

REDUCE YOUR TAXES BY INVESTING IN CORPORATE CLASS

When it comes to tax minimization, the use of corporate class mutual fund structures is a strategy that has significant benefits to individuals and to corporations.

Most mutual funds are trusts. A mutual fund trust is a single fund with a particular investment mandate. Corporate class mutual funds use a corporate structure where multiple funds with different investment objectives are held within a mutual fund corporation. This structure allows expenses and capital losses to be shared among the different funds and therefore reduce the overall taxable income of the mutual fund corporation. Therefore, capital losses incurred in one fund can be used to offset capital gains that are realized in another fund and expenses incurred by one fund can be used to offset the income generated in another fund.

Starting January 1, 2017, corporate class mutual funds, lost the benefits of tax-deferred switching among the various funds held within the corporate class structure. In the past, the capital gains that would normally be triggered when units in a fund are sold at a profit, could be deferred until the year in which the unitholder sells all his/her holdings in the corporation. However, after the end of 2016, switches among different corporate class mutual funds will result in capital gains or losses, and the tax treatment of switches between different corporate class mutual funds will be the same as conventional mutual funds that are structured as trusts.

Despite this change in taxation, corporate class mutual funds continue to offer other major tax advantages compared to conventional mutual funds.

One of the primary benefits of corporate class funds which will continue is the ability to pool the income and expenses of all funds in the fund family. By doing so corporate class mutual funds offer the ability to minimize or defer overall taxable distributions.

The corporate class structure is particularly beneficial to income funds that tend to produce returns in the form of fully taxable interest income or for foreign equity funds that produce dividends that are ineligible for the Canadian dividend tax credit. The corporate class structure can reduce taxes by offsetting fully taxable income with unused expenses and loss carry-forwards transferred from other funds in the corporate class fund family.

Since Canadian corporations can only distribute dividends and capital gains, distributions from corporate class mutual funds are only in the form of eligible Canadian dividends or realized capital gains, which are taxed at a much lower rate than regular income. In Ontario, at the top personal marginal tax bracket, interest income is taxed at 53.53%, while capital gains is taxed at 26.76% and eligible dividends are taxed at 39.34%.

The corporate class structure has many benefits for high net-worth individuals who own non-registered funds held outside registered plans such as RRSP or tax-free savings accounts. This kind of structure also provides tax advantages for small-business owners who invest their excess cash in corporate accounts owned by their operating or holding companies that are subject to high corporate taxes.

Benefits for In Trust Accounts

The corporate class structure is also of benefit to parents and grandparents who hold units of mutual funds in informal in-trust accounts for their children or grandchildren. Normally, any interest or dividends paid by a conventional fund are taxable in the hands of the parent or grandparent who contributed to these accounts, while capital gains are attributed to the child (who normally has no income and hence pays no taxes). Corporate class funds are ideal vehicles for in-trust accounts as their distributions are in the form of dividends or capital gains and hence can minimize the taxes payable.

Benefits for Retirees

The corporate class structure can also be of benefit to retirees who have set up systematic withdrawal plans and regularly withdraw funds from their non-registered portfolio to create an income stream. Retirees can not only enjoy tax efficient income earned within the corporate-class funds, but they can also realize tax efficiency on their regular withdrawals as their income stream could be set up in a way that it is considered return of capital until the adjusted cost base of the units grinds to zero and this would allow them to defer taxes and create a more tax-advantaged stream of income. This will also allow them to minimize the claw back of their Old Age Security (OAS) income.

As discussed above, corporate class mutual funds have the key benefit of accelerated compounded growth (because of reduced or eliminated distributions). However, the benefits to corporations go beyond those available to individuals.

Benefits for Corporations

Benefits of corporate class mutual funds for corporations are as follows:

- **Converting interest income to capital gains** – The corporate class structure minimizes the potential for distributions from fixed income vehicles allowing investors to ‘convert’ income to capital gains. For example, money market and bond funds would benefit from capital gains tax rates rather than interest income allowing you to keep more of your investments. If your corporation is in the highest tax bracket in Ontario this means that you can convert an overall 57.66% tax rate on interest income or an overall 64.23% tax on foreign income to a 30.96% tax rate on capital gains income or a 39.34% tax on eligible dividends.
- **Withdrawing trapped money from the corporation tax free** – Using the Capital Dividend Account (CDA) it is possible to minimize the taxes payable by the business owner by withdrawing from the CDA, the non-taxable portion of capital gains – money that would otherwise be trapped in the corporation.
- **Avoiding Provincial Capital Tax** – Although capital tax has been removed at the federal level, provincial capital tax may still apply. Since it is a tax on assets rather than on income, the tax impact can be substantial. Corporate Class funds qualify your corporation to be exempt from the provincial capital tax.

- **Preserving the Small Business Deduction (SBD)** – Corporate class mutual funds can reduce the potential impact of the new passive investment rules for investments held in Canadian Controlled Private Corporations (CCPCs) on small business deduction (SBD). Budget 2018 proposed to gradually reduce access to the small business tax rate for corporations earning “significant” passive investment income. Under the new rules if a corporation and any of its associated corporations earn more than \$50,000 of passive investment income, the amount of the corporation’s income eligible for the small business tax rate will be reduced by \$5 for every \$1 of investment income over \$50,000. A corporation’s small business limit (i.e., the limit of active business income that can be taxed at the small business tax rate and is currently \$500,000) will be reduced to zero if the corporation and its associated corporations together earn \$150K or more of passive investment income.

As Canadian investors remain among the most heavily taxed investors in the world, Corporate Class structures provide an efficiency that should not be overlooked.

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