

Maximizing after-tax returns is what matters most

TAX-SMART INVESTING®

In a country like Canada, where taxes can be almost 50% of your taxable income, saving taxes should always be a priority.

At AIC, our investment approach incorporates tax planning to minimize your investment tax bill each year. This approach to maximize your after-tax returns is evidenced by our commitment to tax-smart education, a strong corporate philosophy grounded in tax minimization and our tax-smart investment products.

A tax-smart portfolio is a portfolio that focuses on maximizing after-tax investment returns. After all, it's not how much you earn, but how much you keep that matters most.

AIC believes in maximizing after-tax wealth (i.e. your bottom-line cash flow). We are proud of being Canada's tax-smart investment manager and a committed educator of Canadians in matters of investing, tax planning and an integrated tax-smart investment approach.

This brief is one in a series on tax-smart investing. We believe you will find this brief, along with our tax-smart investment products, helpful in maximizing the value of your taxable investment portfolio.

Combine tax planning and investing

Canadians often feel helpless at tax time as they watch the government take some of their hard earned income. Few people, however, think about maximizing their investment returns on an after-tax basis by more diligently planning the types of returns they should be earning in their non-registered accounts.

Most money managers are paid to maximize pre-tax returns – those returns you see published in mutual fund tables and advertisements in newspapers. However, as an investor and a taxpayer, what matters is how much goes into your pocket after-tax. Unfortunately, after-tax return information is not easily found in Canada. That's where AIC can help.

How important is tax and investing?

If you made 8% this year on the purchase and sale of a mutual fund, you may have made only 6% after-tax. Indeed, taxes can put a dent in the performance of your investment portfolio. Yet many people still have not realized the significant impact high taxes can have on their investment returns.

It is important to examine the after-tax return on investments when comparing rates of return between various investments held in a taxable account. You cannot simply conclude that a GIC paying 5% interest is better than a dividend rate of 4%. Dividends paid by Canadian companies are subject to a lower rate of tax, thereby providing a higher after-tax return than a GIC paying an equivalent return. Often an investment providing a lower gross rate of return results in greater after-tax income in your pocket. Even more lucrative are capital gains, since capital gains are now the lowest taxed form of investment return in Canada for most middle and high income taxpayers (the level at which capital gains are taxed at a lower rate than dividends differs by province. See AIC's *Tax Rate Card* for details). This means a lot more cash in your pockets, after-tax, if you are accumulating wealth in the form of accrued capital gains.

The question is: Are you correctly focusing on after-tax returns? AIC is.

At AIC, our goal is to create long-term wealth for our clients by concentrating on capital growth at a superior rate of return and tax minimization.

What types of returns can you earn?

When you buy an investment, your returns can take the form of interest, dividends or capital gains. For a Canadian in the highest tax bracket, realized capital gains are taxed at a lower level than Canadian source dividends which are taxed at a lower level than interest or other "regular" income.

Unrealized capital gains attract no taxation until the asset is sold or deemed to be sold. Owning equities for the long term, with little buying and selling, results in the lowest taxation annually. This “buy-and-hold” approach is the investment style used by AIC. Of course, investment purchases should be based on a number of factors, including your risk preference, cash flow needs and liquidity requirements. But when you can, taxes should also be considered when planning your portfolio.

The tax effectiveness of RRSPs and RRIFs

In Canada, a great tax deferral is an RRSP or RRIF. Contributions to an RRSP will provide a current tax deduction (assuming you have RRSP contribution room) and investments inside an RRSP grow tax-deferred. Hopefully, once you are retired and need to withdraw funds from your RRSP or RRIF you are in a lower tax bracket and subject to less tax on these withdrawals than you are today. This is one of the benefits of using

Calculating your after-tax return

Although most published information shows your pre-tax return, it is possible for you to calculate your returns on an after-tax basis. The after-tax return is what remains of the pre-tax return after tax is subtracted from taxable income and capital gains. If you take your pre-tax return and multiply it by the marginal tax rate applicable to that type of income, you can estimate the tax you pay. Your gross return, less the tax you pay, is the amount of your after-tax return in dollars. Percentage wise, your after-tax return is your after-tax return in dollars divided by the amount of your original investment.

Let us consider the following example of an individual who is a resident in the province of Ontario.

Jim invested \$10,000 in units of a Canadian equity mutual fund during January 2004. During 2004 the fund distributed \$300 of interest income and \$500 in Canadian dividends to Jim. These distributions were reinvested to purchase additional units of the fund. At the end of the year, Jim’s investment was worth \$11,500.

Jim’s pre-tax returns include the interest income and dividends distributed to him, as well as the unrealized capital gain due to the increase in the fund’s value.

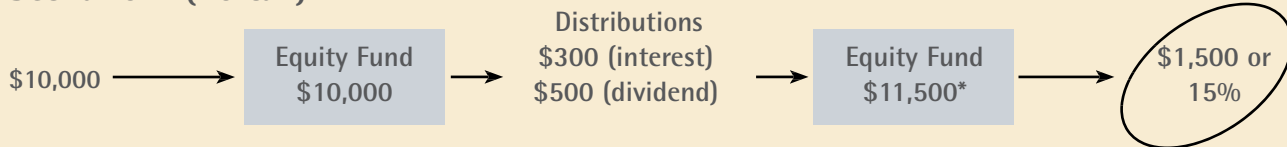
Assuming Jim is in the highest tax bracket in Ontario (income greater than \$113,804 in 2004), the taxes due on these returns are as follows:

- \$300 interest income is taxable at 46.41% tax rate resulting in \$139 of tax.
- \$500 Canadian dividends is taxable at 31.34% tax rate resulting in tax of \$157.
- The unrealized capital gains does not trigger tax at this time; these gains are not taxable until the fund is sold.

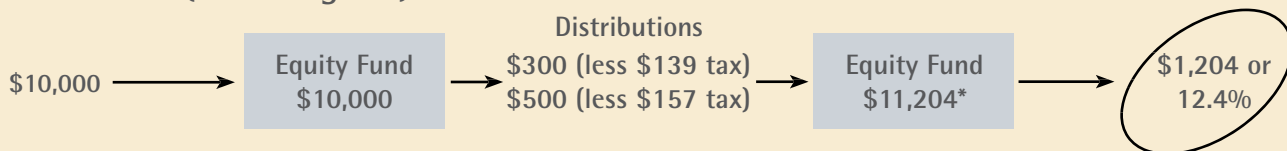
This means that the total tax Jim does pay this year is \$296 (\$139 plus \$157). Therefore, his pre-tax return is \$1,500 or 15 per cent, which is made up of his reinvested distributions of \$800 plus \$700 of unrealized capital gains due to an appreciation in the fund’s value. The after-tax return in dollars is \$1,204 (\$1,500 less \$296). As a percentage, his after-tax return is 12.04 per cent (\$1,204/\$10,000). This means that Jim lost almost three per cent of his return to pay current taxes.

The impact of taxes on investment returns

Scenario A (no tax)



Scenario B (including tax)



*Includes \$700 unrealized capital gains and reinvested distributions.

an RRSP for your savings. Even if you are not in a lower tax bracket when the money is withdrawn from the RRSP or RRIF, you have had the advantage of deferring tax within the plan for decades, in many cases.

Tax-smart investing is tricky with your RRSP or RRIF

It is important to note that individuals who have a diversified portfolio inside their RRSPs do not personally enjoy the benefits of the lower rate of taxation on dividends and capital gains generated inside the RRSP or RRIF. This is because all earnings inside the registered plan remain completely tax deferred. It is only when withdrawals are made from the RRSP or RRIF that taxes are due. In fact, these withdrawals are not tax friendly and are taxed as regular income, subject to your marginal tax rate. This tax rate is the same rate that would be applied to interest income and regular income, which are the highest taxed income types for every income tax bracket in Canada. You might wonder whether or not an RRSP is worth it, considering the high rate of tax that might apply to your withdrawals. In most cases, the answer is a resounding yes. Due to the initial tax deduction, and the deferral of tax on earnings in the plan, you are usually better off with an RRSP than solely a non-registered account. See AIC's Tax Smart Bulletin *The Great Debate – are RRSPs passé?* for further details.

Tax-smart investing requires a different strategy for RRSP/RRIF and non-RRSP/RRIF accounts

Generally speaking, it is tax-smart to hold your highest taxed investment income inside your RRSP or RRIF to defer the taxation of that income. This means that to the event you wish to own interest bearing investments in your overall portfolio, it may be best to hold those investments, plus derivative investments and foreign income inside your RRSP or RRIF to avoid personally paying a high rate of tax on this income.

It may be more appropriate to hold tax-smart investments, such as low turnover “buy-and-hold” equity mutual funds, in your taxable accounts since tax rates are lower on capital gains and dividends. To make your portfolio as tax-smart as possible, you should try to purchase mutual funds with low portfolio turnover and minimal distributions of income. With a buy-and-hold strategy, almost all of the return on the investment is generated in the form of tax-deferred growth, which keeps your annual tax bill to a minimum and helps to create more after-tax wealth in the long term.

Next steps

AIC continues to help Canadians understand tax issues related to mutual funds. Contact your financial advisor for more information on taxation and mutual fund issues that concern you.

This brief is adapted from Kurt Rosentreter's book, *50 Tax-Smart Investing Strategies* published by Stoddart Publishing.

Canadian provinces and territories impose their own tax rates in addition to the federal tax rates. Therefore, depending on where an investor lives, that individual's tax rate may differ from any examples shown. The content of this bulletin is for informational purposes only and in no way should be construed as tax or investment advice. Please consult a professional advisor for advice related to your specific situation.

AIC's STRATEGY FOR SUCCESS:

BUY.

A simple summary of our approach to mutual funds at AIC is this: choose the right heroes and keep the faith. We buy into excellent companies – the best of the best – in strong, long-term growth industries and we hold these investments for the long run. The goal is a better rate of return for our clients.

HOLD.

Stand for nothing and you are likely to fall for everything. The truth is, bears, bulls and other unpredictable market influences eventually disappoint short-term investors who focus on share prices rather than a company's true worth. At AIC, we stick with the quality businesses in which we invest.

AND PROSPER.

Prosperity to us means meeting the three objectives of investing. It means preserving your principal over the long term. It means growing your money at a good rate. And it means protecting your investment from the ravages of taxes. It's really quite simple. And the results over the long term are something to behold. Of course, what you do with your prosperity in the end is up to you.

Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. Commissions, trailing commissions, management fees and expenses may be associated with mutual fund investments. Please read the prospectus before investing.

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**BUY. HOLD.
AND PROSPER.™**



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