TAX-EFFICIENT CAPITAL PRESERVATION

RETURN OF CAPITAL

How long will my money last? This is one of the top trigger questions retirees have for their advisors. The answer can be simple and effective, by using the right combination of guaranteed and variable income returns and supplementing this with a return of capital to make savings last longer. In fact, using the right investments, cash flow can be increased through tax savings. Why is this? Withdrawing capital at opportune times to maximize cash flow can make more sense than drawing money from your RRSP or RRIF when tax costs of 30 to 50% (depending on province of residence and income levels) can erode capital quickly. A tax free return of capital may be a sounder choice for supplementing income requirements, particularly in the shorter term.

Planning to optimize retirement income by including a return of capital involves two opportunities:

1. Build a fixed cash flow: Estimate the retirement period (for most 65 year olds that's about 20 years). Then plan an orderly depletion of capital based on conservative forecasts for returns on investment.
2. Focus on capital preservation: "Income for life" is the goal at retirement. Capital will go farther if it is withdrawn with precision – only what's needed – and then left invested to continue to compound and grow. A more tax efficient withdrawal will result in a smaller capital encroachment.

Using a T-SWP

The T-Series (or T-SWP) is an investment structure designed to provide a regular, consistent level of cash flow received as a return of capital, which is not taxable. The great benefit is that you can switch into a T-Series without incurring tax consequences, for the purposes of supplementing retirement income.

PLANNING CONSIDERATIONS

Retirement income planning seeks to optimize fixed and variable income sources to result in a consistent, reliable monthly income stream, after tax. This is more difficult when the retirement period coincides with a period of low or negative returns in the marketplace or when retirees must rely on capital accumulations that fluctuate in value. The T-SWP can help smooth out those unpredictable circumstances.

Your advisor can show you how to supplement cash flow gaps without eroding capital significantly in the process.

What are the tax implications?

When capital to be used for retirement resides in a non-registered account, tax will be reportable on resulting earnings, such as dividends and interest, annually. You will also pay tax on any growth in the value of the original investment over its original or Adjusted Cost Base (ACB) when the investment (whole or part) is disposed of.

However, you will not pay tax again on the return of your original capital (i.e., the after-tax money you have invested in the account). A combination of taxable income and tax-paid capital can thereby supplement monthly income, without a significant spike in taxes.

If capital is returned from a mutual fund (such as a T-SWP), it's important to understand that the adjusted cost base of the fund units is reduced by the capital returned. This means that when the fund units are disposed of, the capital gains on the disposition will be increased. So although there are no immediate income tax consequences due to the return of capital, there will be consequences (in the form of capital gains tax) when the units are disposed of.

AGF

What are you doing after work?®

Sound Choices in planning tax efficiencies with T-SWPs

Aside from the additional cash flow that can be created on a tax-preferred basis when a return of capital forms part of a withdrawal strategy, there are additional tax benefits:

1. **Reduce tax, avoid clawbacks.** Using a T-SWP structure can be helpful in managing income levels so that federal and provincial taxes are reduced and also clawbacks of refundable or non-refundable tax credits, or Old Age Security are avoided or minimized.
2. **Reduce tax instalments.** In addition, reducing net income by withdrawing a return of capital will reduce quarterly tax instalment remittances in some cases, which in turn creates new cash flow. Ultimately those tax savings allow the taxpayer to return to a reduced capital payout so that the money can be used to produce income again.
3. **Do some elder care planning:** A T-SWP structure can help families generate cash flow for life events that may be unexpected. This can include funding tax on the transfers of assets such as cottages or the minimization of net income to manage income-tested per diem fees at nursing homes.

INVESTMENTS THAT RETURN CAPITAL

There are many types of investments and income-producing assets that typically provide some portion of tax free return of capital.

1. **Mutual funds.** Many types of mutual funds can be structured as a T-SWP, including income funds, high-yield income funds, dividend funds, growth funds, Canadian funds, balanced funds, U.S. funds, international funds and global funds. Switches between funds is possible on a tax-free basis in a corporate class fund.
2. **Tax-Free Savings Accounts (TFSAs):** A Tax-Free Savings Account is unique in that the distributions and capital growth are also tax free. Some of the distribution is considered to be a return of capital. This is your original invested value.
3. **Income trusts:** Most income trust distributions would include some combination of dividends, capital gains and return of capital.
4. **Non-registered annuity payments:** The annuity payment will be a combination of return of capital and interest income. In the early years of the annuity payment schedule most of the distribution will be interest and a smaller portion will be return of capital. As the annuity reaches what may be considered as the 'halfway point' in its life, the return of capital portion begins to be greater than the interest portion. As the years go by, the interest portion becomes smaller and smaller while the return of capital portion of the payment grows larger and larger.
5. **Prescribed annuities:** Prescribed annuities were designed to level off the changes in the interest portion and the return of capital portion of the annuity payment over time. As a result, over the life of the annuity, the return of capital portion and the taxable interest portion remain the same each and every year.
6. **Principal residence dispositions:** When it's time to downsize, the money received from the disposition of the principal residence is received on a tax exempt basis. This financial windfall can help to pay down debt, shore up TFSA and RRSP contribution room and enhance non-registered investments, that might include a variety of tax efficient funds.

Strategies to optimize return of capital

While any return of capital will deplete the asset pool that produces future income, withdrawals of tax-paid capital can be a good strategy in the following instances:

Bridging income gaps: Increasing the ratio of return of capital withdrawals can help you meet cash flow requirements in cases where the portfolio has otherwise been unable to generate income returns because of market fluctuations.

Be sure all tax-efficient solutions have been explored. For example, it may make sense to liquidate non-performing investments in non-registered accounts to generate new capital for spending while creating capital losses that can be applied to prior year capital gains or carry-forward to future tax years.

Additional options may include taking capital from TFSAs (at no tax consequence) and borrowing in the short term against other non-registered investments to create tax-deductible interest income.

Funding emergencies: Medical emergencies may require a sudden cash infusion because of unexpected travel or other medical expenses. A return of capital can assist over this period without increasing the financial hardship when the only other option is a taxable withdrawal from a Registered Retirement Income Fund (RRIF) or Registered Retirement Savings Plan (RRSP).

ACTION PLAN: Return of capital

There are two situations in which a return of capital strategy, by using a T-SWP structure in particular, is most advantageous:

1. **When you need cash flow, but not taxable income:** The return of capital strategy provides cash flow and not taxable income. A key consideration in planning is the taxpayer's exposure to clawback zones. With the right professional advice, you can ensure that important government income benefits would not be reduced or lost when cash flow is supplemented with a return of capital.
2. **When market cycles are volatile:** You may choose to use this tool during market cycles that are more volatile. In some cases this withdrawal option may provide a consistent level of cash flow only as needed on a periodic basis. But, because net invested capital is reduced over time, you may not wish to keep a T-SWP in place over the longer term, because you'll generate a deferred capital gain.

In planning for the right amount of cash flow, consider the following steps:

- **Income source counts.** Determine whether the most tax-efficient income sources have been used to obtain the required cash flow results.
- **Tax liabilities count.** Evaluate the overall taxes paid, the average and marginal rate of tax, the government benefits received and the clawback zones. In the event that any of these need to be improved, consider changing the mix of income sources.
- **Time counts.** Determine how to supplement earnings with a return of capital. This planning should focus on the length of time capital will last, and the income taxes payable now and in the future as a result of the return of capital. It also should consider the return on investment.

With a return of capital solution, you can achieve some outcomes that lead to peace of mind in retirement:

- **More cash flow**
- **Less tax**
- **Less risk, which results in capital preservation**

What are you doing after work?®

SOL098 10-16-E