# Corporate Class Structures: Tax Strategies and Investment

## Is a Corporate Class Mutual Fund Structure Beneficial For You?

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A corporate class structure for mutual funds is when all of your funds are under one umbrella for tax purposes. (1)(3)(4)(5)(6) You can switch between funds that issue all forms of income (interest, dividends and capital gains) and not pay taxes until you withdraw the money from the whole structure. Any withdrawals would be taxed as capital gains even if the original income was in the form of interest or dividends. The timing of when the gains are incurred, as well as when the taxes are paid is up to you. There is also a possibility of receiving a "return of capital" ahead of your capital gains, which is not taxable. A return of capital is receiving the money you invested rather than the money earned on the investment. This would defer your capital gains taxes until all of your capital is returned to you, which would defer your overall tax bill. This sounds good doesn't it?

There are many factors to consider before utilizing this structure to see if it is beneficial for you and they are described below in more detail. Some of the factors are: the type of income generated by the mutual funds, your income tax bracket, the amount of money you invest, the fees outside of this structure compared to within the structure, frequency of your trading between funds, your past and future capital gains or losses and your risk tolerance. Keep in mind that this is a type of tax shelter, much like an RRSP or TFSA, but the rules are different. You need to know how they all work so you can utilize them as best that you can in the situation that serves you best. You also need to know when it is not worth it for you to utilize the tax shelters.

### Income Generated By the Mutual Funds

If you are buying investments that only provide capital gains, like small cap funds or commodity funds, this structure will not make a difference for you with the exception of receiving a return of capital earlier rather than when "the sell event" occurs. If you sell a portion of your funds yourself, you will receive some return of capital nonetheless, but the timing would be different. The corporate class structure allows you to claim a return of capital first, followed by the capital gains. If you are primarily invested in securities that generate interest, like fixed income (bonds, mortgages, GICs etc.), the idea of having them taxed as capital gains may be useful to you. If you have equities that create dividends, the structure may also be useful because capital gains are generally taxed more favourably than dividends. If you have dividends from foreign corporations, the tax rules are more complicated as the foreign governments may withhold part

of your income to pay foreign taxes before the money gets to you. This will depend on the type of investment you have (based in Canada or elsewhere as an example), the type of account you have (retirement, registered or not) and which country the dividends come from. The reference to dividends in this article is assuming they come from eligible Canadian corporations that would receive the dividend tax credit.

## Your Income Tax Bracket

The corporate class structure is designed for people who pay a lot of taxes and who do not have other avenues or tax shelters to reduce their tax burden. If your tax bracket is low, the incentive to invest in something more complex and which requires more planning will not be as appealing. The fact remains that taxes for all the forms of income (interest, dividends and capital gains) will be higher in the high tax brackets and lower in the low tax brackets. The structure is beneficial if the tax rates are high and will remain the same throughout your investment horizon. If tax rates are lower at some particular point in your income stream, this structure may be of less value than originally planned. Another thing to consider is the higher your income tax bracket, the more beneficial it is for you to receive capital gains. You may have a lot of assets but not a lot of income, as opposed to a low amount of assets and a high income. The strategy in these two cases would be different from a tax perspective.

## The Amount of Money You Have in the Structure

The more money you have to invest, the more likely you will have used up RRSP room, TFSA room or other common registered tax shelters. On the flip side, the more money you have to invest, the more tax options you have that should also be examined such as corporations, trusts, charitable giving or investing overseas. As the amount that you invest increases, the fees will decrease, which will make the cost of the structure more attractive. The more money you have invested, the more flexibility you would have to diversify funds and spread the income types between many funds. If you have assets of a million dollars or more to invest, fees can be negotiated in some cases. There doesn’t appear to be a minimum or maximum threshold amount for investment for most companies. Questions about minimum or maximum assets should be asked before you commit to investing to see if there any restrictions that may impair your investment strategy.

## Fees

These corporate class products tend to be more expensive than comparable products of the same type. The fees inside the corporate class structure tend to be about 0.2 to 0.4% per year higher than a typical mutual fund. (2) This is only the Management Expense Ratio for the fund. There are also sales charges at the front or back end (when you buy or sell) that can add significantly to the cost. The average increase in cost according to a Brock University study is over 1%. (2) To go along with the fees, there are usually fewer choices in a structure verses being able to buy whatever product you want. There may also be restrictions on alternative asset classes or specific niche products. These structures tend to assume that active

management (having someone pick the stocks or holdings) is better than passive management (investing in an index). This is usually not true unless you have a good portfolio manager with a consistent record. (7) Lastly, if there are products that having selling restrictions or minimum holding periods, this may impair your ability to switch funds even if the time is right to switch products. The conditions may allow you to switch products, but penalize you with extra fees. As the amount of your assets increases, fees should go down and can be negotiated as noted earlier. Make sure you understand the rules for entering and exiting the structure so that you can evaluate before committing.

The assumption in investment literature is that gains generally are more common than losses, but the timeframe may have to be extended for 10 or more years before the averages are in your favour. The S&P 500 return history from 2000 to 2010 is an example of this, as is the NASDAQ over that some period, gold companies during the 1990's or Japan in the 1990's. If you have to wait for this length of time and the fees are higher, you will generally lose more money if all else is equal. If you have no gains or losses for a period of 10 years, yet the fees are 1 to 2% higher each year for the same investments, this will mean a loss of a fair amount of capital.

The key question to ask is: "Would I invest in the same products inside and outside of the structure and be happy with the results?"

Frequency of Trading

If you are a buy and hold investor, this structure will not provide as much benefit as a frequent trader. One of the selling features of this corporate class structure is that you can switch funds as often as you like without incurring any tax consequences. You *may however incur sales fees every time you switch funds.* Unless you are very good at market timing, this advantage does not exist for you, as switching will create losses which can be done outside of this structure as well. If you trade infrequently, but rebalance your portfolio every so often with large swings in the market, this may be beneficial for you as these large gains would not be taxed until sometime in the future. If you trade very frequently (buying and selling the same funds within 30 days of each other), you may be able to avoid a tax rule that tags frequent trading as income or creates superficial losses. If you intend to be a trader on the other hand, you may want to examine trading as a business and declaring relevant expenses. These topics should be discussed with a tax consultant.

Accumulated Capital Losses

If you have accumulated capital losses from the past, this structure may not provide much benefit for you because any gains you receive can be offset against these losses, resulting in no taxes payable until your losses are used up. On the other hand, if you have accumulated capital gains, this structure may provide you with tax savings right away. If you have unused RRSP or TFSA room, you may be better off using these tax shelters instead of a corporate class structure because you are not paying taxes on your gains. In the case of a TFSA, you will not pay taxes on any money that you make regardless of how you make it. There are limitations with

contribution room with both of these products which would not exist with a corporate class structure.

Risk Tolerance

Risk tolerance should also be considered before making any investment decisions. In this particular case, there is a tendency for people to let tax decisions override the quality of the investment. There is also a tendency to try to time the market or take more risk since the results will be treated as capital gains. The thinking is “I have an opportunity to take advantage of the tax rules, so I will increase my trading to try to maximize my tax savings”. The other line of thinking is “I wouldn’t normally be switching between funds, but since there are no consequences, I will do it more often.” These lines of reasoning need to be balanced against whether you are in fact successful at market timing, or whether you are making the same amount of money when all is said and done compared to your usual investment pattern. This issue needs to be examined by understanding what your psychology is in terms of trading, and where your weaknesses are. If you use a gambling analogy, you may be a very skilled poker player, and consistently win against other poker players. However, if you start betting on horses, you tend to overdo it and lose large amounts of money because you think you will succeed as often as in poker. Tax structures change the rules of the investment game, so you need to factor that in with the investment strategies that work for you and see if the combination of the tax shelter and your investment style is successful.

As with any investment idea, the advantages and disadvantages must be examined for your individual situation. This analysis should also be revisited when changes occur like tax bracket, income, investment preferences or personal changes. This should be done looking at your entire money situation so that you weigh all the alternatives and choose which one serves you the best.

Sources:

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