

# When taxes devour hard-earned (though small) returns

**It's tax time, and it's also a time of disillusionment for many investors who are required to include their hard-earned mutual fund income on their tax returns. Not only is it already a feat to have actually earned this money, it's just as frustrating to realize how much of it may be taxed.**

By Jean-Philippe Décarie

**T**oo few investors appreciate the tax implications of returns generated by their mutual funds...when they actually generate returns, that is.

And this lack of awareness is no stranger to the fact that mutual fund companies don't account for the impact of taxes when publishing their funds' annual returns.

This of course pertains to investments held outside of RRSPs, as the Taxman has no claim to returns earned within a registered retirement plan.

More than 50% of mutual fund investments are held in non-registered plans and are therefore subject to annual tax bills.

AIC, well known for its flagship AIC Advantage Fund, believes that Canadian mutual fund firms should always publish after-tax returns, as U.S. companies have been required to do since April of 2001.

## Supported by research

To illustrate the true spread that exists between the posted returns and those obtained after tax, AIC financed a study for a research group from Toronto's Fields Institute.

Entitled "*The Impact of Personal Income Taxes on Returns and Rankings of Canadian Equity Mutual Funds*," this study shows that the ranking of funds based on after-tax returns are quite

different from pre-tax rankings.

The researchers studied 10 years of returns produced by 343 Canadian equity and balanced funds. It turns out that 50% of the funds were ranked differently once their after-tax returns were calculated.

The least tax-efficient fund fell back no less than 185 places from its pre-tax ranking.

AIC points out that its AIC Advantage Fund was ranked number 4 out of 343 funds based on its average pre-tax rate of return of 18.53% over 10 years.

Factoring in tax implications, AIC Advantage Fund advanced to second place with an after-tax return of 15.93%.

## Three examples to show the impact of taxes

**To fully understand how tax treatment affects returns according to the type of income generated by three different fund categories, we are illustrating three examples used in a study published in the *Canadian Tax Journal*.**

This example has the advantage of being simple, clear and able to summarize the issue in a nutshell.

Let's assume that Eric has \$100,000 to invest over 20 years and has three mutual funds to choose from.

Each fund offers a pre-tax return of 10%. Eric's marginal tax rate is 46.4% and he plans to liquidate his investment after the 20-year period.

Fund A generates 100% interest income; Fund B, 50% interest and 50% deferred capital gains; Fund C, 100% deferred capital gains.

The chart entitled "Mutual fund tax efficiency" shows how much money Eric would have at the end of 20 years. As you can see, although each fund

posted the same pre-tax rate of return of 10%, the after-tax return is significantly different depending on which type of income the fund earned annually.

Fund A lost 4.64% of its annual compound return to taxes, Fund B lost 2.98% and Fund C, 1.2%.

Research on after-tax returns indicates that on average, investors in the highest marginal tax bracket lost 1.35% each year to taxes on their Canadian equity or balanced mutual fund investments 1991 to 2001.

Mutual Fund tax efficiency		\$100,000 after 20 years		
Portfolio Composition	Pre-tax return	Balance before tax	Balance after tax	After-tax return
<b>Fund A:</b>				
100% Interest	10%	\$284,129	\$284,129	5.36%
<b>Fund B:</b>				
50% Interest and 50% Deferred Gains	10%	\$439,239	\$388,000	7.02%
<b>Fund C:</b>				
100% Deferred Gains	10%	\$672,750	\$539,872	8.80%

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