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Investment Insight

# Comparing SWPs to Series T Funds – Pay tax now or pay tax later?

When it comes to planning for an income stream during retirement, Canadians are presented with many options. For non-registered investors, the tax treatment of the investment is an important consideration.

One popular investment option for generating income is mutual funds. They can provide an income stream through the use of a systematic withdrawal plan (SWP), or they may offer a Series T option (also referred to as T-Class). Both choices provide tax-efficient cash flow during retirement; however, Series T has the potential to defer more tax until some future time.

The following will compare receiving a non-registered income stream from a SWP versus using a Series T option.

## Comparing a SWP to Series T

At the time of each SWP, there is a sale of units to fund the withdrawal. This sale will trigger a capital gain or loss. Receiving income in this manner can be tax-efficient since only a small portion of the income stream is taxable as a capital gain; the balance will be non-taxable return of capital (ROC).[1] However, the ROC received does reduce the adjusted cost base (ACB) dollar for dollar.[2]

With Series T the payments are treated as distributions and therefore no units are sold and capital gains are not realized. These distributions are expected to be primarily ROC and as previously mentioned will reduce the investor's ACB. The receipt of ROC is tax free until the ACB reaches zero at which point additional distributions that are reported as ROC are taxed as capital gains.

In addition, in either situation there may still be taxable distributions reported. These should be the same or similar if the underlying fund is the same.

With a SWP, the amount of the capital gain realized on the sale of the units will generally start small and grow over time as more ROC is received and the ACB is ground down. Series T distributes all of the ROC first, at which point future ROC distributions are taxed as capital gains. Assuming taxable distributions to be the same, Series T provides a tax deferral in the early years, but higher tax reporting in the later years, once the ACB reaches zero. Interestingly, the net tax payable upon cashing out would be the same.

The following example will help illustrate the timing difference from a tax perspective.

## A Tale of Two Tax Efficient Income Streams

Dave and Betty, both age 65, have each accumulated funds to invest for their retirement. Dave decides to invest $100,000 in a mutual fund and receives payments using a SWP. Betty also invests $100,000, but instead decides to allocate her funds to the Series T version of the same fund. Here's how each of their portfolios look after 18.6 years.

### Assumptions

| | |
|---|---|
| Initial investment | **$100,000** |
| Payout rate | **6%**[3] |
| Annual rate of return | **7%** |
| Marginal tax rate | **40%** |
| Fund distribution rate | **1%**[4] |

| 7% rate of return | Tax paid on income stream ($) | | Difference ($) |
|---|---|---|---|
| Year | SWP | Series T | |
| 1 | 436 | 400 | **36** |
| 10 | 953 | 430 | **523** |
| 18 | 1,274 | 458 | **816** |
| 20 | 1,341 | 1,632 | **(291)** |

For illustration purposes only.

[1] For the purposes of this piece we assume a positive rate of return and that a sale of units will trigger a capital gain. If the rate of return was negative the sale of units would generally trigger a capital loss.
[2] For more information on the taxation of SWPs, see Tax treatment of Systematic Withdrawal Plans (SWPs) (MK2329E).
[3] Series T monthly distributions are based on a target distribution rate of the net asset value per security of the fund determined as at December 31 of the prior year.
[4] The assumed distribution is paid monthly and comprised 100 per cent of interest income.

## What it looks like after 18.6 years (when the ACB reaches zero with Series T)

| | Betty ($) SERIES T | Dave ($) SWP |
|---|---|---|
| Total cash flow after 18.6 years | 119,812 | 119,812 |
| Ending market value | 116,164 | 116,164 |
| Taxes paid on cash flow over 18.6 years | 7,980 | 16,999 |
| Taxes due on unrealized capital gain | 23,205 | 14,186 |
| Total taxes paid | 31,185 | 31,185 |

For illustration purposes only.

At the end of 18.6 years, Dave and Betty each received the same gross cash flow of $119,812. Since Betty was invested in a Series T fund, she was able to receive more tax free ROC and as a result received $9,019 more after-tax cash flow during the 18.6 year period. If Betty chooses to continue with Series T, going forward she will pay more tax each year on the income stream than Dave[5]. Also, Betty will now face a higher tax bill on the unrealized capital gains as compared to Dave when she sells.

In the end, both Dave and Betty will end up paying the same amount of tax on their respective investments. Dave ended up paying more tax earlier, whereas Betty will pay more tax later.

**Caution:** If the fund earns less than it pays out the investment value will decrease and with Series T the annual payout amount will also decline.

In deciding which option is better, ***one needs to consider*** the impact of inflation – which can make future tax payments cheaper, the marginal tax rate of the investor both today and in the future, as well as the impact on income tested benefits such as Old Age Security.

[5] Betty can switch from Series T to another series or class of the same fund without triggering a taxable event and defer the receipt of ROC and the resulting tax reporting until she or her estate sells the units.

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