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How taxes affect your finances

The goal never changes in the tax game --'keep as much as possible of what you make' -- but to win you have to understand the rules

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Tulips and tax filing time go together in Canada, and the season is fast approaching. As a financial advisor, you can bring value to your client in helping to lighten the burden of taxes, taking advantage of opportunities for deductions and deferrals. Any mutual funds held by clients present their own set of taxation issues, and with T3 and T5 tax slips arriving in the mail, it's important that people holding funds outside of tax-deferred plans like RRSPs understand how taxes affect their finances.

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CREDIT: Peter J. Thompson, National Post

Some mutual fund companies such as AIC Ltd., AIM Trimark Investments and Mackenzie Financial Corp. have resident tax experts whose job is to produce educational material and help financial advisors to understand and explain tax complexities. Another valuable resource is Morningstar Canada's PALTrak software that ranks mutual funds according to their tax-efficiency and shows annual compound returns on a before-tax and after-tax basis.

"We're taxed like crazy in this country, and it's important to keep as much as possible of the money we make," says Sandy Cardy, newly appointed vice-president of Tax and Estate Advisory Services at Mackenzie, and author of a just-released estate planning book called The Cottage, the Spider Broach and the Second Wife. "It's important to focus on investment returns after tax, and defer tax whenever possible. The goal is to keep as much as possible of what you make."

More than half of equity fund investors choose the convenience of automatically reinvesting distributions in new fund units, rather than receiving cash payments. Every year, fund companies send out T3 or T5 slips that show each investor's proportionate share of the fund's net realized gains, and income taxes must be paid accordingly.

"Tax slips are often a source of concern for investors who don't understand why they have to pay tax when they haven't received any money," says Jamie Golombek, vice-president of tax and estate planning at AIM Trimark. "It's important to work with clients to ensure they understand that their distributions have actually been used to purchase new units in the fund, and that the reason they're paying a bit of tax every year is that the fund has realized some profits."

Things can get complicated down the road when funds are sold, and the investor faces a capital gains tax upon disposition of fund units. If your clients haven't kept track of the increases in the adjusted cost base (ACB) each year to reflect the value of any reinvested distributions along the way, they will get dinged again by paying tax on the entire difference between the original purchase price and the sale price.

While many mutual fund companies track changes in each client's ACB as distributions that are paid and reinvested, if the funds are held in the name of the brokerage or financial planning firm -- known as "street name" -- this information may not be available.

Therefore meticulous tracking of distributions paid by mutual funds and recorded on annual T5 and T3 slips is necessary to avoid paying tax twice on the same growth. If the investor chooses not to reinvest the distributions from the fund, and takes the cash instead, the ACB does not change.

When it comes to tax consequences, it's also important to be aware of a fund's portfolio turnover rate. Funds with a high turnover tend to trigger realized capital gains (or losses) every year, while those that buy and hold their stocks allow investors to defer realization of taxable capital gains. It may make sense to hold high turnover funds within an RRSP, providing the risk/reward tradeoff is suitable.

Says AIC's resident tax guru, Tim Cestnick: "Asset location is just as important as asset allocation."

Outside of a registered vehicle, stock funds with relatively low turnover allow investors to avoid the leakage that comes from reaching into their pocket to pay capital gains taxes every year. Tax deferral means more money stays invested, which can be meaningful for investors in a high tax bracket, particularly when compounded over a long time period. There's no permanent escape, however, and taxes will ultimately have to be paid if the fund is sold at a profit.

In response to the growing appetite for tax-favoured investment options, many fund companies have introduced alternatives such as capital class fund structures that allow tax-free switching among funds within the same class structure, and managed yield funds that offer tax-advantaged ways to receive income.

"While there has been growing awareness of the effects of fund expenses on long-term accumulation of wealth, in many cases taxes are the single biggest cost of mutual fund investing," says Mark Warywoda, director of analysis at Morningstar.

"Deferring payment of taxes on funds held in taxable accounts by investing in tax-efficient funds can offer a similar benefit to sheltering funds in an RRSP."

It's important not to let the tail wag the dog by letting tax considerations dominate investment decisions. "Some people have become carried away, and think that tax-efficiency is more important than investment returns, which is a mistake," says Mr. Golombek.