NUMBER CRUNCHING BY TALBOT STEVENS

Taxes made more efficient

How asset allocation and distributions affect after-tax values

SHOWING INVESTORS WAYS TO reduce taxes is an effective way to attract the attention of prospects and add tangible value to existing clients.

Since tax efficiency is not an issue for investments sheltered inside RRSPs or pension plans, let's take a look at the impact of taxes with unregistered investments.

To calculate the after-tax future value of an unregistered investment, it is necessary to know the before-tax return and the breakdown of the return, and to keep track of the adjusted cost base (ACB), which defines how much can later be withdrawn tax-free.

Investment returns can consist of interest, dividend income and capital gains, but also *deferred* capital gains. To crunch the numbers, it is not enough to specify that an investment produces capital gains. We need to know what portion of the total return is a taxable capital gain and what portion is a deferred capital gain (DCG), which compounds tax-free like an RRSP until cashed in by the investor. Mutual funds in general have the potential to produce all four flavours of investment returns, but it is this overlooked DCG portion of the return that determines how tax-efficient an equity investment is.

For example, consider an equity investment that produces only capital gains with a gross before-tax return of 10%. Assuming the future tax rate is no higher than the present tax rate, the best theoretical case is one in which 100% of the return is a DCG.

Assuming an equity fund produces 100% deferred capital gains means there are no annual distributions. This represents the most tax-efficient scenario. Some fund companies have special "corporate class" shares that are designed to allow investors to defer capital gains taxes even during a transfer to another equity fund in the same family of corporate share funds. Some funds are modelled after the Warren Buffett approach of "buy and hold *forever*" to defer taxes. Both approaches are effective ways of achieving the best theoretical case in the "real world."

However, in an effort to minimize your business risk, you should heed two cautionary notes. First, no fund guarantees that there will be no taxable distributions in the future with 100% of returns in the form of deferred capital gains. Second, advisors should be careful not to over-promise and create unrealistic client expectations.

Considering equity investments that produce only capital gains, 100% of the return is taxable annually in the least tax-efficient case. This occurs when there is significant portfolio turnover by the money manager or investor. The table above shows the after-tax value produced by investing $1,000 over various periods for different asset allocations. In addition to showing the most and least tax-efficient capital gain return scenarios, I have shown what may or may not represent an average equity fund, where most — 75% — of the return is a DCG, and 25% of the growth is a taxable capital gain. The projections assume that 50% of capital gains are taxable when realized, a 50% tax bracket and a 10% return before tax.

Any taxable distributions increase the ACB by the after-tax amount of the distribution. Remember that the ACB is the after-tax amount invested and the amount that can be withdrawn tax-free. For example, if we assume that 25% of a 10% return is distributed as a capital gain, the before-tax distribution from $1,000 growing is $25 ($1,000 x 10% x 25%). Of the $25 distribution, half would be taxable in a 50% tax bracket, leaving the investor with an after-tax distribution of $18.75. Thus, the ACB after one year would be the $1,000 original investment plus the after-tax distribution of $18.75, or $1,018.75.

To highlight and quantify the importance of tax-efficient investing, the decrease in after-tax value relative to the best case of 100% DCG is shown. Unsheltered interest income is, as we all know, the least tax-efficient asset class, which is why fixed-income investments should be inside RRSPs as much as possible. Over 20 years, 10% interest returns produce 49.9% less than those produced by 10% DCG returns. A better way of explaining this from the perspective of a GIC investor is that with the same 10% returns, pure deferred capital gains produce an after-tax value that is twice as large as is produced with returns that are fully taxed as interest each year.

Now that the capital gains inclusion rate is only 50%, note that dividend income is less tax-efficient than capital gains, even in the worst case, in which all capital gains are taxed annually. When there is a modest amount of capital gain distributions (25% of returns), there is only a small decrease in after-tax values, even after 30 years. Investments become more tax-efficient as the asset allocation produces more capital gains — especially deferred capital gains — and distributions are kept as low as possible. The table shows how tax efficiency becomes more important over longer investment periods, but it doesn't show tax efficiency is more of an issue with higher tax rates.

Even when 100% of capital gain returns are taxable annually, there is a negligible after-tax difference for periods of less than 10 years: $1,000 grows to $2,195 after tax after 10 years for pure deferred capital gains, and to $2,061 (6.1% less) when 100% of the

Importance of tax-efficient investing

After-tax value of $1,000, 50% tax bracket, 10% returns

Years	100% deferred capital gains	75% DCG, 25% taxable CG	100% taxable capital gains	100% dividends	100% interest
1	1,075	1,075 (0%)	1,075 (0%)	1,064 (-1.0%)	1,050 (-2.3%)
5	1,458	1,452 (-0.4%)	1,436 (-1.5%)	1,365 (-6.4%)	1,276 (-12.5%)
10	2,195	2,160 (-1.6%)	2,061 (-6.1%)	1,863 (-15.1%)	1,629 (-25.8%)
20	5,296	5,002 (-5.6%)	4,248 (-19.8%)	3,469 (-34.5%)	2,653 (-49.9%)
30	13,337	11,966 (-10.3%)	8,755 (-34.4%)	6,461 (-51.6%)	4,322 (-67.6%)

FIGURES IN BRACKETS SHOW THE PERCENTAGE INCREASE RELATIVE TO 100% DEFERRED CAPITAL GAINS (BEST-CASE SCENARIO)
SOURCE: NAVIPLAN SOFTWARE

INVESTMENT EXECUTIVE CHART

return is taxable as a capital gain annually. This means that for short periods, the tax efficiency of equity funds is insignificant in the after-tax lump sums produced.

However, we must be very careful not to make inaccurate conclusions. The table shows the after-tax values that remain after cashing out the investment completely and paying any triggered capital gains taxes. This is the right analysis for an after-tax estate valuation, or to determine how much of a down payment is available to buy a house. But what if, as with most clients, the real goal is to generate after-tax retirement income over, say, a 25-year period?

The 25-year after-tax income produced after investing $1,000 for 10 years is $172 a year with 10% capital gains that are 100% taxable annually, compared with $221 a year when the returns are 100% deferred capital gains. In this case, even with the same 10-year savings period, the difference between the least tax-efficient equity investment and the most tax-efficient equity investment is an improvement of 28%, which most clients would agree is significant.

Choosing tax-efficient equity investments can make a tangible difference in terms of your client's retirement lifestyle. It is critical to evaluate investment alternatives from an after-tax income or lump-sum perspective as indicated by your client's goals, accounting for real-world distributions that reduce tax-efficiency. IE

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