



STRATEGIES

Taxation and common investment expenses and fees

TAX-SMART INVESTING®

In a country like Canada, where taxes can be almost 50% of your taxable income, saving taxes should always be a priority.

At AIC, our investment approach incorporates tax planning to minimize your investment tax bill each year. This approach to maximize your after-tax returns is evidenced by our commitment to tax-smart education, a strong corporate philosophy grounded in tax minimization and our tax-smart investment products.

A tax-smart portfolio is a portfolio that focuses on maximizing after-tax investment returns. After all, it's not how much you earn, but how much you keep that matters most.

AIC believes in maximizing after-tax wealth (i.e. your bottom-line cash flow). We are proud of being Canada's tax-smart investment manager and a committed educator of Canadians in matters of investing, tax planning and an integrated tax-smart investment approach.

This brief is one in a series on tax-smart investing. We believe you will find this brief, along with our tax-smart investment products, helpful in maximizing the value of your taxable investment portfolio.

® Tax-Smart Investing is a registered trademark of Kurt Rosentreter, licensed to AIC Limited.

Investment expenses

Investors incur various expenses in the course of their investment activities. Some of these costs relate to the purchase and sale of investments, while others are for maintenance and administration. The treatment of these costs for Canadian tax purposes is important in assessing net investment returns after expenses and after taxes.

Interest

Basic rules

It is not uncommon for investors to use debt, whether a line of credit, a margin account or a bank loan, to help fund their purchases of investments. The primary condition necessary for interest deductibility as it relates to investments is that the borrowed money must be used to earn income from property. It's not necessary that the property or investment in question actually generate income, but merely that there is a reasonable expectation that income can be earned.

Income from property includes interest, rent, royalties or dividends, but not capital gains. Therefore, the potential for capital gains is insufficient to support a claim for interest deductibility. However, common shares and equity mutual funds, which commonly produce capital gains, have the potential to pay any amount of dividends, and therefore, according to Canada Customs and Revenue Agency¹ (CCRA), the interest expense on money borrowed to invest in common shares and equity mutual funds is generally fully deductible.

If borrowed money relates to purchases of fixed income investments, such as GICs, bonds or T-bills, the related interest expense can only be deductible to the extent of the interest earned. For preferred shares, which often carry a fixed dividend yield, an interest deduction may be claimed even when the dividend yield is less than the interest rate charged on the related borrowed funds. However, the interest deduction is limited to the dividend income earned in the year and, in the case of preferred shares of Canadian corporations, to the extent of the grossed up dividend (i.e. the taxable amount of the dividends).

Interest on personal borrowings, such as home purchase loans or credit card debt, is not deductible. Interest on loans relating to registered accounts, such as RRSPs, or interest on loans to acquire life insurance policies (other than taxable annuities and segregated funds) is not deductible.

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AND PROSPER.**





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Use of borrowed money

How is the use of the borrowed money determined for purposes of assessing the deductibility of the related interest expense? There are two things to look at — the current use and the direct use. If both point to an eligible use (to earn income from property), the interest expense is deductible.

In determining the current use, the onus is on the investor to trace the borrowed money, perhaps through a series of transactions, to a related asset or assets that are currently owned. Even where the original investment purchased with borrowed money represents an eligible use, if that investment is sold and the proceeds are used for an ineligible use, the interest expense ceases to be deductible. This may occur when proceeds from the sale of an investment are used for a down payment on a home, or when an eligible use investment is transferred or contributed to an RRSP.

The tracing becomes trickier when only a portion of the sale proceeds from the original investment are reinvested in an eligible use asset. In this case, only a portion of the interest expense continues to be deductible. For example, assume \$35,000 in borrowed money is used to purchase \$35,000 of equity mutual fund units. The units are later redeemed for \$60,000. If the original \$35,000 loan remains unpaid and \$40,000 of the sale proceeds is reinvested in another mutual fund and \$20,000 used for personal purposes, only two-thirds of the interest expense continues to be deductible — the ratio of the cost of the current eligible use investment (\$40,000) to the total proceeds received from the sale of the original investment (\$60,000).

To the extent that eligible investment assets generate income (dividends, interest), that income can be used for personal spending without jeopardizing the deductibility of any related interest expense. But if the income is reinvested in additional shares or mutual fund units, the tracing of any related borrowed money becomes more complicated because there is no distinction between identical shares or units that relate to the borrowed money and those that arose from reinvested income. As a result, individuals who borrow money for investments, subject to systematic withdrawal plans, may have some difficulty in determining the right amount of interest expense that is deductible for tax purposes.

There may be situations where an individual, who currently has a home mortgage, decides to invest excess cash instead of using it to pay down the

mortgage (particularly if the mortgage rate is lower relative to the expected investment returns). This investor cannot argue that the mortgage loan is now being used for investment purposes because it is the direct use of the borrowed money that is relevant in determining the deductibility of the related interest expense.

Loss of income source or investment

There are situations where borrowed money ceases to be used for a valid income earning purpose because the income source disappears or is severely eroded. This may happen when an investment declines significantly in value, becomes valueless or is sold at a loss. In these situations, an investor suffers an economic loss from the investment's decrease in value. For the investor, it would be an unfairly added burden if the deductibility of the interest expense were denied in these circumstances.

To provide relief in these circumstances, tax rules permit the continued deductibility of interest expenses when an actual loss is realized on investments and the sale proceeds are insufficient to repay the money borrowed for the investment.

Commissions and load fees

Commissions paid for the purchase or sale of securities are not deductible expenses for tax purposes. Instead, purchase commissions form part of the adjusted cost base (i.e. purchase price) of the investment and sales commissions reduce the proceeds on sale. As a result, these costs are taken into account in computing the capital gain or loss on the ultimate sale of the related securities and the related tax benefit of these commissions is therefore limited to one-half of the expense — the capital gains income inclusion rate. Mutual fund load fees (i.e. front end or deferred sales charges) are treated like purchase and sale commissions for tax purposes.

Management, administration and investment counselling fees

Fees paid for investment advice, management and administration of investment assets (other than commissions) are only deductible for tax purposes if paid to a professional investment counsellor or manager. An investment counsellor or manager is an individual, corporation or trust whose primary business is providing advice on buying and selling securities or management and administration of securities (including custodial services, collection and remittance of income, maintaining records and



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purchase and sale of securities on behalf of the investor). In other words, if you pay a spouse or child to manage your investment portfolio, the fees you pay are likely not deductible. The fact that investment counselling or management fees may be computed with reference to the fair market value of the portfolio under management is acceptable from a tax point of view. However, the portion of such fees that reasonably relates to the actual costs of purchase and sale of securities is not deductible. Rather, these costs have to be identified and treated as commissions described above.

Investment counselling fees and management fees paid in relation to securities held in registered accounts are specifically not deductible for tax purposes. In addition, fees paid for general financial counselling or retirement planning are considered personal expenses and are, therefore, not deductible.

Mutual fund MER fees

The management expense ratio (MER) charged directly to a mutual fund, represents a combination of custodial, management, administration and accounting fees. There are a number of mutual fund products that now give investors the option of paying these fees personally, instead of charging them to the fund. For example, wrap account fees are generally paid personally. In both cases, the fees are effectively deductible to the investor.

An MER reduces the investment income distributed and reported to the unitholder. For example, a fund with a gross annual return of 10% and a MER of 2% reports an 8% return for tax purposes. When fees are paid outside the fund, the investor claims the management fee as a separate expense item. The trust reports a 10% return to the investor, which would be included in income, however the investor deducts, as a carrying charge, the 2% fee paid. The net result is an 8% income inclusion.

In years when the management fee exceeds the investment return, mutual fund investors do not get the full tax benefit of the management fee. This is because mutual funds cannot allocate losses to investors. Instead, these losses stay in the mutual fund and can be used to reduce income of the mutual fund in the following year. Although investors who pay

such fees personally get the full tax benefit of the management expenses even in loss years, this difference is merely one of timing (i.e. the deduction).

Tax return preparation fees

Reasonable fees for preparation of income tax returns may be deductible to the extent they relate to accounting and reporting various investment activities on the tax return. Where the investor is also a business owner, the tax return preparation fees are generally deducted in computing net business income, which is reported for tax purposes. Payments are also deductible against any source of income as “other deductions” for amounts paid for advice and assistance relating to an appeal of an assessment/reassessment with respect to income tax, interest or penalties.

Expenses that are not deductible

Assuming that an individual’s investment activities do not constitute a business, the following related expenses would not be deductible for tax purposes:

- The cost of investment journals, Internet subscriptions and other publications relating to investment and financial planning;
- The cost of a computer and software used for accounting, investment analysis or financial planning; and
- Home office costs relating to investment activities.

Next steps

AIC continues to help Canadians understand tax issues related to mutual funds. Contact your financial advisor for more information on taxation and mutual fund issues that concern you.

This brief is adapted from Kurt Rosentreter’s book, “50 Tax-Smart Investing Strategies,” published by Stoddart Publishing. Mr. Rosentreter is Vice President, National Advisor Services at AIC Limited.

Canadian provinces and territories impose their own tax rates in addition to the federal tax rates. Therefore, depending on where an investor lives, that individual’s tax rate may differ from any examples shown. The content of this article is for informational purposes only and in no way should be construed as tax advice. Please consult a professional tax advisor for tax advice related to your specific situation.

¹ Formerly called Revenue Canada.



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AIC's STRATEGY FOR SUCCESS

BUY.

A proven philosophy of investment underscores our approach to mutual funds at AIC. Simply put, we buy into excellent companies (the best of the best) in strong growth industries and hold these investments for the long run. The net outcome is a better rate of return for our clients.

HOLD.

Stand for nothing and you will fall for everything. The truth is, bears, bulls and other unpredictable market influences eventually disappoint short-term investors who focus on share prices rather than a company's true worth. At AIC, we remain faithful to the quality businesses we invest in, with superior results.

AND PROSPER.

Prosperity to us means meeting the three objectives of investing. It means preserving your principal over the long term. It means growing your money at a good rate. And it means protecting your investment from the ravages of taxes. It's really quite simple. And the results over the long term are something to behold. Of course, what you do with your prosperity in the end is up to you.



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