CHOOSING AN APPROPRIATE INVESTMENT SOLUTION

CI GLOBAL ASSET MANAGEMENT

Over the past decade, new investment solutions have been developed and new investment accounts introduced for Canadian wealth advisors to consider when addressing the needs and wants of their Canadian clients.

So what is the most appropriate investment solution for clients? And, should the nature and tax treatment of distributions be considered when investigating investment solutions? Absolutely, as the impact and value to clients may be substantial.

HOW SHOULD WEALTH ADVISORS APPROACH CHOOSING?

Don't lose sight of planning fundamentals. What, when and why do your clients need or want from their investments? Ask questions, as questions leads to dialogue and insight into what your clients need or want today and in the future. Do they need income from investments to support lifestyle today? Or, are their investments earmarked for funding retirement, say 20 years down the road? Do they have other wealth planning needs or wants?

PROVIDING THE ABILITY TO ACCESS CASH FLOW

All wealth planners today should consider income versus cash flow, and the flexibility and control that accessing cash flow provides from a planning perspective. Income is reported on an income tax return generating a tax liability, whereas cash flow is not reported and does not trigger tax.

Canadian investors today have two means to generate tax-free cash flow from investments, namely a TFSA and T-class Corporate Class mutual funds held in open, non-registered investment accounts.

T-class funds are an added feature available to Corporate Class fund investors and provide a monthly distribution consisting of return of capital (ROC). Most T-class funds allow their investors to withdraw upwards of 8% of the fund value, or a fixed dollar amount annually. Any ROC distribution received in excess of a client's needs can be reinvested; thus ROC can be customized to what the client requires in a given year.

ROC is a distribution of cash flow, not income. As it is a return of an investor's capital, any ROC distribution reduces the adjusted cost base (ACB) of the fund for tax purposes. When shares of the T-class fund are sold, or when the ACB of the fund eventually reaches zero, capital gains will be triggered. Capital gains are tax-efficient income to all Canadian investors.

CANADIAN INVESTORS WHO MAY BE INTERESTED IN T-CLASS

A Canadian investor who does not want to trigger income from their investments but may need or want to access capital from their investments should consider T-class. Those clients may include:

- Individuals in top marginal tax brackets who need access to additional funds but don't want it taxed as income at high tax rates;
- Retirees looking to supplement cash flow and meet lifestyle needs prior to receiving CPP or OAS;
- Retirees looking for additional cash flow without having to be concerned about triggering OAS clawback;
- Individuals, trusts or corporations looking to fund certain expenditures, such as life insurance, without triggering income and having to fund with after-tax dollars;
- Trusts that are looking to generate capital to distribute to identified capital beneficiaries tax efficiently; and
- Any investor wanting flexibility and access to cash for unplanned expenditures without having to worry about triggering capital gains unnecessarily and who can simply reinvest any ROC payments if not needed.

In any wealth plan, having access to cash flow over a period of time provides flexibility and control over the nature of investment income reported and when it's reported, allows for the smoothing of investment income reported, reduces income taxes paid overall and leaves more invested without compromising the ability to provide for the needs or wants of investors.

Simply, to quote Aristotle, “The whole is greater than the sum of its parts.” When wealth advisors recommend an investment solution that addresses the needs and wants of their clients in a flexible, tax-efficient manner, they have provided value.

CASES TO DEMONSTRATE BENEFITS OF CASH FLOW AND T-CLASS INVESTING

Case A: Honorary Bubie – Recently widowed woman whose net worth is >$12 million, including $1 million in a RRIF, $5 million in holdcos and $6 million in open investments (Account A). She wants $350,000 ($100,000 for herself and $250,000 to support two sons) every year, a new will providing a $3 million bequest to charity and the remainder to be divided evenly between her four children.

Previously: To generate $350,000 in after-tax cash flow, she and her husband were each withdrawing $150,000 from their respective RRIFs and the remainder was funded by liquidating open investments.

Suggestion: She continue to draw $150,000 from the RRIF for $100,000 after-tax income, with any extra to be invested in a TFSA or open investments, carve off $3.5 million from Account A, transfer to new Account B and invest $3.5 million in 8% T-series fund. First $250,000 in ROC from Account B will fund support for two sons and any remaining ROC can be re-invested. Advisor to check Account B quarterly to ensure FMV exceeds $3 million. In her new will, Account B is identified to be used to fund her $3 million charitable bequest.

Result: Boys’ support is funded with cash flow, not income, which means less income tax paid on an ongoing basis and more remaining for investment and estate planning purposes. Upon her death, any capital gains generated upon the donation of Account B will have an inclusion rate of 0% as the account will be donated in kind, and her terminal tax return will also reflect the donation of $3 million to reduce income taxes otherwise owing.

Case B: New retirees – Couple, both 60, have combined RRSPs of $750,000, combined TFSAs of $90,000, and joint open investments of $500,000. They want $60,000 combined to support retirement lifestyle needs.

Suggestion: RRIF $500,000 of RRSPs, and both withdraw $25,000, arrange for ROC of $15,000 from open investments for five to 10 years, to bridge until CPP/OAS starts, to support retirement lifestyle needs. Any extra ROC not needed for lifestyle can be reinvested.

Result: Smoothing of income, as RRIF withdrawn in controlled manner, which lowers average tax rate over long term, providing flexibility and control as to when CPP/OAS starts, and having access to cash flow, which provides flexibility and control to deal with retirement lifestyle surprises. Lower reported income means lower income taxes and tax rate, which translates to more investment assets to support retirement lifestyle needs longer.

Case C: Fair father funding life insurance – Mr. Z, a widower, has two daughters and owns 100% of Z Opco and $1million in open investments. One daughter (A) has worked with Mr. Z in Z Opco over the past 15 years, and his other daughter (B) lives out of province and has been a stay-at-home domestic engineer for the last 12 years, raising her three children. Mr. Z has recently met with his advisors to discuss his estate and he has decided to allocate Z Opco to A, which has a FMV of $2 million and to arrange for the purchase of life insurance of $2 million personally naming B as beneficiary. The premium on the life insurance is $25,000 annually. The remainder of his estate is to be divided equally between his two daughters.

Suggestion: Mr. Z is already in the top marginal tax bracket from salary and dividends from Z Opco. To support his lifestyle needs (he is generous and really enjoys life), suggest he invest $500,000 of his open investments in a T-class fund with 5% ROC. $25,000 in ROC will be used to fund the life insurance premium to fund B’s inheritance.

Result: Life insurance premiums addressing his estate planning intentions are funded tax efficiently. Mr. Z is not triggering additional taxable income at top marginal tax rates to fund annual life insurance premiums.

Visit us at ci.com/en/tax-retirement-and-estate-planning

Published June 10, 2021

21-05-341300_E (05/21)