Mackenzie
TAX & ESTATE PLANNING

Tax Strategies for Mackenzie Capital Class Mutual Funds

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This article will discuss the attributes and advantages of ***Mackenzie Capital Class Mutual Funds.*** *The* ***Mackenzie Capital Class*** *structure is designed to attract a segment of the mutual fund investment market with a preference for long-term investing and tax deferral.*

Various strategies utilizing Mackenzie Capital Class Funds that can reduce individual and corporate client exposure to various types of tax are discussed in this article. In addition, a general overview of Mackenzie Capital Class is provided followed by a discussion of the unique attributes of the Mackenzie Capital Class structure versus competitors.

> *"Whether you are saving for retirement in an RRSP or putting money aside in an open account, Mackenzie Capital Class funds offer investors a great way to reduce and defer their tax exposure."*
>
> Sandy Cardy, CA, CFP
> Senior Vice President, Tax & Estate Planning

Mackenzie Capital Class Tax Planning Strategies

Mackenzie Capital Class Mutual Funds offer a variety of planning solutions to individual and corporate clients.

Individual investors

Investors with a preference for tax deferral

Utilizing capital losses from spouse

Timing of realized gains to enhance tax planning

Net capital losses realized in a given year may be carried back to any of three preceding taxation years or forward indefinitely to offset future taxable capital gains. By investing in Mackenzie Capital Class, an investor can crystallize capital gains to coincide with capital losses or to increase income during low income years.

Utilizing capital losses from spouse

It is possible to transfer accrued capital losses between spouses. As a rule of thumb, if the spouse with the higher marginal tax rate is invested in Mackenzie Capital Class, they can crystallize a capital gain to take the best possible advantage of a tax strategy that utilizes the lower income spouse's accrued capital losses.

Avoiding the OAS clawback

Pensioners with incomes in excess of $63,511 (2007) must begin to repay part of the Old Age Security benefit through the tax system. This repayment is commonly known as the "clawback". OAS is eliminated, or completely "clawed back" when income exceeds $102,865 (2007). Dividends are preferentially taxed due to the dividend tax credit; however, they do result in higher clawback amounts than otherwise would occur with other forms of income. As of the May 2, 2006 Federal Budget, investors must include 145% of the cash amounts of Canadian dividends in income – the 15% clawback rate is applied to this gross amount. Therefore, consider Mackenzie Capital Class Funds as part of a pensioner's non-registered asset mix. Gains are not taxed until the investor redeems from the corporate class struture and at that time, only 50% of those gains need to be included in income.*

Income splitting

One of the most significant opportunities in the attribution rules applies to capital gains and minor children. Unlike income producing assets, capital gains realized on the disposition of property by a minor do not attribute to the transferor. To income split with minor children it is therefore advantageous to invest in assets, such as Mackenzie Capital Class Funds, that have the ability to generate capital gains as opposed to ordinary income-producing assets.

(Note that Capital Class Funds may also pay ordinary dividends.)

Retirement Income Optimization

Registered Retirement Savings Plans (RRSPs) are still the best way to make sure investors can afford the retirement an individual wants. Many Canadians are finding that the potential for tax-deferral provided by Mackenzie Capital Class Funds can provide a good complement to registered retirement income. This is because withdrawals are taxed as capital gains, not as income. A blend of registered and non-registered investing can provide retirees with tax efficient income streams.

* Please see the last page of this brochure for more information on switches within Capital Class.

Retirement Compensation Arrangements

As the pension limits in Canada are essentially low, supplementary employee retirement plans are becoming more common. These top-up pensions offered by some employers cannot be funded on a tax-sheltered basis as tax rules cap the amount of pension that a tax-sheltered Registered Pension Plan can pay. There are no statutory limits on these supplementary plans, offering more flexibility to the employee. The federal government has, however, imposed complex rules to make sure that there is no tax shelter for the supplementary plan's capital or investment earnings. These rules are referred to as Retirement Compensation Arrangements (RCA). In its simplest form, the RCA consists of a trust. The contribution is deductible by the employer on the same basis as if it had been paid as salary. But there is a special 50% tax on the contributions to the RCA and also a 50% tax on the plan's investment earnings (which are refunded when the RCA pays out benefits down the road to the recipient). While the tax on the contributions is unavoidable, the tax on the investment earnings can be reduced by using Mackenzie Capital Class Funds that offer tax-sheltered deferral.

US estate tax

A Canadian resident may have an exposure to US estate tax if they own US situs (or located) assets. Property located within the US includes (but is not limited to):

- US real estate
- Shares in a US corporation whether held in a Canadian account or outside Canada
- Bonds, debt and other debt obligations issued by US corporations

As well, discretionary managed accounts where the individual owns US situs securities will still be subject to US estate tax even though the buy and sell decisions are not made by the individual owner.

Note that even US property held in a Canadian registered plan such as a RRIF or RRSP must be counted towards determining your client's total US situs assets for purposes of US estate tax.

Units of Canadian mutual fund trusts that invest in the US market may be exempt from US estate tax; however, tax experts have had varying opinions on mutual fund trusts. As an alternative to mutual fund trusts, consider holding US funds within Mackenzie Capital Class. Shares of Canadian mutual fund corporations are defined not to be US situs property and accordingly are generally not subject to US estate tax.

Corporate investors

Capital tax

Capital Tax applies to large businesses, including public, private and holding companies with a certain level of taxable capital on their balance sheets. Many companies holding T-Bills and other debt instruments can be subject to provincial and federal capital tax. Investing in Mackenzie Capital Class Funds (such as the low risk Mackenzie Sentinel Canadian Managed Yield Class and Mackenzie Sentinel U.S. Managed Yield Class) can offer capital tax relief. In computing tax, corporations may claim a deduction in respect of eligible investments – an investment in a mutual fund can be deducted in calculating capital tax only to the extent that the investment is represented by shares of a mutual fund corporation and not by units of a mutual fund trust.

The corporate capital dividend account

A private corporation's capital dividend account may be increased by the non-taxable portion of capital gains resulting from the disposition of eligible capital property. Therefore an amount equal to one-half (50%) of all capital gains realized by the corporation on the disposition of Mackenzie Capital Class Funds, if any, is added to the capital dividend account. At any point in time when there is a positive balance in the capital dividend account the corporation may elect to pay a tax-free dividend to shareholders.

The same strategy cannot be used with a mutual fund trust as it is not "eligible capital property" under the Income Tax Act.

Overview of Mackenzie Capital Class Funds

Deferral of tax – switching

In essence, a mutual fund corporation is a family of funds contained within a single taxable corporation. Mackenzie Capital Class is organized so that each mutual fund is a different class of shares and the shares are exchangeable from one class to another on a tax-deferred basis. By utilizing a rollover provision in the Income Tax Act, the share exchange is deemed not to be a disposition for tax purposes and consequently no immediate taxable gain is realized on the switch. For example, an investor can move his money from the Mackenzie Universal US Blue Chip Class fund to the Mackenzie Maxxum Dividend Class fund without incurring an immediate capital gain. In this manner, investors can reallocate asset classes without triggering immediate tax consequences. Accordingly, Mackenzie Capital Class Funds can provide one stop shopping to investors looking for flexibility in changing their asset mix over time.
The tax-deferred conversion provision that underpins these funds is only available with respect to the shares of corporations, not the units of trusts.*

Distributions

At year-end, all mutual funds generally distribute taxable income to investors; however, distributions may be lower under a mutual fund corporation than they would be in a mutual fund trust. Within Mackenzie Capital Class, only one corporate tax return is filed for the entire mutual fund corporation, notwithstanding the fact that there are many different classes of shares. The corporate structure allows capital losses in one fund to offset capital gains in another fund; this may benefit investors by reducing the likelihood of taxable mutual fund distributions to investors.

* Please see the last page of this brochure for more information on switches within Captial Class.

Mackenzie Capital Class Funds

Mackenzie Capital Class Funds have unique innovations that make the corporate structure even more attractive to investors vis a vis other mutual fund corporations. Typically, many mutual fund corporations have two major disadvantages when compared to mutual fund trusts:

- Unlike mutual fund trusts, mutual fund corporations (including Mackenzie Capital Class) are subject to capital tax in some provinces on shareholders' equity and long-term debt (described in more detail below).
- A corporation is a flow-through entity only with respect to capital gains and dividends from Canadian corporations. A mutual fund corporation can avoid paying tax on dividends from Canadian corporations and capital gains by distributing such income to the shareholders. Interest and foreign income earned inside a mutual fund corporation cannot be flowed-out in kind and therefore is first taxable inside that corporation, net of fund expenses, at top corporate tax rates. It may then be distributed to investors after-tax in the form of a taxable Canadian dividend, resulting in double taxation. For this reason, a Canadian or foreign bond or money market fund would ordinarily be offered as a trust rather than a corporation, although the income would not be as tax-efficient in doing so.

Unique attributes of Mackenzie Sentinel Managed Yield Class (Canadian and US) and Mackenzie Sentinel Managed Return Class

To offset the foregoing disadvantages, we have developed two corporate funds that seek to generate returns similar to money market and bond funds but overcome the disadvantages of traditional money market and bond funds with similar risk held within a mutual fund corporation. The inclusion of the Managed Yield and Managed Return funds, designed to provide returns similar to money market and bond funds respectively, enhance the tax effectiveness of Mackenzie Capital Class Mutual Funds. The Mackenzie Sentinel Managed Yield Funds (money market) hold a portfolio of stocks hedged to provide a stable monthly return and minimal price fluctuation. The Mackenzie Sentinel Managed Return Class (bonds) produces a bond-like risk and return pattern derived from selling equities forward at a fixed price. Distributions from these two funds, when required, are paid in the form of capital gains dividends or ordinary dividends from a taxable Canadian corporation, both of which are treated better for tax purposes than highly taxed interest income. The returns on these funds are highly correlated to short-term interest and bond returns; however, the capital gains dividends that they pay are taxed at only half the rate that would apply to interest income and the ordinary dividends are subject to the regular gross-up and dividend tax credits that are available for dividends from other Canadian corporations. The Mackenzie Sentinel Managed Yield funds are also attractive to corporate clients who require a relatively stable unit value and an investment that does not attract federal and provincial capital taxes, as do bonds, t-bills and mutual fund trusts. In a low interest rate environment, the difference between the tax rate on interest income and capital gains produces a smaller relative savings than when interest rates are higher. As interest rates rise, the Managed Yield strategy is proportionately more effective.

Capital gains refund mechanism

As with other mutual funds, Mackenzie Capital Class can reduce its taxable capital gains through the use of the capital gains refund mechanism (CGRM). The CGRM allows some or all of a mutual fund's realized capital gains for the year to be effectively "exempt" from tax.

The CGRM is intended to shelter the portion of capital gains realized by the mutual fund that approximates the gains realized by investors during the year who redeem units or shares. The mutual fund can retain those gains rather than distribute them. This practice has the effect of minimizing the capital gains distributed to shareholders while at the same time reducing (but not eliminating) the likelihood of any corporate tax in Mackenzie Capital Class on capital gains.

One factor that has a positive correlation with the amount of capital gains that can be retained is the proportion of the fund's shares or units redeemed in the year. In general, the higher this number, the lower the capital gains distribution. The CRA are of the view that a shareholder converting shares of one fund into shares of another fund within a mutual fund corporation does not constitute a redemption for purposes of the CGRM. However, within Mackenzie Capital Class both the Managed Yield Fund and the Managed Return Fund work to further enhance the efficiency of the CGRM.

- Corporate fixed income investors have been attracted to these two funds. By its very nature, these funds attract investors for relatively short periods as a place to park un-invested funds and receive a tax-efficient return.* Furthermore, these funds are attractive to institutional investors for short term parking of funds at year end because an investment in a corporation is deductible for capital tax purposes. Mackenzie Capital Class realizes higher redemptions as a result of the increased volume of activity with the Managed Yield Fund. Generally, the higher the redemptions in the year, the higher the CGRM and the more realized gains that can be retained in the corporation. This is of benefit to shareholders because the greater the amount that can be retained in the corporation, the less that needs to be distributed to them for inclusion in their tax return.

* Short-term trading fees may apply to withdrawals of the Managed Return Fund under specific circumstances.

Each Capital Class fund is a class of shares of Mackenzie Financial Capital Corporation ("Capitalcorp"), which is a mutual fund corporation. Unlike mutual fund trusts that calculate their income tax as individual entities, a mutual fund corporation must compute its income for tax purposes as a single entity rather than on a fund specific basis. Therefore, all income, including capital gains, generated by the Capital Class funds is aggregated for tax purposes. The aggregate capital losses are used to offset the aggregate capital gains and, to the extent that results in net capital gains for Capitalcorp, capital gains dividends are paid to investors as described in the simplified prospectuses and annual information forms of the Capital Class funds. Increased capital gains increase the likelihood that capital gains dividends will have to be paid. While switching among Capital Class funds results in no immediate tax consequences to an investor, switching activity may trigger capital gains within Capitalcorp, thus increasing the possibility of a capital gains dividend being declared.

The information provided is general in nature and is intended to highlight various tax planning issues. This information should not be relied upon or construed as legal or tax advice. Readers should consult with their advisors, lawyer and tax professionals for advice before employing any of these strategies.

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