TD Wealth

How efficient is your investment portfolio?
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Constructing an investment portfolio involves several client-specific considerations including factors such as investor risk tolerance, investment time horizon, account type, and individual tax status. However, one often overlooked consideration is the overall efficiency of the investment vehicles and account type used to implement a portfolio. This discussion will explore some of these return maximizing portfolio management strategies in greater detail.

Although this discussion covers some advanced concepts, page 7 (see 'Creating an Efficient Portfolio') contains a summary which provides a simplified breakdown of the topics reviewed throughout the paper. I will begin by exploring the primary types of investment income tax in Canada.

Types of Investment Income Tax

Interest Income

Interest income is fully taxable to the individual, and usually is associated with fixed income investments. Income earned outside Canada is considered foreign income. Many countries have withholding taxes that are deducted before a Canadian investor receives a payment from a foreign investment, resulting in foreign tax paid (see 'Foreign Withholding Taxes and Account Type' on page 6)[1].

Dividends

Dividends are a periodic payment to a shareholder from corporate earnings that have already been taxed. To avoid unfair double taxation (once by the corporation and again by the individual shareholder), the Canada Revenue Agency (CRA) uses an enhanced gross-up and dividend tax credit mechanism[2]. The result to the taxpayer is eligible dividend income is generally taxed at a lower rate than regular income[3].

Capital Gains

Capital gains tax is applied to the profits earned on the sale of an investment. The profit is the amount the investment has increased in value compared to the adjusted cost base, and is determined at the time of sale, not while it is held by the investor[4]. The tax payer generally only pays tax on 50% of any capital gains calculated while capital losses can be carried forward to future years to offset capital gains earned in the future[5].

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[1] https://www.tdassetmanagement.com/document/PDF/solutions/how_ETFs_are_taxed_en.pdf
[2] Ibid.
[3] Ibid.
[4] Ibid.
[5] Ibid.

In other words, you typically do not pay capital gains until an investment is sold. You can think of this deferral opportunity as an interest free loan from the government. As a result, capital gains are often considered the most tax efficient type of investment income.

A Review of the Most Common Investment Vehicles

Individual Stocks

A stock represents a share in the ownership of a company, which is a claim on the company's assets and earnings. There are usually two primary types of stock returns: dividends and capital gains.

Owning individual stocks can provide better tax flexibility since you are able to individually choose which investments to buy and sell. Alternatively, the buy and sell transactions within traditional fund vehicles such as mutual funds and exchange traded funds are at the discretion of the Portfolio Manager.

Foreign dividends are also subject to withholding tax levied by the jurisdiction of incorporation of the stock issuer. In Canada, the weighted average foreign withholding tax rate on international stocks is 12%[6]. The U.S. withholding tax rate charged to foreign investors on U.S. dividends is 30%, but this amount is reduced to 15% for taxable Canadian investors by a tax treaty between the U.S. and Canada[7]. ***However, investors are generally exempt from U.S. withholding tax when they hold U.S. stocks directly in a Registered Retirement Savings Plan (RSP) or Registered Retirement Income Fund (RRIF)[8].***

Individual Bonds

A bond is a debt instrument that pays interest at a set rate at regular intervals such as monthly, semi-annually, or annually. The stated interest rate at the time of issue of the bond is usually close to the interest rate in the market at that time. Most bonds trade on an active secondary market where the price fluctuations based on the difference between the stated interest rate and current market interest rate for a bond with a similar time to maturity. Many other factors, including changes in the credit rating of the bond also affect the price[9].

Bond prices move in the opposite direction to interest rates. If the market interest rate drops after issue, you may find that your bond is trading for more than you paid for it. The drop in the interest rate makes your bond more valuable, causing it to trade at a premium. Conversely, if interest rates rise after issue, you may end up holding a bond that is paying interest at less than the current rate and potential purchasers will only buy your bond at a discount[10].

[6] https://www.blackrock.com/ca/individual/en/literature/brochure/withholding-tax-reference-guide-en-ca.pdf
[7] Ibid.
[8] Ibid.
[9] https://ca.rbcwealthmanagement.com/documents/258147/258168/Bonds+-+the+tax+implications+%282016%29.pdf/5bc97111-bf9e-4250-b208-184f2758584f
[10] Ibid.

The following table summarizes the different possible taxation outcomes you could have from the purchase and sale of a bond. Given interest rates have been steadily declining for decades, most bonds are currently trading at a premium, and therefore will have a capital loss at maturity.

Table 1: Potential tax results from selling a bond paying regular interest

		Sell at Discount	Mature/Sell at Par	Sell at Premium
	Price	..., 97, 98, 99	100	101, 102, 103, ...
Buy at Discount	... 97 98 99	Capital Gain or Capital Loss	Capital Gain	Capital Gain
Buy at Par	100	Capital Loss	No Capital Gain or Capital Loss	Capital Gain
Buy at Premium	101 102 103 ...	Capital Loss	Capital Loss	Capital Gain or Capital Loss

[11]

Mutual Funds

A mutual fund is a company that pools money from many investors and invests the money in securities such as stocks and bonds. Investors buy shares in mutual funds, and much like individual stocks, each share represents an investor's part ownership in the fund and the income it generates[12].

In most situations, income from mutual funds is taxed in 2 ways[13]:

- While you own the shares or units, you are taxed on the distributions of income that are flowed out to you. The distributions can be capital gains, dividends, foreign income, interest, or other income. A return of capital will reduce the adjusted cost base of your units or shares.
- When you sell the units or shares, you are taxed on the gain, if any. This is usually a capital gain because your mutual fund investment is typically considered capital property for tax purposes.

[11] https://ca.rbcwealthmanagement.com/documents/258147/258168/Bonds+-+the+tax+implications+%282016%29.pdf/5bc97111-bf9e-4250-b208-184f2758584f

[12] https://www.investor.gov/introduction-investing/basics/investment-products/mutual-funds-and-exchange-traded-funds-etfs

[13] https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/tax-return/completing-a-tax-return/personal-income/line-127-capital-gains/completing-schedule-3/publicly-traded-shares-mutual-fund-units-deferral-eligible-small-business-shares-other-shares/tax-treatment-mutual-funds/income-mutual-funds-taxed.html

Mutual funds are often utilized as a low-cost opportunity to hire professional investment managers and create a globally diversified portfolio. In Canada, mutual funds are usually held in-trust, which allows the fund company to flow the taxable income to its unitholders instead of being taxed within the trust at the highest marginal tax rate.

However, there are a few tax inefficiencies associated with mutual funds. For instance, when you purchase a mutual fund, you are acquiring any previous deferred capital gains within the fund. This means that if the Portfolio Manager were to sell a holding with a gain, you will have to pay the capital gains tax even though you may not have a gain on the mutual fund units.

Another disadvantage to mutual funds is what is known as 'cash drag'. Cash drag as applied to mutual funds is the diminished return caused by holding cash to cover future redemptions and future fund purchases. Most funds keep approximately 5% of the portfolio in cash and equivalents[14].

Exchange Traded Funds (ETF's)

An ETF is a type of security that involves a collection of investments that often tracks an underlying index, although ETF's can invest in any number of industry sectors or use various investment strategies. They differ from mutual funds in that they are listed on exchanges and ETF shares trade throughout the day just like ordinary stock[15].

ETF's are most commonly used by investors for passive exposure to a market or industry. Passive managers do not attempt to beat the market but instead attempt to match it before deducting fund costs. As a result, passive ETF's usually have lower management costs and expense ratios than actively-managed mutual funds.

To mirror the performance of the market, ETF's typically assign a weighting to each holding based on that holdings market capitalization which is the dollar market value of a company's outstanding shares of stock. One advantage of a market-cap weighted index is its simplicity. As stock prices change daily, the weightings of index components automatically adjust[16]. However, there are also drawbacks to this method as certain holdings may make up a large proportion of your portfolio not because of their business fundamentals, but due to their popularity.

ETF's can also reduce the cash drag issue found with some mutual funds through their creation and redemption process. Simply put, each ETF share attempts to represent a proportionate share of the underlying securities that make up the ETF. To help ensure the ETF share price is valued, the ETF company employs an authorized participant to create and redeem the shares as needed[17].

[14] https://www.investopedia.com/terms/m/mutual_fund_cash_level.asp
[15] https://www.investopedia.com/terms/e/etf.asp
[16] https://www.investopedia.com/articles/exchangetradedfunds/08/index-debate.asp
[17] https://www.etf.com/etf-education-center/7540-what-is-the-etf-creationredemption-mechanism.html?nopaging=1

A Review of Canadian Investment Account Types

Registered Retirement Savings Plan (RSP) and Registered Retirement Income Fund (RIF)

An RSP is a retirement savings and investing vehicle for employees and the self-employed in Canada. Pre-tax money is placed into an RSP and grows tax free until withdrawal, at which time it is taxed at the marginal rate[18]. The growth of an RSP is determined by its contents.

RSP's have two main tax advantages. First, contributors may deduct contributions against their income. For example, if a contributor's tax rate is 40%, every $100 they invest in an RSP will save that person $40 in taxes, up to their contribution limit. Second, the growth of RSP investments is tax sheltered. Unlike with non-RSP investments, returns are exempt from any capital gains tax, dividend tax, or income tax. This means that investments under RSP's compound at a pre-tax rate[19].

In effect, RSP contributors delay the payment of taxes until retirement, when their marginal tax rate will be lower than during their working years[20].

In the year an RSP holder turns 71, the RSP balance must be liquidated, shifted to a RIF, or purchase an annuity. Once converted to a RIF, contributions are no longer permitted, and the account holder must withdraw a minimum amount each year.

Given the tax-sheltered nature of the RSP and RIF, they are ideal accounts to hold less tax efficient investment income sources such as interest income. Additionally, as mentioned previously, U.S. withholding taxes are not levied within an RSP or RIF.

Tax-Free Savings Account (TFSA)

The TFSA program began in 2009 as a way for individuals who are 18 and older and who have a valid SIN to set money aside tax-free throughout their lifetime. Unlike an RSP, contributions to a TFSA are not deductible for income tax purposes, however investment income and withdrawals are tax-free[21].

The TFSA contribution room is made up of[22]:

- The TFSA dollar limit plus indexation
- Any unused TFSA contribution room from the previous year
- Any withdrawals made from the TFSA in the previous year

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[18] https://www.investopedia.com/terms/r/rrsp.asp
[19] Ibid.
[20] Ibid.
[21] https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/tax-free-savings-account.html
[22] https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/tax-free-savings-account/contributions.html

Provided an individual was 18 or older in 2009 and a resident of Canada, the 2019 lifetime TFSA contribution limit is $63,500. Investment income earned by, and changes in value of TFSA investments will not affect TFSA contribution room for the current or future years[23].

Non-Registered Account

Non-registered accounts are taxable investment accounts available to Canadian citizens. As the name suggests, it is not registered with the Canadian federal government and have no contribution limits[24]. Non-registered accounts are fully taxable.

Corporate Investment Account

Corporate investment accounts are taxed similarly to non-registered accounts, however corporate accounts may offer a tax deferral advantage. To illustrate, profits from an active business are usually subject to a low corporate tax rate. The after-tax earnings can then be distributed to shareholders in the form of salary or dividends. If the salary or dividends are received by an individual shareholder, they are subject immediately to personal income taxes. If instead the dividends are received by a holding company, the dividends may be eligible to flow tax-free, allowing the entire amount of the dividend to be reinvested on a pre-personal tax basis. In most cases, this will result in an additional 20-30% of capital available for reinvestment within the holding company, with the personal tax liability deferred until the funds are needed for personal use[25].

Our Canadian tax system is designed to be neutral between investment income earned personally and investment income earned through a corporation. What this means is that after the corporation pays tax on its investment income and the shareholder pays personal tax on dividends received from the corporation, the total corporate and personal tax payable should be approximately the same amount as what the shareholder would have paid if the investment income was earned directly by the shareholder[26]. CRA refers to this as integration, but it does not account for the tax deferral advantage.

Foreign Withholding Taxes and Account Type

Canadian investors get an enormous benefit from diversifying their portfolios with U.S. and international investments, but this benefit carries a cost in the form of foreign withholding taxes. The amount of foreign withholding tax payable depends on two important factors. The first is the structure of the ETF or mutual

[23] https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/tax-free-savings-account/contributions.html
[24] https://www.investopedia.com/terms/u/unregistered-account-/-nonregistered-account.asp
[25] https://www.mnp.ca/en/posts/do-i-need-a-holding-company
[26] https://ca.rbcwealthmanagement.com/documents/400761/1654595/Investment_holding_companies_08242018_high.pdf/d8e38c08-ba1c-448e-96e8-16caec606042

fund that holds the investment. Canadian investors can most commonly get exposure to U.S. and international investments in three ways[27]:

1) Through a Canadian-listed ETF or mutual fund that holds the investments directly
2) Through a US-listed ETF
3) Through a Canadian-listed ETF that holds a US-listed ETF

In all three cases, investors are potentially subject to withholding taxes levied by the countries where the investments are domiciled known as Level 1 taxes. However, in scenario's 2 and 3, investors may also be subject to an additional withholding tax by the U.S. government called Level 2 taxes.

The second key factor is the type of account used to hold the ETF or mutual fund. Different account types (RSP's/RIF's, TFSA's, non-registered, and corporate accounts) are vulnerable to foreign withholding taxes in different ways. Here is how foreign withholding tax is generally applied to each account type[28]:

1) Canadian-listed ETF or mutual fund that holds the international investments directly

a. **RSP, RIF, TFSA:** Level 1 withholding taxes apply and are not recoverable.
b. **Non-registered:** Level 1 withholding taxes apply but are recoverable.
c. **Corporate account:** Level 1 withholding taxes apply but are partially recoverable.

2) US-listed ETF and Canadian-listed ETF that holds a US-listed ETF

a. **RSP, RIF, TFSA:** Level 1 and Level 2 withholding taxes apply and are not recoverable.
   i. One exception is U.S. withholding taxes are not charged within an RSP or RRIF.
b. **Non-registered:**
   i. Level 1 withholding taxes apply and are not recoverable.
   ii. Level 2 withholding taxes apply but are recoverable.
c. **Corporate account:**
   i. Level 1 withholding taxes apply and are not recoverable.
   ii. Level 2 withholding taxes apply but are partially recoverable.

[27] https://www.advisor.ca/my-practice/continuing-education/foreign-withholding-taxes-how-to-estimate-the-hidden-tax-drag-on-u-s-and-international-equity-index-funds-and-etfs/
[28] Ibid.

Creating an Efficient Portfolio

We can combine the above information regarding investment income tax, investment vehicles, and account type to help create a tax efficient portfolio. Based on what we have reviewed, we can generally assume the following account types are best suited to hold these investment vehicles:

RSP and RIF:

- Canadian and U.S. income producing investments (i.e. bonds).
    - One offsetting consideration is the possible capital loss associated with holding fixed income in a low interest rate environment (see 'Individual Bonds' on page 2).
- Canadian and U.S. stocks.

TFSA:

- Canadian income producing investments.
- Canadian stocks.

Non-registered and corporate accounts:

- International income producing investments.
    - ETF's should be a Canadian-listed ETF that holds the investments directly.
- Canadian and International stocks.

Of note, other client specific considerations factor into creating an optimal client portfolio. Examples of the types of questions we consider when implementing an efficient portfolio are the following:

1) How does the portfolio structure affect a client's financial plan?
2) Could the portfolio structure lead to adverse future income tax implications?
3) Does the general economic environment change how the portfolio should be structured?

In sum, creating an efficient portfolio requires an advisor who is knowledgeable in all areas of portfolio management such as financial planning, investment vehicle structure, and the taxation of investment income. At Momentum Wealth Management, we believe in creating a customized investment portfolio structured to best achieve your financial needs.

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Commissions, trailing commissions, management fees, and expenses all may be associated with mutual fund investments. Please read the fund facts and prospectus, which contain detailed investment information, before investing. Mutual funds are not guaranteed or insured, their values change frequently and past performance may not be repeated.

Commissions, management fees and expenses all may be associated with investments in exchange-traded funds (ETFs). Please read the prospectus and summary document(s) before investing. ETFs are not guaranteed, their values change frequently and past performance may not be repeated. ETF units are bought and sold at market price on a stock exchange and brokerage commissions will reduce returns. Index returns do not represent ETF returns.

Capital gains taxes deferred will be payable when the units of a fund are sold or to some extent when their adjusted cost base goes below zero. Return of capital (ROC) distributions does not constitute part of a fund's rate of return or yield. ROC reduces the adjusted cost base of the units to which it relates.

Index returns are shown for comparative purposes only. Indexes are unmanaged and their returns do not include any sales charges or fees as such costs would lower performance. It is not possible to invest directly in an index.

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