Wealth Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Tax-efficient asset location

A strategy to help enhance your after-tax return on investments

When creating your investment plan, you've likely given consideration to your asset allocation. Asset allocation involves finding the right balance of different types of investments such as fixed-income, equities and cash or cash equivalents that would be appropriate for you, given your goals and risk tolerance. But when reviewing your overall investment portfolio, have you considered asset location? Asset location is how assets are distributed between all of your accounts, such as non-registered, registered and in some cases, corporate accounts. Asset location is important because investment returns are taxed differently, depending on what type of income you generate and where you earn it. So paying attention to the type of income each investment generates, as well as which account you hold each investment in, may have a significant effect on your after-tax return.

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Paying attention to how investment income is taxed

The type of investment income you generate, whether it's interest income, Canadian dividend income, capital gains or foreign income (for example, dividends from foreign corporations), matters when it comes to your taxes. Interest income and foreign income are generally taxed at the same rate as employment income, at your marginal tax rate. Canadian dividend income is virtually always more tax-efficient than interest income because you are entitled to a dividend tax credit that reduces your taxes payable. Capital gains are also very tax-efficient since only half of the capital gain is taxable.

Holding the right investments in the right accounts

It is important to determine not only the types of investments that meet your needs, but also where to hold these investments. This is because each of your accounts, such as your Registered Retirement Savings Plan (RRSP), Tax-Free Savings Account (TFSA) and your non-registered account, are subject to different tax rules. You may be able to reduce the overall taxes on your investments just by holding your investments in the appropriate accounts.

Here are some rules of thumb to keep in mind when considering which account is right for various investment types. The investments discussed here are categorized based on the typical types of income they generate. For example, fixed-income investments mainly generate interest income while dividend-paying stocks generally produce dividend income and capital gains when sold. There are many other types of investments (e.g. mutual funds, ETFs and REITs) but since they can produce a variety of income types including interest, dividends, capital gains and return of capital, you may need to analyze these types of investments on an individual basis. For example, a particular mutual fund may be more likely to generate interest income because that specific fund mainly invests in bonds.

Also, keep in mind that finding the optimum asset allocation across accounts is a complex task, and in some cases, the suggestions below may not be applicable to your situation. Further, in addition to the type of income generated by the investment, you will want to consider your investment time horizon, account contribution limits, personal tax rates and expected return and yields. For example, where you would typically avoid holding a foreign paying dividend stock in your TFSA to avoid the non-recoverable foreign withholding taxes, you might consider holding it in your TFSA if you expect that security to quadruple in value in order to pay no tax on a large capital gain.

Note that the following asset location considerations are for Canadian residents who are not U.S. persons (including U.S. citizens, residents or green-card holders).

Account	Key takeaways	Consider holding	Generally avoid
RRSPs/ RRIFs/ Locked-in Plans	Income earned and capital gains realized in these accounts are tax-deferred, which means that the income is not taxed while it is earned in the account. As such, the income and growth can compound on a tax-deferred basis until you eventually withdraw the funds. When you withdraw the funds, you pay tax on the withdrawal at your marginal tax rate. Under the Canada-U.S. tax treaty, there is a special exemption from U.S. withholding tax on interest and dividend income that you earn from U.S. investments in these accounts.	**Canadian and U.S. interest** – bonds, GICs, T-bills, etc. that pay interest income (fully taxable outside of a registered account). The U.S. generally does not withhold tax on interest payments made to Canadian residents. **U.S. dividends** – U.S. dividends are exempt from U.S. withholding tax under the Canada-U.S. tax treaty. U.S. dividends are fully taxed like interest income when held outside of a registered account.	**Foreign (non-U.S.) interest** – there may be withholding tax on interest income received from countries other than the U.S. This tax can't be recovered through a foreign tax credit. **Canadian dividends** – you can't claim the Canadian dividend tax credit if the dividend is earned within these accounts. As such, preferential tax treatment on the dividend will be lost. **Foreign (non-U.S.) dividends** – there may be withholding tax on dividends, which can't be recovered through a foreign tax credit. **Capital gains** – the preferential tax treatment of capital gains is lost inside these accounts. The entire value is fully taxable when withdrawn. Also, you can't claim a capital loss to offset capital gains if securities held in the account decline in value. Nor do you recover RRSP contribution room.
TFSAs	Income earned and capital gains realized within these accounts are not taxed, even when you withdraw the funds.	**Canadian and U.S. interest** – bonds, GICs, T-bills, etc. that pay interest income (fully taxable outside of a registered account). The U.S. generally does not withhold tax on interest payments made to Canadian residents. **Canadian dividends** – even though you can't claim the Canadian dividend tax credit if the dividend is earned within a TFSA, you will be paying no tax on the dividend. **Capital gains** – there will be no tax on any capital gain realized in your TFSA.	**U.S. and foreign dividends** – there may be withholding tax on dividends, which can't be recovered through a foreign tax credit. **Foreign (non-U.S.) interest** – there may be withholding tax on interest income received from countries other than the U.S. This tax can't be recovered through a foreign tax credit. **Capital losses** – you can't claim a capital loss to offset capital gains if securities held in your TFSA decline in value. Nor do you recover TFSA contribution room. As such, pay attention the volatility of the investment when deciding if you want to hold it in a TFSA.
Personal non-registered accounts	The income earned and capital gains realized in your non-registered account are taxed annually.	**Capital gains** – preferential tax rate when capital gains are realized. Capital losses realized can offset capital gains. **Canadian dividends** – preferential dividend tax treatment resulting in lower effective tax rates. **U.S. and foreign dividends** – although foreign dividends are fully taxed like interest income, foreign taxes withheld may qualify for the foreign tax credit. **Return of Capital (ROC)** – ROC distributions are not taxable in the year they are received. Instead, they reduce the adjusted cost base of your investment for tax purposes and therefore result in a larger capital gain or smaller capital loss when you eventually dispose of your investment. As such, it is typically best to earn ROC distributions in your non-registered account in order to benefit from preferential tax rate on capital gains or be able to claim the capital loss.	**Canadian and foreign interest** – bonds, GICs, T-bills, etc. that pay interest income are fully taxable in a non-registered account.

In summary, from a tax perspective, it may be worthwhile to focus on holding equity investments such as Canadian dividend-paying stocks in your non-registered account to benefit from the preferred tax treatment of capital gains and dividends. Also, where possible, you can consider holding fully taxed income investments such as interest inside your registered accounts to defer or eliminate the tax on income that is fully taxable. As for foreign income, you'll have to pay close attention to what type of income the investment generates as well as the source country of the investment. For example, for U.S. dividend-paying securities, it may be better to hold them inside an RRSP as there will generally be no withholding tax versus holding them inside a TFSA where there will be withholding tax on the dividend payments. Of course, if the after-tax return on the U.S. security is better than any other investment you believe you should hold, then you may still consider holding it in your TFSA.

If you have a corporation

If you own a corporation, you may want to include your corporate investment account into your asset location decisions. Generally, the income and capital gains earned on investments within your corporation will be considered passive investment income. This is regardless of whether you're investing in an operating company or holding company. This is also assuming that the income generated from investing is not pertaining to and incidental to your business or practice (if you have one).

The taxation of passive investment income earned in a corporation is far from straightforward. If you would like a more detailed review of how each type of income is taxed, please refer to our article on the taxation of investment income in a corporation. From a high level perspective, the Canadian tax system was designed so that, theoretically, there should be no material tax advantage or disadvantage to earning passive income through a corporation. However, the Canadian tax system is not perfect and there is currently a tax cost to earning investment income through a corporation in all provinces and territories where the income is earned in the corporation and distributed out to the shareholders. Despite this, there are still some rules of thumb to consider when deciding whether a particular type of investment is suitable for your corporation from a tax-efficiency perspective.

Account	Key takeaways	Consider holding	Generally avoid
Corporate account	When a private corporation earns passive investment income (excluding taxable Canadian dividends), it is subject to a general tax rate plus an additional refundable tax on the investment income. A portion of the total tax paid is refundable to the corporation when taxable dividends are paid out to the shareholders. The amount that is refundable to the corporation is reduced if the corporation earns foreign investment income and is eligible to claim foreign tax credit for the non-resident withholding tax paid. Taxable Canadian dividends earned in a private corporation from publically traded securities are subject to a special refundable tax. This entire tax is refundable to the corporation once taxable dividends are paid out to the shareholders.	**Canadian dividends** – entire tax paid is refundable to the corporation once the corporation pays a dividend to shareholders. Due to this, taxable Canadian dividends are tax neutral if earned through a corporation when compared to earning the dividends personally. **Capital gains** – preferential tax rate when capital gains are realized. Capital losses realized can offset capital gains. The non-taxable portion of the capital gain can be paid out to shareholders tax-free through the capital dividend account, when there is a positive balance.	If foreign taxes are withheld on investment income generated within the corporation, and the corporation claims a foreign tax credit, the refundable portion of tax is reduced, thereby increasing the overall combined corporate and personal tax rate on foreign dividends when they are earned in a corporation and paid out to the shareholder. **U.S. and foreign dividends** – dividends are subject to withholding tax. **Foreign (non-U.S.) interest** – there is likely withholding tax on interest income received from countries other than the U.S. **Canadian interest** – after foreign income, Canadian interest is the least tax-efficient.

Paying attention to your other objectives

While tax-efficiency is important when creating your investment portfolio, it should only be considered after you've decided on the appropriate asset allocation for your risk tolerance and investing goals. For example, if you're a conservative investor, you would typically invest in principal protected investments such as GICs. Since you are aware that interest doesn't benefit from tax-preferred treatment, you may be tempted to invest in other products that generate Canadian dividends or capital gains. However, given your investor profile, high risk equities with large potential for capital growth may not make sense in your circumstances.

You should also consider your needs and objectives, your time horizon and so on. For example, if you have surplus cash, before investing, you should first determine if you have an immediate need for the cash. Do you need the cash to pay income tax instalments or make a major capital expenditure? If so, it might not make sense to invest the funds. If there is no immediate need, but you may need the funds in the short- or medium-term, you will want to ensure that the investments you choose can be easily liquidated when the time

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comes. Alternatively, are your long-term objectives your main priority? Perhaps you wish to boost your retirement savings or enhance the value of your estate. In this case, you may want to consider investments that feature tax-sheltered growth and tax-free payouts.

Conclusion

It's not always what you earn, it's what you keep. If you want to keep more of what you earn as an investor, then investing tax-efficiently, and considering asset location, may help you build and protect your wealth. Working with an RBC advisor and a qualified tax advisor can help you make informed decisions on which tax-efficient investments or strategies may be most appropriate for you.

This article may contain several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

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