Wealth Management
Dominion Securities

Fewer taxes, please … we're Canadian

Talk to us today for more information about tax-smart investing.

However you invest, do it tax-smart

From sea to shining sea, taxes are as much a part of Canadian life as talking about the weather and the metric system. But wherever you invest, if you're north of the 49th parallel, take heed of how your investments are taxed to get the greatest after-tax benefit – and keep more of those earnings in your pocket.

Start your tax-smart engines

As a rule of thumb, tax minimization is a part of any sound investment strategy, but shouldn't eclipse the other reasons to invest. Your decision to invest in a certain stock, asset class or region should be based on your goals, how long you plan to invest, your risk tolerance and a host of other factors.

Average versus marginal tax rates

Your average tax rate (also referred to as your "effective" tax rate) is the percentage calculated when the total tax paid is divided by your taxable income. Your marginal tax rate is generally the percentage of tax paid on the next dollar of taxable income. There is a difference between the two rates because Canada has a system of progressive tax rates. The average tax rate is always equal to or less than the marginal tax rate.

Not all investment income is created tax-equal

Different types of investment income receive different tax treatment, so don't be blinded by an investment's pre-tax rate of return. Instead, look beyond to the after-tax return potential, taking into consideration your income level and marginal tax rate, as well as any other considerations that might apply to your situation and affect the eventual return.

Once you've evaluated the investment's after-tax returns, consider other factors, such as the investment's risk level, the opportunity for capital appreciation, its liquidity and so on. In most cases, you will retain more after-tax income from capital gains and dividends from Canadian companies than from interest income and foreign dividends. As the chart on page four illustrates, what you keep from $1,000 of interest, Canadian-source eligible dividends and capital gains varies relative to your tax bracket.

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Class by class, how it all breaks down

Interest income

You may receive interest income at varying frequencies during the year, such as semi-annually or monthly. This interest income is fully taxable at your marginal tax rate, like salary income. It is taxable in the year it is received, and must be declared on your tax return.

If you do not actually receive the interest income during the year, you still must declare it as "accrued interest." Accrued interest means the interest you earned in the year – even if it is not paid in the year. Investments that require the annual accrual of compound interest include compound Canada Savings Bonds, strip coupons and compound GICs. If the term of an investment is not more than one year, such as a T-bill, the income should be reported in the year it is received.

Canadian-source dividend income

Dividends received from Canadian corporations are effectively taxed at a lower rate than interest income, due to the Dividend Tax Credit that is applied to the federal and provincial tax payable. This tax credit is meant to recognize that the Canadian corporation paying the dividends has already paid tax on its earnings, which are now distributed to its investors.

Foreign income

Foreign income is fully taxable at your applicable marginal rate. If you receive a dividend from a foreign company, you will pay tax on that dividend at the same marginal tax rates as interest income. You won't be able to use the Dividend Tax Credit, which is only available for dividends from Canadian corporations.

Return of capital

You may sometimes receive a non-taxable payment called a "return of capital" from an investment such as a Real Estate Investment Trust (REIT), royalty income trust or mutual fund. These return of capital distributions reduce the adjusted cost base (ACB) of your investment for income tax purposes, and the reduced ACB results in a larger capital gain or smaller capital loss when you eventually dispose of the investment. Think of return of capital distributions as tax-deferred income.

Capital gains and losses

You may realize capital gains, or losses, when you sell an investment. Half of a capital gain is taxable at your marginal tax rate and half of a capital loss can be used to reduce your taxable capital gains. It is the most tax-efficient source of investment income at higher tax brackets.

Consider income-splitting strategies that can transfer the tax-reporting obligation for investment income from higher- to lower-income family members, reducing your family's overall taxes.

Tax-loss selling and superficial losses

Tax-loss selling allows you to offset taxes on your capital gains, first within the current tax year, and if there are any remaining net capital losses, you can use the losses to reduce any taxable capital gains reported in any of the three previous calendar years, or carry them forward to reduce any taxable capital gains you may realize in future years.

A superficial loss may take place if you sell any security at a loss and then acquire an identical security in the period starting 30 days before the disposition and ending 30 days after the disposition. The result of a superficial loss is that the capital loss will be denied, and that denied capital loss will be added to the ACB of the identical acquired investment. Essentially this means the capital loss cannot be immediately claimed for tax purposes. But if you delay your repurchase until after the 30-day period, superficial loss rules don't apply – and you can claim your capital losses.

Minimize taxes like a pro

Once you know how your investments are taxed, get wise to the following tax-smart planning tips:

- Consider income-splitting strategies that can transfer the tax-reporting obligation for investment income from higher- to lower-income family members, reducing your family's overall taxes.
- Hold a greater proportion of your Canadian dividend-paying stocks outside your RRSP, RRIF or other registered plans to take advantage of their tax-preferred treatment.
- Look into a Dividend Reinvestment Plan (DRIP) that automatically reinvests your dividend payments into additional shares of the corporation – for even more powerful compound growth.
- Before the end of the calendar year, think about selling certain investments to recognize capital losses – to reduce taxable capital gains realized on other investments during the year.
- Structure your fixed-income purchases so the maturity dates fall after the end of the current calendar year – potentially deferring tax for up to 16 months.

Be sure to consult with your professional tax advisor before taking any action on any tax strategy.

How much do you keep?

The investment income you keep, after tax, per $1,000

The amount of investment income that you keep from various types of investment income will depend on your tax bracket – and the characteristics of the investments themselves. For example, dividends from Canadian corporations are taxed more favourably than dividends from foreign corporations that have not already contributed to Canada's tax system. The illustration below assumes you are in the highest marginal tax bracket (based on the average Canadian marginal tax rate across all provinces and territories).

Interest and foreign income

$498

Eligible dividends from Canadian corporations

$652

Capital gains

$749

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