Solutions FOR FINANCIAL PLANNING

Understanding investment fees and taxes

Which investment fees qualify as tax deductions?

Working with your advisor to develop an investment portfolio is an important part of creating a life plan that will help you reach your goals. You can choose from a wide range of investment products, including mutual funds, segregated funds and exchange-traded funds (ETFs). And while the objective is to get your money working for you, the reality is that fees will often be involved.

There's a lot of behind-the-scenes expertise involved in the creation and maintenance of financial products and services. The fees you pay can be viewed as an investment in this expertise. Sometimes these fees are worked into the price of the product itself, and sometimes they are charged separately as part of a fee-based program. The good news is that some of those fees could qualify for a tax deduction.

Fees that qualify as a deduction

According to the Income Tax Act,[1] a taxpayer is allowed to deduct fees that are charged for advice on the buying or selling of specific shares or securities, or for the administration or management of securities held by that taxpayer, provided that the fee amounts paid are reasonable. Further, deductible fee-based services must be provided by a person (e.g., an advisor) or entity (e.g., an investment firm) whose principal business is providing buy/sell advice on specific securities or includes the administration or management of securities. Investment fees that meet these criteria can be deducted against any source of taxable income earned during the year.[2]

A taxpayer may also deduct the applicable sales tax: Goods and Services Tax (GST), Harmonized Sales Tax (HST) and Quebec Sales Tax (QST).

What's not deductible?

Some investment-related items can't be claimed as a tax deduction, including:

- Commissions paid on the trading of stocks and ETFs[3]
- Transaction fees to purchase and sell investments
- Fees paid for general financial counselling or planning
- Subscription fees paid for financial magazines and newspapers

Fees in a registered account

Fees associated with registered accounts, such as Tax-Free Savings Accounts (TFSAs) or Registered Retirement Savings Plans (RRSPs), involve different considerations. Advisory and other investment fees charged on registered assets, regardless of the investments held, are not tax deductible.

However, you have the option to pay the investment fees charged on a registered account from the registered account itself or from outside the account. Whether that makes sense depends on the type of registered account.

With a TFSA, where after-tax dollars can grow tax-free, paying fees outside the TFSA can maximize those tax-free savings as they're not directly reduced by the fees.

For RRSPs and Registered Retirement Income Funds (RRIFs), where amounts are taxed when withdrawn, the answer depends on your time horizon, rate of return and tax rate. A fee paid inside the RRSP or RRIF uses pre-tax dollars. While this reduces the value of your tax-deferred investment, it also reduces the amount of tax the Canada Revenue Agency (CRA) will collect on future withdrawals.

Segregated fund contracts

Currently, the CRA does not consider investment fees related to segregated fund contracts as a tax deduction. This rationale is based on the view that a segregated fund contract is an insurance contract and not a share or security held by the investor, a key requirement for fee deductibility.

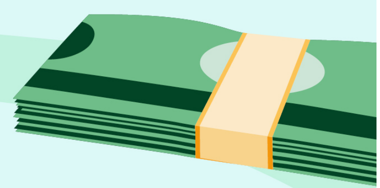
Embedded fees and MERs

Mutual funds and ETFs receive fees that are embedded in the product itself as part of the management expense ratio (MER), which also includes operating expenses and taxes charged to a fund. While these fees don't qualify as a tax deduction, they are deducted by the fund before income is distributed to investors, which reduces the amount of taxable income for the investor.

Comparing MERs and investment management fees

You may be wondering about the different impacts of a tax-deductible fee or an MER on your investments. Here's an example:

- **Stephanie** has **$250,000 invested** in a taxable account.
- She wants to compare the tax benefits of a mutual fund trust that only has an MER (**Series A**) and another that has a combination of an MER and an advisor fee (**Series F**).
- For simplicity, she uses a fixed income mutual fund with a **5% return**, all of which is interest income.
- Series A has a **2% MER**. Series F has a **1% MER and 1% tax-deductible** advisor fee for the same total fee of **2%**.
- Her marginal tax rate is **50%.**



	Series A	Series F
Initial investment	$250,000	$250,000
Interest income	$12,500	$12,500
MER – (2%), (1%)	($5,000)	($2,500)
Distribution	$7,500	$10,000
Advisor fee – (0%), (1%)	—	($2,500)
Taxable distribution	$7,500	$7,500

Tax on distribution	($3,750)	($3,750)
After-tax income	**$3,750**	**$3,750**

When interest income is earned and the total fee is the same, the fee structure (whether the fund has only a MER or has a combination of MER and advisor fee) makes no difference to the investor's after-tax income. This is because you have the same total fees (**$5,000**), reducing the same total taxable income (**$12,500** of interest income).

While an investor's after-tax interest income is the same regardless of the fee type (MER or tax-deductible fee), small differences in their after-tax income may occur when the MER is used to reduce other types of income distributions — namely foreign income, Canadian dividends or capital gains.

Understanding common investment fees

Canadians enjoy access to a wide variety of investment products – and fees are part of the deal. Fees charged by investment firms help to offset costs associated with account administration, investment product management and transactions made on your behalf. Whether you are just getting started or have been making regular contributions to a well-established investment portfolio, here are some of the common fees that you should be aware of.

Management fees

A management fee is paid to a portfolio manager or investment advisor to cover the cost of managing your investments. The fee is based on a set percentage of the portfolio value.

MER (management expense ratio)

The MER is the total of all the operating expenses for a mutual fund or ETF, such as legal, accounting and management expenses. It is expressed as a percentage of the fund's value, and the fund's reported performance is net of the MER.

Trading commissions and broker fees

These are usually paid every time you buy and sell stocks, bonds and ETFs. Charges may vary based on an investment firm's rates. There is typically a basic amount per trade, but charges may differ based on the number of trades and the size of the account.

Fee for service

Fees may be charged by an advisor or investment firm for advice provided regarding the buying or selling of specific shares or securities.

Fees serve an important purpose and can be part of an annual investment discussion. Speak with your advisor for more information.

[1]Canada Revenue Agency, IT238R2 ARCHIVED - Fees paid to investment counsel.

[2] For Quebec tax purposes (for individuals and trusts, not for corporations), the deductibility of the investment counsel fees (as investment expenses under Quebec rules) paid during a year is limited to the total investment income realized during the same year (including interest, taxable capital gains, grossed-up Canadian dividends and gross foreign income). Investment fees that aren't deducted in the current year can be used in the three previous years or carried forward for future years. They're only deductible against investment income.

[3] The commission paid on a security purchase is added to the adjusted cost base (ACB) of the security, while the commission paid on a sale is subtracted from the proceeds received. The result is that a capital gain is reduced by the associated commissions, while capital losses are increased.

Share

Facebook Twitter Linkedin

Home | Current issue | Previous issues | Solutions extras | Solutions videos