Building
Tax Efficient Income

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Some tax lawyers and CPA accountants advise their clients on tax structures to minimize the effects of the income tax act. But what about ways to reduce taxes on income distributions? This is where an investment advisor's assistance can benefit your income goals. In general, the more exotic the tax structure the higher the risk may be to the borrower or investor. At our practice we seek to lower investment risk, while creating tax efficient income in the most optimal fashion. For example, a widow with several million dollars of mortgage capital was referred to our practice. Mrs. X was paying a 53.3% marginal rate of tax on an inclusion rate of 50% in a well - known private mortgage fund. Due to industry issues affecting the mortgage fund's individual obligations, both in direct investments in large buildings and in syndicated loan participation, and a higher percentage of capital required by OFSI to provide security for retail investors in its funds, liquidity restrictions were put in place. It is not uncommon for investors to lack full knowledge of the details of their investments. This fact plus her concern about Covid 19 effects on syndicated mortgages, made her feel uncomfortable about her investment and worried about how she would achieve her stated goal of high monthly income.

This was our solution for her:

Certain tax benefits within the mutual fund industry are allowed so we recommended a corporate class trust structure. CRA allows a mutual fund to organize as a corporation. As a corporate class structure, the fund is treated by CRA as a single taxable entity that can aggregate income and expenses as well as realized gains and losses from its underlying share classes. This provides increased tax efficiency for an investor. Considering our client's goals, we created a combination of a corporate class actively managed diversified bond trust and a non-corporate class Canadian senior debt fund for an accredited investor. The senior debt yielded over 7% and unlike a syndicated mortgage investment, our client's money ranked at the top of creditor protection, rather than at the bottom. This addressed her safety concerns, and how to generate a higher income yield.

Using a corporate class structure, interest income equivalent to our new client's mortgage investment will now be re-characterized as capital gains. These capital gains can be deferred until units are redeemed which may allow more units to remain invested and compound over the long term. One of the primary benefits of corporate class funds is the ability to pool the income and expenses of all funds in the fund family. By doing so corporate class mutual funds offer the ability to minimize or defer overall taxable distributions. The corporate class structure is particularly beneficial to income funds that tend to produce returns in the form of fully taxable interest income or for foreign equity funds that produce dividends that are ineligible for the Canadian dividend tax credit. The corporate class structure can reduce taxes by offsetting fully taxable income with unused expenses and loss carry-forwards transferred from other funds in the corporate class fund family.

The senior debt yield pays annual distributions. We tailor our solutions to each client's cash flow. Our new client has existing cash flow from several rental properties enabling 100% of reinvested cash flow for her solution. Should additional monthly cash flow be required in the future, we will modify our solution to accommodate our planning net of existing sources of income including government benefits.

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The following tax example is from Nine Point Investment Management, who are skilled in credit markets. Nine Point ran this scenario assuming a 4% annual income distribution with no market gains on the holdings and the entire investment being redeemed after 15 years. The concept of tax efficiency and recharacterization of capital is shown clearly below:

Hypothetical Example Corporate Class Taxation

		Bond Trust	Corporate Class Bond Trust	Tax Class Return of Capital Trust
AFTER 15 YEARS	Initial Investment	$100,000	$100,000	$100,000
	Cash Flow(1)	$60,000	$0	$60,000
	Tax on Interest Income(2)	$32,118	$0	$0
	After Tax Cash Flow	$27,882	$0(3)	$60,000
	Market Value End of 15 Years	$100,000	$180,094	$100,000
	Adjusted Cost Base	$100,000	$100,000	$40,000
	Tax on Capital Gains at Redemption	$0	$21,437	$16,059
TOTAL AFTER TAX RETURN		$27,882	$58,657	$43,941

Assumed bond yield of 4%. Assumed all distributions are return of capital.
Actual distributions are return of capital and capital gains

1. Assumes Ontario's top marginal rate 53.53%
2. CRA permits mutual fund corporations to distribute only Canadian Dividends and capital gains, not ordinary income
3. Assumes a marginal rate of 53.3% and a 50% inclusion rate for capital gains.
   •To calculate your after-tax return in the corporate class the fund earns $80,094.
   50% inclusion rate for capital gains is $40,047.00. Tax is $40,047 X.5353 = $21,437
4. The 3rd column is another tax effect known as T-Class. Each distribution is not taxed but does lower the average cost paid. Hence the average cost lowers from $100,000 to $60,000. Your tax effect is your capital gains tax of $30,000 x the client total tax rate of 53.53%.

If you seek sources of tax efficient income, be it corporate class, tax deferral on investments, tax minimization, call our team at Raymond James at 647 696 0140. We would be happy to discuss your situation.