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Watch out for that tax tail

Michael Nairne, Serious Money

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Even the wealthiest investor can end up with chihuahua-sized returns if they are not careful of the tax bite.

There is an old saying that you should not let the tax tail wag the investment dog. However, without proper planning, high net worth investors - whose wealth extends well beyond traditional RRSP's - may find that the bite of taxes can leave them with Chihuahua-sized after-tax returns.

In my experience, most affluent investors fail to integrate their investment and tax planning in a manner that optimizes after-tax returns. Their investment managers typically develop strategies without consultation on their overall tax situation. When the accountant is left out of the investment planning, opportunities for tax reduction through such techniques as income splitting and tax loss harvesting are easily missed. Hence, a fragmented approach to wealth management is the root of the problem. Investors often further contribute to this fragmentation by selecting their investment managers solely on the basis of pre-tax performance. Yet, one study of Canadian mutual funds found a significant difference

in the performance ranking of funds based on their pre-tax returns versus their after-tax returns. The superstar manager who beats the pants off his or her peers on a pre-tax basis might be a so-so performer on an after-tax basis.

Worse, in a naive attempt at diversification, investors may allocate their capital among separate, independent investment managers and allow them to operate without the coordination necessary to effectively minimize their tax bite. I have seen many situations where the RRSP ends up at least partially invested in Canadian equities with one manager while the investment manager handling the taxable account is busy investing in bonds, the interest on which is much more highly taxed than Canadian dividend income or capital gains. In fact, one study in the U.S. found that the average household misallocates one-third of its taxable bonds to taxable accounts.

Proper investment tax planning should, at the outset, catalogue the entire gamut of existing and potential asset locations within the entire household and the related tax reduction or deferral opportunities. These include the traditional vehicles such as RRSP's, RESP's and TFSA's as well as the opportunities presented from a low tax bracket spouse or child. Although the Canada Revenue Agency and the Courts have foreclosed some income splitting techniques over the years, there are still a number of ways to shift capital within the household such as spousal loans, family trusts or gifting.

Once catalogued, the decisions around asset mix, taxability and location can be fused into an integrated strategy designed to pursue optimal after-tax returns. Corporate bonds, for example, might be allocated to the RESP's for teenage children in order to both reduce taxes and ensure money is available for tuitions. More volatile high yield bonds might be placed in RRSP's where the time horizons are longer. Canadian equities might be allocated to the low-bracket spouse where the enhanced dividend tax credit more effectively reduces taxes.

There are also various tax-advantaged products available to further reduce taxes. Corporate class funds can be used to defer taxes. Where appropriate, insurance can be used to shelter returns on bonds. The forward agreements used by some funds can effectively convert interest income into a return of capital distribution or defer capital gains. One caveat – the fees for many of these products tend to be higher so one should ensure that the tax benefits outweigh the incremental costs.

Finally, manager performance should be assessed on returns after both fees and taxes. It is not only the low cost of ETF's that explains their popularity. Many ETF's are tax efficient due to their low portfolio turnover and unique redemption structure. With properly planning, the tax tail can wag in complete harmony with the investment dog.

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