ARE YOUR INVESTMENT FEES TAX DEDUCTIBLE?

Over the years, Simon and Judy Smith had saved and built what was becoming a significant portfolio of investments. Partly built upon their own savings and later bolstered by money inherited from their parents, they had $85,000 in each of their RRIFs, $25,000 in their Tax-Free Savings Accounts (TFSAs) and a joint open investment account with $110,000. A recent newspaper article had suggested that they may be able to deduct some of their investment fees on their tax returns.

They knew that they pay fees for investment advice and for management services but it seemed that there are several qualifications that first must be considered to determine exactly which kinds of fees can be deducted. They wondered which fees might be deducted as carrying charges on line 221 of their tax returns.

Checking with their financial planner, they learned that to be deductible fees must:

- have been paid for advice connected to the buying and selling of a specific investment.
- cover the cost of administering or managing an investment owned by the taxpayer.
- not be a commission
- relate to investments made on investments held in a non-registered, or open, account.
- not relate to investments held within an RRSP, RRIF RESP and TFSA account.

Based on this information, they would only be able to deduct fees on the joint open account investments. But there was another consideration. Some of their investment fees were paid directly and others indirectly. In the case of their wrap account the investment fees were charged directly from their holdings. These fee charges appeared clearly on their quarterly statements. As a result they could simply report their gross investment income from their wrap portfolio and deduct the investment management fees separately as a carrying charge.

However, in the case of their mutual funds, fees were embedded in the fund's management expense ratio (MER) and so were paid indirectly. Their mutual fund MERs are not disclosed separately on statements, income tax slips or returns. Unlike rap accounts or separately managed accounts, mutual funds deduct the fees first and then report investment income (distributions) and asset values net of fees.

Ultimately it wouldn't matter whether fees are paid directly or indirectly, the net result is the same. Here's an example:

	Indirect	*Direct*
Initial investment	100,000	100,000
Realized income	10,000	10,000
Less: MER @ 2.3%	(2,530)	–
Net Asset Value (NAV)	107,470	110,000
Distribution	(7,470)*	(10,000)
Remaining investment	100,000	100,000
Income	7,470	10,000
Management fee @ 2.3%	—	(2,530)
Net income before tax	7,470	7,470
Personal tax @ 28.2%	(2,107)	(2,107)
Net income after tax	5,363	5,363

** Mutual funds generally distribute all income annually to avoid paying tax at the fund level.*

In both cases, assuming the same management fee, the investor ends up with their original investment of $100,000 plus net income of $5,363.

> *The definition of investment fees does not include financial planning services, though if they relate in part to a sole proprietorship or a rental property, a portion may be.*

Whatever the case, the fees that are deducted should appear reasonable to the CRA. In many cases, investment fees are based on a reasonable percentage of the fair market value of the portfolio, and these are generally considered reasonable. It should also appear reasonable to you. The amount of time spent and work done by the investment professional for advice and service should also be considered.

While the deduction of mutual fund sales commissions are specifically disallowed, it is worth noting that commission payments on a non-registered investment will increase the adjusted cost base (ACB) at purchase which will, in turn, reduce the taxable amount of the proceeds at time of sale. In this way, they work to reduce the capital gain (or increase the capital loss) on an investment. This reduces the tax payable or enhances a loss carry-forward. Remember, capital gains are currently only 50% taxable, so commissions might be thought of as being 50% tax deductible. You can't claim them as a carrying charge, but not all the benefit is lost. Of course, in order to take advantage of this, investors must remember to adjust their gain or loss for any commissions paid.

All investment fees are subject to GST/HST. Naturally these amounts are not deductible. For wrap and separately managed accounts the rate is based on the account owner's province of residence. Mutual funds base the rate upon the proportion of the fund's investors resident in each province.

Alas, said their planner, the definition of investment fees does not include financial planning services, though if they relate in part to a sole proprietorship or a rental property, a portion may be. In their case, the portion of their investment fees that applies to his financial planning advice would not be deductible. When there is an all-in fee , it may be quite difficult to distinguish which potion of the fee might be deductible. CRA has not provided any helpful guidance on this point, so investors are left to their own discretion to determine what is reasonable. In most cases it is prudent to ask your tax preparer what the best practice is.

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