living abroad, the client likely will need to include worldwide income every year for tax purposes in the new country and this will include any realized annual income on his or her non-registered investment portfolio. To defer this tax liability, the client can consider leaving Canadian investments in an MFC, which generates income primarily in the form of unrealized capital gains. Upon return to Canada the client can time the realization of the capital gains to coincide with lower-income years.

As the pension limits in Canada are essentially low, supplementary employee retirement plans are becoming more common. These top-up pensions offered by some employers cannot be funded on a tax-sheltered basis as tax rules cap the amount of pension that a tax-sheltered registered pension plan can pay. There are no government limits on these supplementary plans. The federal government has however imposed complex rules to make sure there is no tax shelter for the supplementary plan's capital or investment earnings. These rules are referred to as retirement compensation arrangements (RCA). In its simplest form, the RCA consists of a trust. The contribution is deductible by the employer on the same basis as if it had been paid as salary. But there is a special 50% tax on the contributions to the RCA and a 50% tax on the plan's investment earnings (which are refunded when the RCA pays out benefits to the recipient). While the tax on the contributions is unavoidable, the tax on the investment earnings can be avoided by using corporate-class funds that offer tax-sheltered deferral.

A Canadian resident may have an exposure to US estate tax if he or she owns US situs (or located) assets. Property located within the US includes (but is not limited to):

- US real estate
- shares in a US corporation whether held in a Canadian account or outside Canada
- bonds, debt and other debt obligations issued by US corporations.

As well, discretionary managed accounts where the individual owns US situs securities will still be subject to US estate tax even though the buy and sell decisions are not made by the individual owner.

Note that even US property held in a Canadian registered plan such as a RIF or RSP must be counted toward determining total US situs assets for purposes of US estate tax.

Units of Canadian mutual fund trusts that invest in the US market may be exempt from US estate tax; however, tax experts have had varying opinions on mutual fund trusts. As an alternative to mutual fund trusts, consider holding US funds within an MFC. Shares of MFCs are defined not to be US situs property and accordingly are generally not subject to US estate tax.

Corporate investors Capital tax applies to large businesses, including public, private and holding companies with a certain level of taxable capital on their balance sheets. Many companies holding T-bills and other debt instruments can be subject to provincial and federal capital tax. Investing in conservative corporate-class mutual funds can offer capital tax relief. In computing tax, corporations may claim a deduction in respect of eligible investments — an investment in a mutual fund can be deducted in calculating capital tax only to the extent that the investment is represented by shares of a mutual fund corporation and not by units of a mutual fund trust.

A private corporation's capital dividend account may be increased by the nontaxable portion of capital gains resulting from the disposition of eligible capital property. Therefore an amount equal to 50% of all capital gains realized by the corporation on the disposition of MFCs (which may be higher than that of the mutual fund trust counterpart) is added to the capital dividend account. At any point in time when there is a positive balance in the capital dividend account the corporation may elect to pay a tax-free dividend to shareholders. The use of the capital dividend account in retirement can provide tax-free income and reduce the possibility of reduction of income-tested benefits.

Flexibility is crucial

Without flexibility, clients can become locked into specific funds because the potential tax cost is too great to switch to a more suitable fund. This can cause portfolios to become stagnant or imbalanced and over time may prevent clients from taking a more conservative stance as they approach retirement. Over the long term, MFCs allow clients to adjust their asset mix without tax cost. Also, the corporate-class structure can significantly reduce and possibly eliminate year-end taxable distributions. Reducing the difference between pretax and after-tax compounding within a corporate structure will have a dramatic effect on a client's future net worth.

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source allowance deduction is currently being phased out while full deductibility of provincial resource royalties and taxes is being phased in.

Alberta permits a full deduction for provincial resource royalties and taxes. If these provincial resource royalties and taxes exceed resource allowance, the excess is available for a deduction (called ARTD) under Alberta income tax rules. Accordingly, the 2003 federal changes to phase-out resource allowance and phase-in Crown charge deductions are ignored for Alberta income tax purposes until 2007 when the resource allowance deduction is eliminated and provincial royalties and taxes are 100% deductible. A carry-over of unused accumulated ARTD will be permitted until December 31, 2013.

Alberta provides a royalty tax credit each year that is applied to reduce Alberta income tax payable, with any excess credit being cash refundable. The current maximum ARTC is $500,000 on up to $2 million of Alberta qualified royalty. Qualified royalties include royalties on conventional oil and gas production and on certain oil sands leases.

Qualified royalties exclude any royalty under an agreement granting rights to oil sands as defined in the Alberta Mines and Minerals Act. Consequently, Alberta royalties on oil sands mining projects likely do not qualify for ARTC. However, most taxpayers access the maximum ARTC on royalties paid on conventional oil and gas production.

Conclusion

Taxation of the oil sands is largely driven by existing rules that apply to conventional oil and gas and to conventional mining