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Beware the HST grab

by Gordon Pape
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Canadian investors are about to be socked with a new tax that will cost them hundreds of millions of dollars each year. What we don't know at this point is exactly who will end up paying it.

The tax grab arises from Ontario's plan to combine its provincial sales tax with the federal GST to create a harmonized sales tax (HST). The move was announced in the March provincial budget and is scheduled to take effect one year from now, on July 1, 2010. One of the results will be a big increase in the tax on mutual fund fees.

Three Atlantic provinces (New Brunswick, Nova Scotia, Newfoundland and Labrador) moved to an HST several years ago but this issue did not arise at that time because no major fund companies are based there. Ontario is an entirely different story. Although its HST will theoretically apply only in Ontario, it could end up hitting investors across Canada unless some kind of allocation system can be worked out.

Most people don't realize it, but Ottawa already takes a small piece of their returns from mutual funds. That's because the 5 per cent GST is applied to certain financial services, including mutual fund management fees. As a result, investors currently pay an additional 0.1 per cent on a 2 per cent management charge.

This has resulted in a tax bonanza for the federal government. The size of the mutual fund industry has increased 20 times since the GST was first introduced. According to estimates prepared by the Investment Funds Institute of Canada (IFIC) the industry now has about \$632.7-billion in assets under management (including IFIC members and non-member companies such as CI Funds). Using an average MER of 1.9 per cent (not including GST), this means about \$12-billion is subject to the tax which works out to about \$600-million a year for Ottawa's coffers. And this does not include revenue derived from exchange-traded funds (ETFs), segregated funds (insurance companies), and pension plan funds.

(It's worth remembering that the GST is collected even if your fund loses money. You may be out of pocket but the government never is!)

Currently, mutual fund fees are not subject to provincial sales tax. But if the Ontario HST goes through as planned, the combined rate would be 13 per cent which would increase the tax on a 2 per cent management fee to 0.26 per cent. IFIC estimates this would add almost \$385 million to the taxes paid by Ontario investors.

The average management expense ratio (MER) on Canadian mutual funds is already one of the highest in the world. Such an increase would increase the costs significantly and would come directly out of investors' pockets in the form of reduced returns.

To complicate matters, residents of other provinces also risk being hit by the increase even though it theoretically applies only in Ontario. That's because the majority of mutual fund trusts (60 per cent to 70 per cent, IFIC says)

are based in that province. Unless some way is found to apply different tax standards to funds held outside the province, this raises the possibility that a Calgary resident buying an Ontario-based fund would be hit with a 13 per cent tax on the management fee even though Alberta has no provincial sales tax.

This situation would also create a tax advantage for fund groups that are based outside Ontario, such as Investors Group, which is headquartered in Winnipeg, and Mawer Investments of Calgary. Unless there is a policy change, an Ontario resident could open an account directly with those companies and avoid the 8 per cent portion of the HST (but not the 5 per cent GST).

"The federal government should be concerned that people outside Ontario are not subject to a harmonized tax," says Barbara Amsden, director of research and strategy for IFIC. She met with officials of the federal Finance Department in Ottawa on June 29 to discuss the issue but said afterwards they "did not seem impressed" with the request for some kind of relief. Instead, they seemed to be more focused on finding some kind of "allocation formula" that would offer relief to residents of other provinces.

That could be a nightmare for the fund industry. The assets of mutual funds are pooled on a national basis, not held in separate chunks based on province of residence. So trying to apply a tax selectively is almost impossible. Conceivably, this could lead to the creation of separate classes of funds for each province to reflect the appropriate tax rates, a prospect no one wants to think about because of the confusion and fragmentation that would result.

The logical solution would be to exempt fund management fees and similar financial charges from the GST/HST. But doing so would cost cash-strapped governments hundreds of millions of dollars. Ottawa certainly won't give up the \$600 million it now receives. Ontario, which is also under the gun financially, would dearly love to grab a piece of that pie so their Finance Department mandarins are equally unlikely to be receptive to pleas for an exemption.

Since neither level of government is likely to give ground, Ontario residents should be prepared to pay a larger portion of their fund returns to the tax man. The question is whether people living in other provinces are going to get caught in the net as well.

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