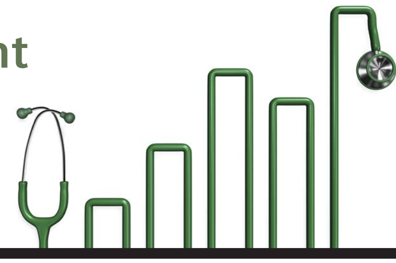
EFFICIENT

Russell Investments

Funding a healthy retirement with tax-efficient income



One of the chief concerns for those in or nearing retirement is whether your income will be sufficient to meet your retirement spending needs. As investment portfolios gyrate along with the markets, it has become increasingly important to ensure your retirement portfolio is designed to provide the cash flow necessary to help you meet your retirement goals.

Incorporating corporate class solutions into a portfolio can help create tax-efficient cash flows that ensure a steady and consistent income stream throughout retirement.

A well-designed retirement portfolio will make use of both registered and non-registered assets to supplement income provided by government and/or company pension plans.

Assets held in registered accounts can benefit from tax-sheltered growth during their lifetime. Apart from a few credits and deductions which serve to reduce the tax payable, withdrawals from registered accounts are fully taxed as income at the owner's effective tax rate. However, there are several options to consider in order to help maximize the after-tax income that can be provided by non-registered assets.

Different types of income receive different tax treatment:

Interest Income

- Income generated from fixed-income securities and any foreign dividends
- Taxed at the investor's marginal tax rate

Dividends

- Quarterly payouts from certain equity investments that represent a portion of company profits
- Canadian eligible dividends receive a tax credit, which may make them an attractive source of income for many investors in high tax brackets

Capital gains

- Generated when a fund manager shifts allocation or an investor sells securities at a higher price than purchased
- Taxed at 50% of investor's marginal tax rate

Return of Capital (ROC)

- A portion of the original investment that has been returned to the investor in the form of a distribution
- Is not taxable in the year it is received
- Reduces the Adjusted Cost Base (ACB) of the investment portfolio
- However, when the ACB reaches zero, the remaining distributions are in the form of capital gains

Clearly, income in the form of ROC with its tax-deferral characteristics is worth considering.

Two investment options providing distributions that may include an ROC component are:

- Units of mutual fund **trusts** that pay a fixed annual rate of distribution
- Units of mutual fund **corporations** that pay a fixed annual rate of distribution

What benefits does ROC have for an investor?

ROC distributions are not included in the calculation of taxable income. That means ROC distributions may provide a supplementary source of income without impacting the Old Age Security pension, the Guaranteed Income Supplement and spousal tax credits. Additionally, ROC distributions may provide a means of "income bridging" for those individuals who have deferred Canada Pension Plan payments in order to recieve a higher payout at a later date.

However, because ROC reduces the ACB of an investment, it increases the size of the capital gain realized when the portfolio is sold. That realized gain is subject to the capital gains tax.

How can you take advantage of ROC?

Let's take a look at an example which illustrates the after-tax benefits of choosing an investment that can provide distributions in the form of ROC.

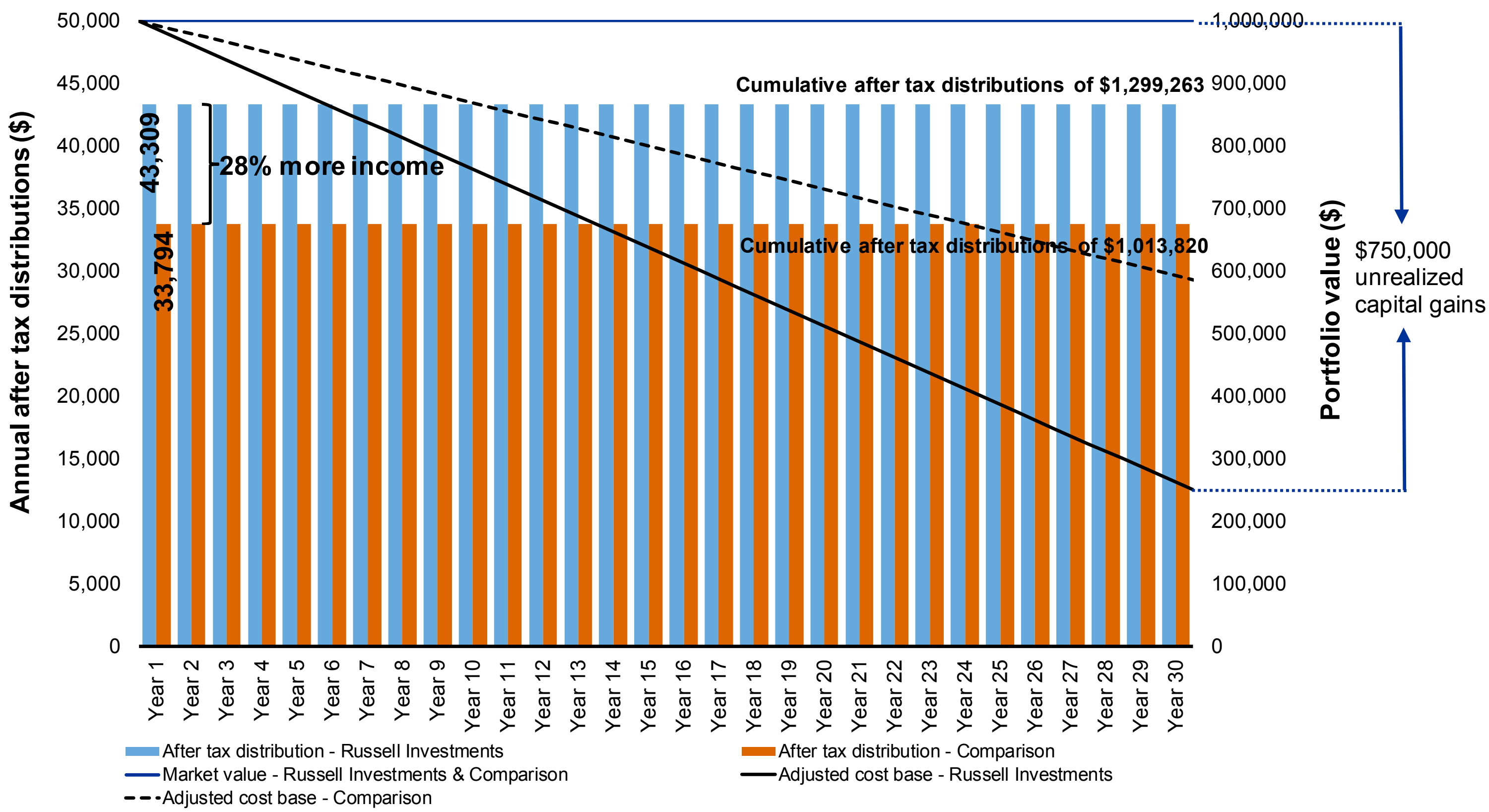
In this scenario, we compare two portfolios.

	Primary portfolio	**Comparison portfolio**
Initial portfolio value	$1 million	$1 million
Asset allocation	60% equity/40% fixed income	60% equity/40% fixed income
Fund structure:	Corporate class	Trust
Annual pre-tax distribution amount	$50,000	$50,000
Annual return (net of fees)	5%	5%
Distribution option	5%	5%

In this hypothetical example, the investor is a resident of Ontario in the highest tax bracket.[1] The **primary portfolio** is a Corporate Class portfolio that resembles Russell Investments Diversified Monthly Income Class (Russell Investments Class Portfolio). We have selected the 5% distribution option in order to meet the investor's annual pre-tax income requirement and we have assumed the portfolio has an annual return of 5% net of fees. The forecast return is a hypothetical assumption that is used in this example for illustration purposes only. It has no relationship to historical returns and is not intended to predict expected future returns of the Russell Investments Diversified Monthly Income Class or any other Russell Investments Canada Limited (RICL) fund.

The **comparison portfolio** is a "do-it-yourself" portfolio consisting of individual securities with the same asset allocation as the primary portfolio. We will use a proprietary tax-illustration tool to show the outcome.

Russell Investments Class Portfolio (60% equity / 40% fixed income) vs Comparison Portfolio



As the chart illustrates, annual gross distributions of $50,000 and annual after-tax distributions of $43,309 for the Russell Investments Class Portfolio (the **primary portfolio**) remain constant until year 30. The ACB of the Russell Investments Class Portfolio declines rapidly because ROC represents 67% of the gross annual distribution[2]. At the end of year 30 the ACB is almost exhausted and the investor is facing a capital gain of $750,000 upon liquidation of the Russell Investments Class Portfolio.

In this scenario there are two factors working in the investor's favor from a tax-efficiency perspective:

1. The corporate class structure is designed to minimize and defer taxable distributions.
2. Annual distributions from the Russell Investments Class Portfolio are primarily ROC.

Both factors can reduce the investor's annual tax bill. As a result, the investor receives cumulative annual after-tax distributions of $1,299,263 from the Russell Investments Class Portfolio over the 30-year period. This after-tax amount represents 28% more income than the cumulative annual after-tax distributions the investor would have received had they invested in the **comparison portfolio** and 14% more after-tax income than provided by the trust version of the same fund. How might your retirement plans be different if your annual after-tax cash flow increased by 28%?

With personal tax rates on the rise investors should be exploring opportunities to minimize the amount of tax they pay. Considering corporate class solutions that can enhance the tax-efficiency of the distributions provided by your investment portfolio can assist in creating a financially healthy retirement.

Defer taxes to enhance after-tax returns

- Distributions that include a ROC component can provide an investor with the opportunity to defer taxes, perhaps to a time when the investor's marginal tax rate has declined.
- Corporate class funds that pay regular distributions are designed to provide distributions in the form of ROC and/or capital gains.

Assumptions

While care is taken in preparation of this document, no warranty can be made as to its accuracy or applicability for any particular purpose. The purpose of the illustrations in this document is primarily to show the after-tax benefits of Russell Investments Diversified Monthly Income Class. The rates of return used in the calculations are hypothetical and for illustration purposes only and are not intended to be, nor should be construed to be, an indication as to the past or future return of Russell Investments Diversified Monthly Income Class.

Tax rates are taken from the Canada Revenue Agency website on December 12, 2019. Please note that rates may vary from time to time and such change may not be reflected in this document. The after-tax distribution is calculated using the marginal tax rate at the top marginal bracket for Ontario current to December 12, 2019.

The calculations used in this document make several assumptions*:

The assumed equity dividend yield is 2.5%

The assumed fixed income yield is 3.00%

The assumed equity turnover rate is 40.00%

In calculations pertaining to the trust version of the primary portfolio, the assumed percentage of distributions as capital gains and interest income are estimates based on the historical distributions for Russell Investments Diversified Monthly Income.

In calculations pertaining to the Comparison Portfolio, the assumed percentage of distributions as dividends and interest income are estimates based on the yield assumptions and the allocations of Russell Investments Diversified Monthly Income.

In calculations pertaining to the Russell Investments Class Portfolio, the reinvested annual year-end distribution is assumed to be 50% of the expected return.

All Canadian dividends are assumed to be eligible dividends. All other dividends are assumed to be income.

The monthly distributions may consist of return of capital. The investor's cost base will be decreased by the return of capital distribution which potentially may defer their tax liability.

All distributions are assumed to be paid annually and taxes are applied at year end.

[1] The marginal tax rate is taken from the Canada Revenue Agency website and is current as of December 12, 2019. The top marginal tax rate for Ontario is 53.53%.

[2] In this scenario, we have assumed the annual gross distribution of $50,000 is provided as ROC. In addition, we have assumed the Russell Investments Class Portfolio pays a year-end capital gains dividend. Consequently, the after-tax distribution of $43,309 reflects the gross distribution net of tax payable on the year-end capital gains dividend. Any year-end capital gains distribution will vary annually.

* Based on Russell Investments Strategic Planning capital markets forecasts as of December 31, 2019 (5-year horizon)

For more information on how Russell Investments can help you pursue your investment goals, please ask your advisor or visit us at **russellinvestments.com/ca**

Important Information

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