

THE 2004 QUEBEC BUDGET AND INTEREST DEDUCTIBILITY: SOME EXAMPLES

Due to the significant change to interest deductibility made by the province of Quebec in its 2004 budget, we thought it would be good to provide some examples of how the new rules work.

Some advisors may now be thinking of moving away from owning mutual funds with a buy-and-hold approach since these funds do not pay out distributions as often as other funds might. This concern is not a valid one. In fact, mutual funds that make taxable distributions will often leave the investor worse off, even after the tax rule changes. We have prepared examples below to show why.

THE NEW RULES

The new rules will now limit investment expenses, including interest deductions, to the amount of investment income (which includes the taxable portion, or one half, of capital gains) each year. If the investment expenses exceed the investment income, the excess expenses can be carried back up to three years, or carried forward indefinitely, to apply against investment income in those other years.

Marie's Example:

Marie borrowed \$100,000 to invest in mutual funds this year. She incurred expenses totalling \$7,000 this year. This includes \$5,000 of interest costs on the loan, plus \$2,000 in investment management fees. Marie's mutual funds grew in value this year by \$7,000, but those mutual funds did not make any distributions to Marie. Marie has no other investment income.

Marie will not be able to deduct any of the investment expenses this year since she had no investment income. Instead, those expenses can be carried back up to three years to offset investment income she might have reported in a prior year, or can be carried forward indefinitely to use in the future as she realizes investment income.

Impact on Marie's taxable income this year: No net impact. She has no income, and no deductions.

Jean's Example:

Jean borrowed \$100,000 to invest in mutual funds this year. He incurred expenses totalling \$7,000 this year. This includes \$5,000 of interest costs on the loan, plus \$2,000 in investment management fees. Jean's mutual funds made distributions to him as follows: \$2,000 of interest income, plus \$4,000 of realized capital gains. Jean has no other investment income.

Jean will have to report \$2,000 of interest income on his tax return, plus a \$2,000 taxable capital gain (50% of the \$4,000 actual capital gain), for a total of \$4,000 of investment income. Therefore, Jean will be able to deduct \$4,000 of his investment expenses. This will leave \$3,000 of investment expenses (\$7,000 less \$4,000) to be carried over to other years to offset investment income in those years.

Impact on Jean's taxable income this year: No net impact. He reports \$4,000 of investment income, and claims \$4,000 of investment expenses.

BUY-AND-HOLD VS. FUNDS MAKING DISTRIBUTIONS

Some may argue that it now makes sense to invest in mutual funds that provide distributions each year, as in Jean's example above. The argument is that taxable distributions will make it possible to use up those investment expenses.

There is no advantage to owning funds that make distributions. Consider the example of Eric and Sylvie. Each borrows \$100,000 to invest. Each incurs \$7,000 annually in investment expenses (interest and other costs). Eric invests in a buy-and-hold mutual fund that grows by 7% annually, but makes no distributions annually. Sylvie invests in a mutual fund that also earns 7% annually, but the full 7% is distributed as realized capital gains each year. Sylvie reinvests the 7% return each year in the same fund. Both Eric and Sylvie sell their units at the end of Year 10.

You will notice that Eric is not able to deduct any of his investment expenses annually since he has no investment income annually. Sylvie reports a 7% capital gain annually. Just 50% of that capital gain is taxable, so she reports an additional \$3,500 in her taxable income in Year 1. Sylvie is able to claim \$3,500 of investment expenses in Year 1 since she has \$3,500 of taxable investment income. Assume that Eric and Sylvie have no other investment income.

	Eric	Sylvie
Investment income – Year 1	\$0	\$7,000
Taxable investment income – Year 1	\$0	\$3,500
Investment expenses claimed – Year 1	\$0	\$3,500
Impact on taxable income	\$0	\$0
Value at end of Year 1	\$107,000	\$107,000
Adjusted cost base end of Year 1	\$100,000	\$107,000
Unclaimed investment expenses	\$7,000	\$3,500
Investment income – Year 2	\$0	\$7,490
Taxable investment income – Year 2	\$0	\$3,745
Investment expenses claimed – Year 2	\$0	\$3,745
Impact on taxable income	\$0	\$0
Value at end of Year 2	\$114,490	\$114,490
Adjusted cost base end of Year 2	\$100,000	\$114,490
Unclaimed investment expenses	\$14,000	\$6,755
Investment income – Year 10	\$0	\$12,870
Taxable investment income – Year 10	\$0	\$6,435
Investment expenses claimed – Year 10	\$0	\$6,435
Impact on taxable income	\$0	\$0
Value at end of Year 10	\$196,715	\$196,715
Adjusted cost base end of Year 10	\$100,000	\$196,715
Unclaimed investment expenses	\$70,000	\$21,643

Sale of units at end of Year 10:

Proceeds of disposition	\$196,715	\$196,715
Adjusted cost base	\$100,000	\$196,715
Capital gain	\$ 96,715	\$0
Taxable capital gain (@ 50%)	\$48,357	\$0
Less: investment expenses	\$48,357	\$0
Impact on taxable income	\$0	\$0
Unclaimed investment expenses	\$21,643	\$21,643

Conclusion:

At the end of the Year 10, both Eric and Sylvie are left in exactly the same position: Both have reported the same taxable income in each year (nil), and both have the same unclaimed investment expenses at the end of Year 10. There was no advantage to owning a mutual fund that makes a taxable distribution annually.

Likewise, there would have been no advantage to either Eric or Sylvie if either had sold some of their units and reinvested the proceeds throughout the period of ownership. This would have triggered a capital gain, and some of the investment expenses would have been used to offset the taxable capital gains, but at the end of the ten year period, the results would have been the same had they simply held onto those units.

In fact, there will be a disadvantage to owning a mutual fund that makes a distribution annually, or voluntarily triggering capital gains by selling units, where:

- The investment income reported in the year exceeds the investment expenses annually. In this case, there could be net taxable income to report annually where distributions are made annually, or where capital gains are triggered by selling units. Deferring the distributions through a mutual fund with low turnover, and holding onto units owned, will defer the ultimate tax liability on that investment income.
- The investor may be subject to clawback of government benefits, such as Old Age Security benefits. If an investor changes his or her focus to owning mutual funds that make taxable distributions annually, or voluntarily triggers capital gains each year in order to offset investment expenses for Quebec tax purposes, this taxable income could reduce OAS and other government benefits that are based on federal net income.
- The federal government has different rules than Quebec on interest deductibility. Choosing mutual funds with greater distributions, or voluntarily triggering capital gains annually to create investment income for Quebec purposes will only serve to increase taxable income federally. This could result in a larger tax liability federally, even though no additional tax may be owing in Quebec due to the claiming of investment expenses.

The information provided in this memo is current as of April 6, 2004, and may be subject to change as federal or provincial tax laws change. If you have any further questions about the changes to the interest deductibility rules in Quebec, or the information presented here, please contact the AIC Tax and Estate Planning Team at taxsmart@aic.com, or 1-866-TAX-SMRT.