FINANCIAL POST

Saturday, April 21st, 2012

Focus on pre-tax returns results in costly tax bills

Michael Nairne, Serious Money

Fotolia

There are a myriad of unnecessary investment tax leakages experienced by affluent investors.

A cardinal error is committed with appalling frequency in managing the investments of affluent families — thinking in pre-tax instead of after-tax returns. This may seem surprising as taxes are often the biggest single expense of wealthy families. Similarly, affluent retirees live on after-tax, not pre-tax cash flows.

Yet, the problem persists. One reason is that the investment industry grew from institutional roots that focused on non-taxable pension plans. Taxes were never a primary consideration and this viewpoint has endured. Second, at a retail level, fund advertisers feature pre-tax numbers. This obscures the vital importance of after-tax returns for affluent investors.

Finally, investment and tax planning are often conducted separately — the accountant worries about the tax bill and the money manager handles the investments. As a result, pre-tax return thinking dominates investment decisions since no one has an integrated picture. Regrettably, this bifurcated treatment often results in needless tax bills.

A classic example involves bonds. Many affluent investors are paying excessive taxes on bond returns held personally in non-registered accounts. In fact, certain government bonds that guarantee a pre-tax positive return if held to maturity result in a negative return, after tax.

An explanation is in order. Most bonds being bought today were issued years ago. The coupon rate was then much higher than today's paltry 1% to 3% yields. Coupon rates of 4% to 8% are quite common on bonds still being traded today. Because their coupon rates are higher than today's prevailing rates, these bonds trade at a premium to their maturity value. This premium dwindles over time as these bonds move toward maturity, eventually hitting zero when the bond is redeemed at its face value.

Overall, the investor is still only earning today's low bond yields. It is just being realized in two parts. One is the coupon of say 4% to 8% while the other is a reduction in return from the falling bond value as the premium dwindles. This is where the tax laws work their devilish mischief. The coupon is taxable every year as interest income. For higher net worth investors, this is often at the highest marginal rate — for simplicity sake, let's say, 50%. When the bond matures, however, the difference between its premium purchase price and the face value is generally treated as a capital loss, only one-half of which may be claimed as an allowable capital loss — in our example, let's say 25%.

After-tax, an investor is losing three ways. First, he or she suffers an incremental tax bill on the premium portion of the bond — a full 25% cost on this component in our example. Second, there is the time value of money — an investor must pay tax at the higher rate on the coupon every year and only realizes the capital loss at the end of the road. Finally, allowable capital losses can only be deducted against taxable capital gains so the quantum and timing of the recovery associated with the capital loss is uncertain.

There are a number of possible solutions to this "bond-doggle" — hold cash instead of short-term maturity bonds; replace bonds with GIC's; buy bonds trading at a discount or new issues; reallocate bonds within the household to low taxed members or registered plans; or use tax-advantaged vehicles such as corporate class funds. Of course, each option involves trade-offs and/or costs that must be evaluated.

The bond squeeze is one of a myriad of unnecessary investment tax leakages experienced by affluent investors. Such problems can only be identified, however, if one has learned to avoid the cardinal error of thinking in pre-tax returns.

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