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The power of deferral

Michael Nairne, Serious Money

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Disheartening returns and high taxes motivate savvy high net worth investors to defer the taxes they pay on investments.

Wealthy people have a peculiar problem. Yes, they pay a boatload of taxes, but that alone is not the issue. Much of the income of many high net worth investors is taxed at the highest marginal rate. With top marginal rates approaching 50% on interest and other income for most Canadians, this tax bite seriously erodes investment returns. Take a bond yielding 4%, for example. At a 50% tax rate, the after-tax return is only 2%.

That is just the tip of the iceberg. This calculation fails to consider inflation. Net of 2% inflation, the real, after-tax return is nil. Zero, zilch, nada, nothing! By taxing both the real and inflationary component of investment returns at high marginal rates, the government eviscerates the compensation due high net worth investors from bonds and GIC's.

The situation is a little better for equity investments. Only one-half the realized gain is included in taxable income. However, given today's unexciting valuations, the expected capital gain on equities is around 6% annually. With taxes chewing up 25% of this gain and inflation at 2%, the after-tax, after inflation return is 2.5%. Add in the after-tax return from dividends, modestly tax-advantaged in the case of eligible Canadian dividends, and the after-tax, real return from stocks is in the 4% range.

It is these disheartening numbers that motivate savvy high net worth investors to defer taxes. This isn't merely postponing taxes. By deferring taxes, an investor is effectively receiving an interest-free loan from the government and, to the extent investment income is earned on this loan, wealth can be enhanced.

Take the example of $1-million growing at 6% per annum on pre-tax basis. If the 6% gain is realized every year and a 25% tax paid, the after-tax wealth grows to $1.55-million over 10 years. If the tax is deferred and only paid at the end of the 10th year, the after-tax wealth accumulates to $1.59-million. The $40,000 difference is the return earned on the deferred taxes.

These numbers skyrocket for longer periods. Over 30 years, based on the same assumptions, the investor who pays tax every year ends up with $3.75-million. The investor who defers taxes and pays them only in the 30th year has $4.56 million, a difference of over $0.8 million. Time is Archimedes' lever in deferral strategies.

The traditional deferral haven is RRSPs. The drawback of RRSPs is that they end up fully taxable on withdrawal or after conversion to a RRIF or annuity. TFSAs provide deferral for the entire life of the holder and their spouse or common-law partner if they are named as the "successor holder" and withdrawals are not taxable. Unfortunately, this perfect solution is marred by the paltry contribution limits. Nevertheless, both play a role in a family's deferral strategies as do RESPs.

One of the most powerful deferral tools is minimizing the sale of stocks in a portfolio. For a married or common-law couple, the taxes on unrealized gains can be deferred until the death of the second partner creating a multi-decade opportunity for wealth enhancement. ETFs tracking broad market indexes are an unparalleled vehicle for combining tax deferral with diversification and low management fees.

Whole life and universal insurance policies are additional deferral vehicles since they are not subject to taxation on their accumulating reserves if they meet the "exemption test" set out in the tax regulations. For business owners and professionals, the small business deduction, a reduction in tax that is available to Canadian-controlled private corporations on active business income, allows for the accumulation of capital taxed at a much lower rate.

The key to investment success isn't just "buy and hold" -- it is "buy, hold and defer".

-Michael Nairne, CFP, RFP, CFA, is the president of Tacita Capital Inc., a private family office and investment counselling firm in Toronto.