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Understanding Tax Treatment of Investment Income

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As investors review their tax returns at this time each year, they are reminded that taxation of investment income varies depending on the type of investment and the type of account. Interest income, dividend income, foreign income, and capital gains all attract different levels of tax and investors are well-advised to structure their portfolios to most efficiently manage their tax bill.

Income received or receivable from investments held within a non-registered account is required to be reported by a taxpayer on their personal income tax return in the following manners.

Interest-bearing Investments

Individuals earning interest income will include interest received or receivable in their income for the year. Interest-bearing investments with a maturity greater than one year will report interest annually based on the anniversary date of the contract whether or not the income is paid out annually or accumulated and paid at maturity.

For example, a $1,000 par value fixed income security purchased to yield 3.5% will pay $35 annually in interest income, which the investor must report each year until it is sold or it matures (the issuer repays the principal

amount at maturity). If the eventual sale price or principal repayment amount is higher than the original purchase price, an additional capital gain will be reported and taxed.

The amount of tax payable on the interest income or eventual capital gain you report depends on your marginal tax rate (see Table 1).

Dividend-paying Investments

A shareholder can receive three types of dividend income from a Canadian corporation: capital dividend, eligible dividend, and "other than eligible" dividend. Capital dividends received are not subject to tax and, therefore, not required to be reported on your personal income tax return.

An eligible or other than eligible dividend received is included in income at the actual amount plus a gross-up of 38% for eligible dividends and 15% for other than eligible dividends. A dividend tax credit is provided to offset the higher tax paid on the grossed-up dividend. The gross-up and dividend tax credit should result in a shareholder paying personal tax at the same rate as if they had personally earned the income of the corporation.

Depending on your province of residence and the type of taxable dividend received, a taxpayer can receive a certain amount of dividends from a Canadian corporation tax-free when they have no other sources of income. A Canadian resident taxpayer living in Ontario in 2018, for example, could earn a maximum of $51,809 in eligible dividends or $30,733 in other than eligible dividends without triggering federal or provincial income tax. Individuals with a significant amount of funds available to invest should speak with an advisor regarding whether setting up an investment holding company would be a beneficial option in order to control the amount and type of dividend income received personally.

Foreign Investments

Foreign income received must be reported on your personal income tax return in Canadian dollars. The foreign exchange rate to be used to convert the foreign amount to Canadian dollars depends on how often the income was received. In general, foreign income should be converted to Canadian dollars using the Bank of Canada exchange rate on the date the income was received. However, if the income was received at various times throughout the year, the Bank of Canada average annual rate can be used.

Foreign dividends received are neither subject to a gross-up rate nor eligible for the dividend tax credit.

In some cases, you may pay a withholding tax in the source country resulting in you receiving the net amount. You are required to report the gross amount in Canadian dollars in your income. The foreign tax paid to the source country may entitle you to a foreign tax credit or a deduction from income on your Canadian personal income tax return.

In addition to reporting income received from foreign investments, investors who hold specified foreign property with a total cost in excess of $100,000 (Canadian) are required to file Form T1135 – *Foreign Income Verification Statement* ("Form T1135"). Specified foreign property includes, but is not limited to, shares of a non-resident corporation held through a Canadian broker. For example, if you hold shares of Apple Inc. in a broker account held in Canada, you will be required to file Form T1135 if the total cost of those shares is more than $100,000.

Capital Gains or Losses

The sale of an investment results in a capital gain or loss to an investor. Capital losses realized on the disposition of an investment can be applied against capital gains realized. Fifty percent of any net capital gains will be included in the income of an individual and subject to tax at their marginal tax rate.

If during a tax year your overall dispositions result in a net capital loss, these losses can be carried back for three years to be applied against any net capital gains of those years resulting in you being entitled to a refund of tax paid in the previous year(s). Net capital losses that are not carried back are able to be carried forward indefinitely and applied against future years' net capital gains.

Minimize Your Tax Payments

For the 2018 taxation year, individuals resident in Ontario[1] who are in the highest tax bracket will pay tax at a rate of 53.53% on interest income. Eligible dividends and other than eligible dividends will be taxed at 39.34% and 46.84%, respectively.

The table below provides the combined federal and provincial marginal tax rates for the top tax brackets of each province.

There are several strategies you can employ to minimize the tax you pay on your investment income.

1. Utilizing Registered Accounts

Holding your investment portfolio within a registered account, such as a registered retirement savings plan ("RRSP") or tax-free savings account ("TFSA"), will minimize your taxes payable. You do not pay tax on the income earned from an investment portfolio held within these accounts as long as you don't withdraw the funds.

Considering your options at a more granular level, given the higher tax rate on interest-bearing investments, you should consider holding these investments within a registered account. Dividend-paying investments should be held in non-registered accounts to the extent that you have already contributed the maximum amount available to your registered accounts.

Table 1: Combined Federal and Provincial Marginal Tax Rates for Top Tax Brackets in Each Province

			Canadian Dividends	
	Brackets $	Interest Income %	Eligible %	Other than Eligible %
Federal	> 205,842	33.00	24.81	26.64
Alberta	> 307,547	48.00	31.71	41.64
	> 205,842	47.00	30.33	40.48
British Columbia	> 205,842	49.80	34.20	43.73
Manitoba	> 205,842	50.40	37.79	45.92
New Brunswick	> 205,842	53.30	33.51	46.88
Newfoundland and Labrador	> 205,842	51.30	42.62	43.81
Northwest Territories	> 205,842	47.05	28.33	35.98
Nova Scotia	> 205,842	54.00	41.58	47.33
Nunavut	> 205,842	44.50	33.08	36.78
Ontario	> 220,000	53.53	39.34	46.84
	> 205,842	51.97	37.19	45.03
Prince Edward Island	> 205,842	51.37	34.23	44.26
Quebec[2]	> 205,842	53.31	39.89	44.83
Saskatchewan	> 205,842	47.50	29.64	39.60
Yukon	> 500,000	48.00	28.92	41.42
	> 205,842	45.80	25.89	38.87

[1] *Assuming the taxpayer has taxable income in excess of $220,000.*

[2] *For amounts received after March 27, 2018.*

Withdrawals from certain registered accounts, such as an RRSP, will be included in income and taxed fully in the year of the withdrawal. Withdrawals from a TFSA are not subject to tax and not included in income in the year of the withdrawal. Therefore, income earned within a TFSA will not be subject to tax during the plan holder's lifetime.

2. Disposing of Investments in a Loss Position

In early December, you should review your realized capital gains for the year with your investment counsellor. If you have a significant amount of realized capital gains in a year and you are holding investments with unrealized capital losses, you may want to consider selling some of those securities to realize the losses. Realized capital losses can be applied against realized capital gains in a given year.

Care must be taken, however, to ensure that you are not altering or jeopardizing your investment strategy, and you are not subject to the superficial loss rules. The superficial loss rules will apply if you, or a person affiliated with you (i.e., your spouse or a corporation that you or your spouse control), purchase identical assets during the period beginning 30 days before and ending 30 days after the disposition, and you continue to hold the identical asset 30 days after the disposition. Application of the superficial loss rules will result in the capital loss being deemed to be nil on your tax return. If the identical asset continues to be held beyond the 30 days after the disposition, the adjusted cost base of the identical asset may be able to be increased by the amount of the superficial loss. Be sure to consult with your investment counsellor and accountant before pursuing a disposition strategy.

3. Gifting Capital Property to a Registered Charity

When you donate securities instead of cash to a registered charity, the disposition of the capital property is subject to a zero-percent inclusion rate (i.e., no tax is incurred on the capital gain that's triggered by the donation) and the donor can claim a donation amount equal to the fair market value of the donated property. As an example, if you had $100,000 of stock that had $50,000 of embedded capital gains in it, you could either sell the stock, pay tax on the gain, and donate the net amount; or donate 100% of the stock directly, collect a donation receipt for the full $100,000 and pay no tax. The charity would also be able to sell the stock without paying tax and so would benefit more.

This article is not intended to provide specific tax advice. Taxation matters are complex and dependent on personal circumstances. Please consult your professional tax advisor.

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