

Russell Insight

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Funding a healthy retirement through tax-efficient income

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One of the chief concerns for those in or nearing retirement is whether their income will be sufficient to meet their needs. With investment portfolios gyrating along with the markets it has become increasingly important to ensure that your retirement portfolio is designed to provide the cash flows necessary to help you meet your retirement goals. Tax-efficient cash flows can provide peace of mind from knowing that your income stream will be steady and consistent during your retirement years.

A well-designed retirement portfolio will make use of both registered and non-registered assets to supplement income provided by government and/or company pension plans.

Assets held in registered accounts benefit from tax-sheltered growth during their lifetime. Apart from a few credits and deductions which serve to reduce the tax payable, withdrawals from registered accounts are fully taxed as income at the owner's marginal tax rate.

While there is little flexibility in terms of the tax treatment of withdrawals from registered plans, there are several options to consider in order to maximize the after-tax income that can be provided by non-registered assets.

Let's review the various sources of income generated by investment portfolios and the tax rates that apply:

- Interest – taxed at investor's marginal rate
- Dividends – eligible dividends receive a tax credit, thereby making them an attractive source of income for investors in high tax brackets
- Capital gains – currently 50% of the gain is taxed at the investor's marginal rate
- Return of Capital (ROC) – while not taxable in the year it is received, ROC reduces the adjusted cost base (ACB) of your investment, which generally results in a larger capital gain when the investment is sold

Clearly, the tax-deferral mechanism offered by ROC is worth considering.

What is ROC?

Return of capital simply means that a portion of the original investment has been returned in the form of a distribution. If an investment fund pays a distribution that exceeds the taxable income realized by the fund then the difference is considered ROC.

ROC is not taxable in the year received. Instead, it reduces the cost base of the investment portfolio. Upon liquidation of the portfolio any realized gain is then subject to tax. In the meantime, the investor has deferred tax on the capital gain until a time of their choosing. The deferral of tax on the distributions means the resulting savings can remain invested in the portfolio.

Why might ROC be beneficial to an investor?

Apart from the ability to defer the realization of gains to a future period in which the investor may be in a lower tax bracket, ROC distributions are not included in the calculation of taxable income. Therefore, ROC distributions may provide a supplementary source of income without impacting the Old Age Security pension, the Guaranteed Income Supplement and spousal tax credits. Additionally, ROC distributions may provide a means of income for those individuals who have deferred Canada Pension Plan payments in order to take advantage of proposed changes.¹

How do you take advantage of ROC?

There are several types of investment funds that provide distributions that include a ROC component:

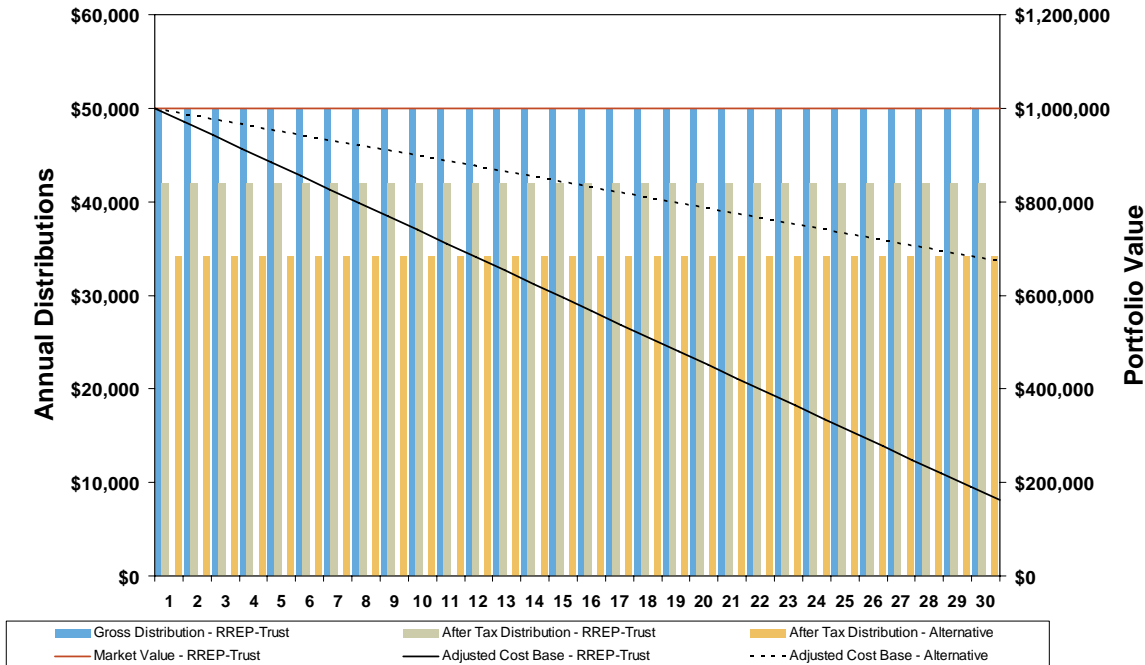
- Mutual funds that pay a fixed annual rate of distribution on a monthly basis
- Corporate Class funds that pay a regular distribution

Let's take a look at a couple of examples which illustrate the after-tax benefits of tax-efficient investment choices.

In both scenarios we will assume the initial portfolio value is \$1 million, the annual pre-tax required distribution is \$50,000 and the investor is an Ontario resident in the highest tax bracket. Also, we have assumed the alternative to the primary portfolio is a do-it-yourself portfolio of individual securities with the same asset allocation as the primary portfolio.

In the first example, the primary portfolio consists of the unit trust version of the Russell Retirement Essentials Portfolio (RREP) which has an allocation of 35% equity and 65% fixed income. We have selected the 5% distribution option in order to meet the investor's annual income requirement and we have assumed that the portfolio has an annual forecast return of 5% net of fees. Since the annual distribution rate is equal to the net forecast return, the market value of the portfolio will not change in our example. The forecast return is a hypothetical assumption that is used in this example for illustration purposes only. It has no relationship to historical returns and is not intended to predict expected future returns of this fund.

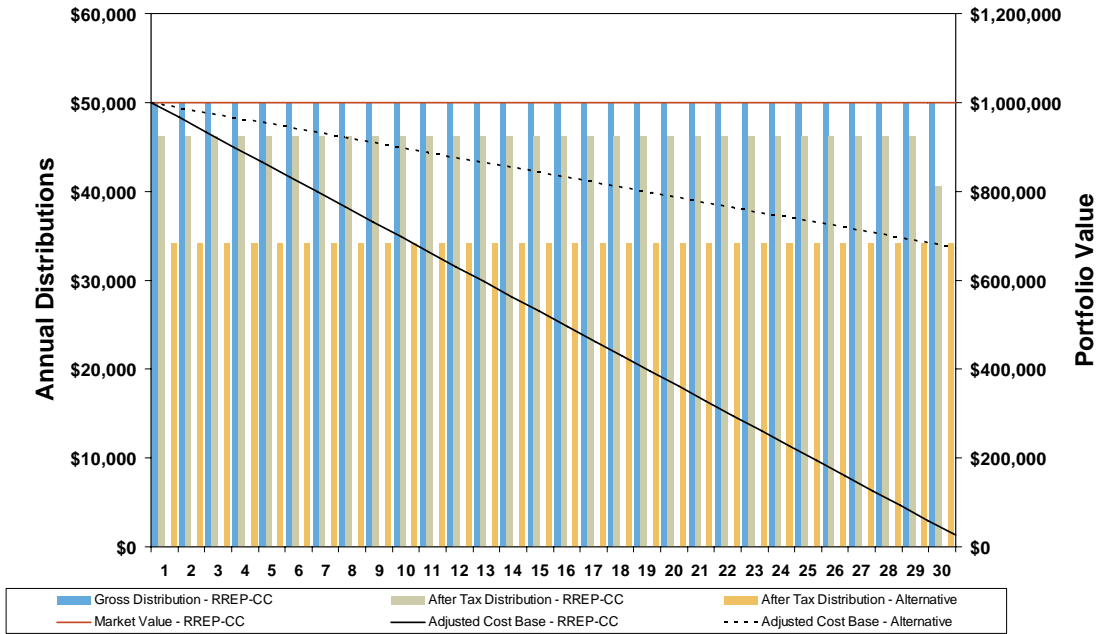
Figure 1 / RREP Trust vs Alternative Portfolio



As Figure 1 illustrates, annual gross distributions of \$50,000 and annual after-tax distributions of \$41,933 remain constant during the 30-year time horizon. While the market value of the portfolio does not change, the adjusted cost base (ACB) of the portfolio declines steadily since a considerable portion (57.8%) of the annual distribution consists of ROC. As a result of the declining ACB, the investor faces an increasing taxable capital gain due upon liquidation. However, deferring the tax payable on the ROC distributions more than offsets the tax payable on the capital gain and the investor receives cumulative annual after-tax distributions of \$1,257,979 over the course of the 30-year period. Conversely, the alternative portfolio provides cumulative annual after-tax distributions of \$1,024,954. The tax-efficiency of annual distributions that include a ROC component implies that over the 30-year period the annual after-tax cash flow from the primary portfolio is 23% higher than the annual after-tax cash flow from the alternative portfolio.

In the second example, the primary portfolio consists of the corporate class version of the Russell Retirement Essentials Portfolio (i.e. Russell Retirement Essentials Class Portfolio) which also has an allocation of 35% equity and 65% fixed income. We have selected the 5% distribution option in order to meet the investor's annual income requirement and we have assumed that the portfolio has an annual forecast return of 5% net of fees. Again, the forecast return is a hypothetical assumption that is used in this example for illustration purposes only. It has no relationship to historical returns and is not intended to predict expected future returns of this fund.

Figure 2 / RREP Corporate Class vs Alternative Portfolio



As Figure 2 illustrates, annual gross distributions of \$50,000 and annual after-tax distributions of \$46,193 remain constant until year 30. The ACB of the portfolio declines more rapidly than in the previous scenario because ROC represents a higher portion of the gross annual distribution. In year 30 the ACB is exhausted and a capital gain must be realized in order to meet the annual distribution requirement.² In this scenario there are two factors working in the investor’s favour from a tax-efficiency perspective:

1. The corporate class structure treats income generated by the class as capital gains.*
2. Annual distributions are primarily ROC, until year 30.

Both items potentially reduce the investor’s annual tax bill. The investor receives cumulative annual after-tax distributions of \$1,380,168 over the 30-year period. This after-tax amount represents almost 35% more income than the cumulative annual after-tax distributions the investor would have received had they invested in the alternative portfolio.

How might your retirement plans be different if your annual after-tax cash flow increased by 35%? Clearly, considering solutions that can enhance the tax-efficiency of the distributions provided by your investment portfolio can assist in creating a financially healthy retirement.

Defer taxes to enhance after-tax returns

- Distributions that include a ROC component can provide an investor with the opportunity to defer taxes, perhaps to a time when the investor's marginal tax rate has declined.
- Corporate class funds that pay regular distributions are designed to provide distributions in the form of ROC and/or capital gains.* Also, corporate class funds allow investors to switch from one class to another without triggering an immediate taxable event and thereby deferring to a later date any taxes that would otherwise be payable.

*This is applicable only to Russell Managed Yield Class and Russell's corporate class structure.

ASSUMPTIONS

While care is taken in preparation of this document, no warranty can be made as to its accuracy or applicability for any particular purpose. The purpose of the illustrations in this document is primarily to show the tax benefits of the RREP (Russell Retirement Essentials Portfolio). The rates of return used in the calculations are hypothetical and for illustration purposes only and are not intended to be, nor should be construed to be, an indication as to the past or future return of the RREP.

Tax rates are taken from the Canada Revenue Agency website on April 2009. Please note that rates may vary from time to time and such change may not be reflected in this document. The after-tax distribution is calculated using the marginal tax rate at the highest marginal bracket current to April 2009.

The calculations used in this document make several assumptions:

The assumed equity dividend yield is 1.50%

The assumed fixed income yield is 4.00%

The assumed equity turnover rate is 40.00%

In calculations pertaining to the trust version of the RREP, the assumed percentage of distributions as capital gains and interest income are estimates based on the recent year's distribution allocations for the Russell Diversified Monthly Income Portfolio.

In calculations pertaining to the Alternative Portfolio, the assumed percentage of distributions as dividends and interest income are estimates based on the yield assumptions and the allocations of the RREP.

In calculations pertaining to the corporate class version of the RREP, the reinvested annual year-end distribution is assumed to be 32.8% of the distribution rate.

All Canadian dividends are assumed to be eligible dividends. All other dividends are assumed to be income.

The monthly distributions may consist of return of capital. The investor's cost base will be decreased by the return of capital distribution which potentially may defer their tax liability.

All distributions are assumed to be paid annually and taxes are applied at year end.

¹ Changes to the Canada Pension Plan (CPP) were recommended by federal, provincial and territorial Ministers of Finance on May 25, 2009. The proposed changes included applying a greater penalty for taking benefits early and a greater bonus for deferring benefits. The changes would take effect in 2011.

² In this scenario, we have assumed the annual \$50,000 distribution is provided as ROC. In addition, we have assumed the Russell Retirement Essentials Class Portfolio pays a year-end capital gains dividend. Consequently, the after-tax distribution of \$46,193 reflects the tax payable on the year-end capital gains dividend. Any year-end capital gains distribution will vary annually. There was no year-end capital gains distribution from the Russell Retirement Essentials Class Portfolio in 2009.

Important information

Nothing contained in this material is intended to constitute legal, tax, securities, or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. Russell recommends that investors obtain specific legal, tax, and investment advice from a licensed professional.

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