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What HST means for your portfolio

Options for reducing the effect of HST on your investment funds

Effective Thursday, Ontario and British Columbia implemented single harmonized sales taxes (HST), combining the federal goods and services tax (GST) of 5% with their provincial sales taxes (PST). Respectively their HST rates are 13% and 12%.

Previously, only GST applied to the management fees and operating expenses associated with investment funds. Professionally managed investment portfolios are now subject to HST - including mutual funds, hedge funds, segregated funds, wrap products, charitable trusts, and exchange-traded funds.

HST implementation rules required a calculation, not based on the location of the fund manager, but rather on the location of the investor and the value of the investments. That created an administrative headache because some provinces already have HST of varying percentages, while some have only GST. Therefore many mutual fund companies developed blended rates.

Blended rates mean that, instead of affecting investors only from BC and Ontario, mutual fund investors in other provinces are also subject to increased MERs. BC and Ontario investors pay less while investors in non-HST provinces help shoulder the tax burden.

For example, with GST only, a hypothetical MER consisting of a management fee of 2.00% and operating expenses of 0.20% has a tax component of 0.11% for a total MER of 2.31%. Using the same fee and operating expenses with a blended tax of 11%, the taxation component is 0.24% generating a final MER of 2.44%.

The effect of a 0.13% increase is not insignificant. Compounded over the long term, increased MERs have a significant impact on retirement savings.

Suppose you have $500,000 inside an RRSP account for 25 years, returning 7% annually. Assuming a modest 2% rate of inflation and a MER of 2.30%, you will be left with a 2.70% return providing a compounded $973,264.97 gain. If the MER was 2.43% you would have a 2.57% return or a $942,928.78 gain. The additional 0.13% in the MER drains $30,336.19 from your retirement savings.

Investors will want to reduce the effect of HST on their portfolios and they have a few options. They can shift from money market mutual funds into GICs or high-interest savings accounts. The primary advantage is that these short-term vehicles do not have management fees. Another is that the absence of fees means they are also tax exempt.

Investors should examine their fee set-up. While fee-based accounts are subject to the new tax structure, commission-based accounts are not. Investors may therefore choose to purchase individual securities in commission-based accounts.

Exchange-traded funds are also worth consideration. Investors can switch out of their underperforming mutual funds and into lower fee ETFs, ultimately reducing the HST paid. ETFs offer significantly lower management fees than mutual funds and therefore, although the taxes on ETFs will rise, the lower fees will limit their impact.

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