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Corporate Tax Centre - In this article, Vern Krishna discusses the importance for aging investors to take tax into account when making investment decisions by outlining return on equity and tax shelter vehicles.

Tax Erosion of Investment Returns (Vern Krishna)

Date: June 24, 2014

Tax Erosion of Investment Returns (PDF)

By Vern Krishna

Ask any gray haired investor if he or she wants to maximize investment income and they will grin and say “obviously”. Ask the same investors if they take tax into account in making investment decisions, and they will likely look at you with glazed eyes. Investors earning interest income of, say, 3 percent from unsheltered investments are likely earning negative returns. What investors do not know about taxes and costs of investments will cause an aging population a lot of grief. Investors believe all investment dollars are equal. It ain’t so. Investors ignore investing costs and taxes at their peril.

The objective of investing is to maximize net return on equity (ROE) within acceptable risk parameters. Investors must make their decisions within their particular risk tolerance levels, taking into account considerations of age, health, and the need for current income versus long-term growth. However, they must also keep sharp about governments, which will want a slice of any gross investment returns. Ultimately, an investor’s ROE is a function of four factors: gross return on investment, costs of investment, inflation, and taxes.

The gross return on equity has two components: the portion attributable to the stocks sensitivity to general market movements, which is measured by its “beta.” A beta of 1, for example, means that the particular stock will move exactly in relation with the market’s general movements. A beta of less than 1, for example, 0.85, means that it is less volatile than the overall market. The investor has no control over this element other than to choose stocks with a beta that accord with his or her risk tolerance. The second element of a particular stock’s performance reflects the stock picker’s luck or skill, which is the “alpha” component. Ultimately, the gross return on a stock is the sum of its beta and alpha performance.

However, there are costs of investments, such as management fees, and trading fees, which one needs to watch for in evaluating mutual fund or stock returns. Since the beta return is a function of the market and not the stock picker’s decisions, one should not pay substantial management fees to earn the beta return. Passive stock index funds and exchange-traded funds, which simply track the market, no more and no less, typically have low management fees, although the range can vary considerably—anywhere from 0.08 to 1.25 percent. Of course, one must expect to pay management fees in order to earn the alpha return that depends upon the stock manager’s skill.

Inflation is a hidden cost that can substantially drag down stock market returns and erode value over the long run. For example, $1 invested in 1914 would be equal to $21 in 2014, which reflects an average annual rate of inflation of 3.08 percent over the past 100 years. We may think we are making money, but our purchasing power erodes each year and, hence, reduces our real ROE on investments. However, as individuals, we have little control over government macro economic policies that might influence the rate of inflation. Given the propensity of governments to run deficits and accumulate debt, we can reasonably expect that the purchasing power of our dollar will erode in the future, just as it has over the past hundred years. In a very limited sense, we can control our personal inflation by choosing the currency in which we wish to invest, but such decisions are best left to professionals, and there are very few, who understand currency and foreign exchange movements.

When coupled with management fees, trading costs and inflation, taxes also drag down the real ROE. However, since Canadian tax law does not treat all investments equally, we actually have some choices between high, medium, and low tax rates on investments, which must be balanced against risk and return.

The first decision is whether we make our investment in a tax-sheltered vehicle, such as a registered retirement savings plan (RRSP) or a tax-free savings account (TFSA). Although there are differences between these two types of plans, they both allow for deferral of taxes, which can add up to meaningful savings in the long run. For example, $100 of tax deferral in an RRSP over 25 years at a rate of 5 percent, for example, will grow to a tax saving of about $350. Compounding of interest is the single most powerful force of growth in the long run. The second factor is that tax sheltered dividend reinvestment adds impetus to performance. For example, the S&P 500 return from 1970 to the end of 2013 was 1114 percent with dividends reinvested.

Taxes play an even more important role outside of tax sheltered investment vehicles because they have an immediate impact upon ROE. Canadian tax law has separate and distinct rules for each type of investment, which affect their net returns. There are at least four major categories of investments: interest income (bonds), eligible dividends (Canadian public corporation stocks), and capital gains (taxable and exempt).

We tax interest income and foreign dividends at the highest rates. In Ontario, for example, the top marginal rate on interest income is about 50 percent. In contrast, we tax Canadian source dividends at about 34 percent at the top end, and capital gains at 25 percent. There are various policy and structural reasons for these differences, which economists debate at length, but for the average investor the crucial element is the net tax cost of each investment is different and should be taken into consideration in deciding where and in what to invest.

The following table illustrates the effect of taxes on net ROE. Assuming interest on fixed income securities of 3 percent, an annual average gross return, dividends and capital gains, of 7 percent on stocks, fees and costs (hidden, trailing, and explicit) of 0.5 percent on bonds, 2 percent on stocks, and inflation of 3 percent, the approximate net ROE on interest, dividends, and capital gains is as follows:

	Interest	**Dividends**	**Capital gains**
Gross return	3.0	7.0	7.0
Fees and costs	0.5	2.0	2.0
Taxes	1.2	1.7	1.3
Net after taxes	1.3	3.3	3.7
Inflation	3.0	3.0	3.0

	Interest	Dividends	Capital gains
Net ROE	-1.7	0.3	0.7

Although approximate, these are not encouraging numbers. The investor's net return improves as we move from interest income to dividends, and even more so to capital gains. To be sure, investors must make these decisions within their particular investment vehicles, risk tolerance levels, and their desire to balance between income and growth. To a limited extent, we can control investment costs, but only if we know what they are. We must also keep an eye on how much the government will take as its share from the investor's returns. As Mark Twain said: "it isn't what we don't know that gets us in trouble. It's what we do know that just ain't so."

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