

Asset “Location” - Tax-Efficient Investing

After we have established investment objectives and then determined the appropriate weighting of different asset classes, our next step in portfolio construction is deciding how to best position individual investments in a client’s various accounts (such as Taxable or RSP). Our goal is to maximize **after-tax** returns, which usually means applying the “least and latest” principle - paying the smallest amount of tax as late as possible.

Important tax “facts” come into play:

- Different sources of income are taxed at different rates. Interest income is taxed at each client’s marginal tax rate, capital gains are taxed at half this rate and Canadian dividends are usually taxed at a level in between the two. The following table summarizes the different marginal tax rates in Ontario for the three main sources of income.

2002 Ontario Marginal Tax Rates

	<u>\$0 to \$30,754</u>	<u>\$30,755 to \$61,509</u>	<u>\$61,510 to \$100,000</u>	<u>\$100,001 and over</u>
Interest	22%	31%	43%	46%
Dividends	5%	16%	23%	29%
Capital Gains	11%	16%	22%	23%

Source: KPMG Tax Facts, 2001-2002

- Capital gains carry additional benefits - often overlooked - in the form of tax deferral. Unlike dividends and interest income which are taxed when received or even earlier, capital gains are not taxed until they are “realized”. In other words, the asset must be sold first. Therefore gains may accrue for many, many years before any tax is due. This untaxed growth can significantly boost long-term after-tax returns.

The next step is to bring these two concepts into the client equation. Since we already know their marginal tax rate and time horizon, we can now overlay the different tax characteristics of the applicable asset classes, our projected returns for each class and also an estimate of portfolio turnover. With all this information in mind, constructing the optimal tax-efficient portfolio becomes more a science than an art.

Let's take a common question: should bonds or equities be held in a tax-sheltered account (e.g. RSP, RRIF, RESP) or a taxable account? We can answer this by working through the issues. Let's assume this client holds both stocks and bonds in their portfolio and has both a taxable account and a tax-sheltered account such as an RSP. Where should each asset class be held?

	<u>Bonds</u>	<u>Stocks</u>
Expected Return	5.0%	10.0%
Tax Rate	48.0%	24.0%
Taxes	2.4%	2.4%
After-tax rate of return	2.6%	7.6%

*Assumes no dividends are being paid

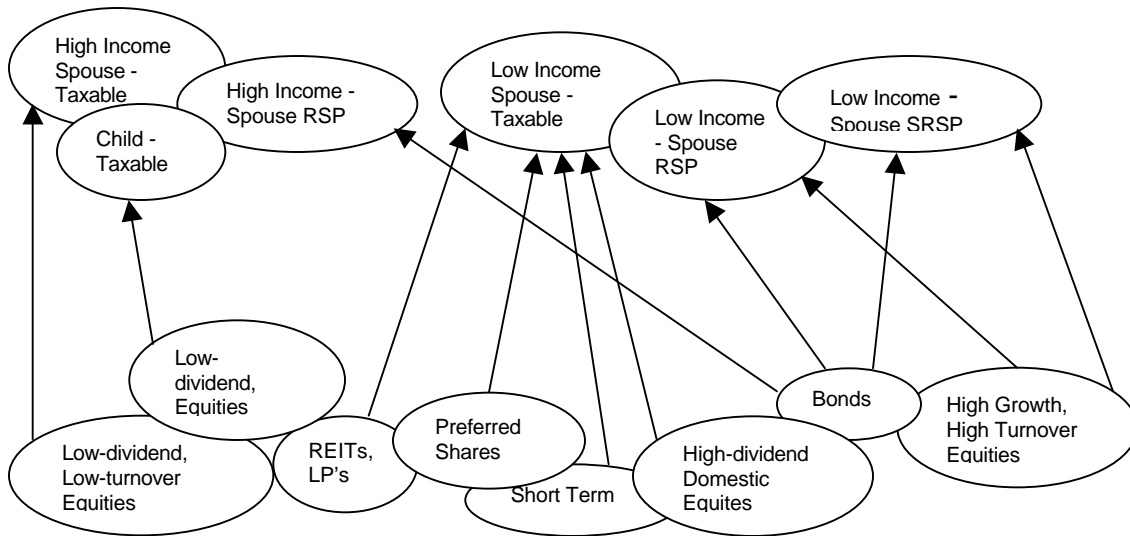
Our goal is to shelter the largest tax liability, leaving the balance to grow for the client. Remember that bonds are taxed at double the rate of capital gains but equities are expected to earn twice as much. It may seem at first brush not to matter whether they are held in the taxable or tax-sheltered accounts since holding either in the RSP would save the tax liability of 2.4%. However, it's with the deferral of the taxes on capital gains that will drive the decision. In this example, holding stocks in the taxable account is definitely more advantageous for time horizons greater than one year.

This benefit compounds as time progresses as the following table illustrates:

	Portfolio Value (Post Liquidation – after all taxes)		
	<u>10 Years</u>	<u>20 Years</u>	<u>30 Years</u>
Portfolio A			
\$10,000 Equities in RSP and \$10,000 Bonds in Taxable	\$26,163.	\$51,692.	\$112,335.
Portfolio B			
\$10,000 Bonds in RSP and \$10,000 Equities in Taxable	\$30,592.	\$67,326.	\$157,489.

This example clearly illustrates the benefits of a “buy and hold” equity strategy over long periods of time. We must qualify this however, with the comment that not all “buy and hold” strategies are created equal. Obviously, risks far outweigh benefits if it is not well diversified among quality holdings. Assessing likely portfolio turnover for various assets

and asset classes is a critical ingredient in determining their ideal placement. (Turnover is the % of the portfolio that is replaced each year with new assets.) It may be beneficial to after-tax returns if losses are realized, but on a tax-basis alone, realizing gains will be detrimental. The issues are complex as the following table illustrates but, once analyzed altogether, lead us to make logical choices in the portfolio construction process.



As the chart indicates, the high-income spouse should be holding assets with low dividends and low turnover in his/her taxable account, minimizing any taxes for a long period of time. Low dividend paying stocks that will be held for many years or broadly based indexed investments fall into this category. For example, indexed products based on the S&P500 or Russell1000 qualify as both have low turnover rates of less than 7% per year and dividends under 1.5%.

The low-income spouse should be capital-gains oriented, shying away from bonds (unless income is required), and this account might also hold some high dividend paying stocks. Remember that, for individuals earning less than \$30,000, Canadian dividends are taxed at an even lower rate than capital gains. We should note though that dividends are taxed when received and the benefits of deferral are not available. When the client needs income, holding bonds (discount bonds particularly) is more suitable in the low-income spouse's taxable account as they are taxed at a lower rate. The trade-off is we forfeit some ability to work towards a more equitable spousal income split going forward since bonds will underperform stocks over long periods of time. Usually the trade-off is reasonable because we have other financial planning strategies (e.g. spousal loans, SRSPs) which more than make up for the difference.

Bonds (particularly those at current and premium rates) should be focused in the high-income spouse's tax sheltered account (RSP, LI-RSP, RIF, etc.) for reasons noted previously and also to minimize the growth in this account relative to its lower income counterpart. Additional bonds and high growth, high turnover stocks should be held in the low-income earner's tax sheltered account to minimize tax liability and to achieve a more effective income split over time through greater growth potential.

Accounts set up for children have their own characteristics. For example, asset allocation in RESPs should be largely dictated by the time horizon of the portfolio, meaning that equities will be reduced as university years approach. In taxable accounts of children we limit exposure to bonds and high dividend paying stocks because income and dividends are attributable back to the contributing parent. Instead high and low turnover stocks with low dividends are appropriate.

A dynamic process

Once the portfolio set-up is complete, we remain cognizant of tax implications in the ongoing process of portfolio management. For instance, asset allocation shifts predicated by market circumstances are undertaken in the taxable accounts if they result in losses and tax-sheltered accounts if they result in a (non-taxable) capital gain. In fact, as a tax-deferral strategy, we may seek to actively realize taxable losses in years when possible because they can be carried back three years and forward indefinitely by the client, providing a “pool” to apply future gains against. Of course, we conduct this strategy with care not to disrupt the overall integrity of the portfolio. We are also mindful of the “superficial loss” rule, ensuring losses are not disallowed by the CCRA.

If the portfolio requires a stream of income for the client’s needs, we will draw from the high-income earner’s taxable account first. You might ask how this is possible in an account invested in low dividend, low turnover stocks. We accomplish it by repositioning assets: selling an asset in the taxable account, simultaneously buying it in the tax-sheltered account with cash or bond proceeds, thereby maintaining the overall integrity of the portfolio.

As with all general discussions of a concept, there are certainly exceptions and complications that arise which may distort the benefits of these strategies. A client’s changing income over time creates one, for example. Fortunately, sophisticated financial planning software is now at our disposal and it has now become an indispensable aid in our ability we use to analyze all aspects of a client’s situation to produce the optimal plan.

We may live in a world where the short-term behavior of financial markets is difficult to predict and sometimes challenging to manage. However, taxes are not. The rules may change from time to time, but at least for the purposes of portfolio management, at any given time they are clear and predictable. Therefore, strategies that minimize and defer taxes are mandatory because they have such a direct and substantial impact on the bottom line of our clients’ wealth.

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