Sun Life

Taxation of investment income

You have a broad choice of investments for your savings. You also have a variety of available investment accounts in which to invest. When making the choice to invest your money, it's important to know the impact that taxation will have. Different types of investment incomes attract tax at varying rates. The after-tax return on investment income can also vary depending on the investment account where you earn the income. Let's look at how the type of investment income and various investment accounts impact your after-tax return.

Investment returns

When investing, you expect to make a return on that investment. Investment returns come in a variety of income types. The most common forms include interest, eligible dividends, and capital gains. Some investments also generate foreign income, capital gains dividends, and return of capital. Each income type may create a different after-tax return for you.

Interest

Fixed income type investments produce interest income. These include investments like guaranteed investment certificates (GIC's), bonds, and treasury Bills (T-bills). Mutual funds and exchange traded funds (ETFs) may also distribute interest income. You report the full amount of interest income and pay tax at your marginal tax rates. Interest income doesn't provide you with any preferential tax treatment unlike capital gains and dividends. You report and pay tax on interest income in the year received or at minimum on its anniversary date. Regardless of whether you receive a T-slip from the financial institution, you still need to report interest earned for the year.

As an example, say you purchase a 3-year compounding GIC on July 1, 2024. The financial institution doesn't pay the interest earned to you until July 1, 2027. However, you report interest earned in 2025, 2026, and 2027. Each year you report the interest earned up to that anniversary year. Since you won't receive cash flows from the investment until 2027, this may create a cash flow issue. You'll want to ensure you have cash on hand for taxes.

Capital gains or losses

Capital gains or losses generally arise when you dispose of an investment and the sale proceeds differs from its adjusted cost base (ACB). A capital gain occurs if the sale proceeds exceed the ACB. A capital loss occurs if the ACB exceeds the sale proceeds.

The ACB generally represents amounts you pay for an investment subject to adjustments. Although complex, some more common items that affect your ACB include:

- expenses associated with purchase of the investment (e.g. commissions) increase the ACB;
- dividends received and reinvested increase the ACB;
- return of capital distributions decrease the ACB; and
- disposing of a portion of the investment generally decreases the ACB.

You may purchase the same stock, mutual fund, or ETF unit at different times at varying costs. The varying purchase price is important when you calculate your ACB. If you dispose a portion of identical investments, you use the average ACB to determine your gain or loss. Identical investments include the same class of stock in a corporation. They also include the same units of a mutual fund or ETF. This is true even when you own them across several non-registered accounts. We recommend you maintain clear records for your investment account activities. These can assist you in reporting your gains or losses and even reduce your taxes.

You generally claim investment capital gains in the year they occur. You use capital losses incurred in the year first to offset capital gains incurred in the same year. You can then carry back unused capital losses three years or forward indefinitely to offset capital gains in those years. In the year of death or the year preceding death, you can use capital losses against any form of income.

Mutual funds, ETFs or shares of corporations can produce a capital gain or loss on sale. Mutual funds and ETFs also trigger capital gains and losses from within the fund. These transactions don't produce taxable gains to the individual investor unless distributed to you. In certain situations, you may receive a capital gain distribution known as capital gain dividend. A capital gain dividend is not a dividend for tax purposes, you report it as a capital gain.

When you incur a capital gain or loss, only portion of the amount is taxable or allowed as a loss. For the past few decades and up to June 24, 2024, the inclusion rate for capital gains and losses was 50%. For example, say you purchase an investment for $10,000 that grew to $12,000 and you sold it. You triggered a $2,000 capital gain and only $1,000 (or 50% of the capital gain) was a taxable capital gain.

However, Federal Budget 2024 introduced a set of rules increasing the inclusion rate for many capital gains and losses. The 50% inclusion rate continues to apply for the first $250,000 of capital gains/losses realized annually on or after June 25, 2024. A higher 66 2/3% inclusion rate applies to capital gains/losses realized above this threshold. Transition rules apply for capital gains/losses incurred in 2024. Different rules also apply to capital gains/losses incurred by corporations and most trusts.

Using the same example above, the taxable capital gain would remain $1,000 if this was your only capital gain in the year. If you already incurred $250,000 of capital gains in the year, the taxable capital gain is $1,333.33. You include the taxable capital gain in your income on your tax return.

Eligible dividends

Canadian public companies pay eligible dividends to their shareholders. If you own mutual funds or ETFs that contain these companies, you may receive eligible dividends through fund distributions. Compared to interest, eligible dividends receive preferential tax treatment. You gross-up dividends for tax purposes and then you apply a dividend tax credit (DTC). This treatment applies because the dividends come from tax-paid corporate earnings. The gross-up and DTC attempts to reduce double taxation. This is the system of integration in the Income Tax Act (ITA) which is not perfect.

For eligible dividends the gross up factor has been 38% since 2012. For example, if you receive $1,000 in eligible dividends, for tax purposes you report $1,380 as income on your tax return. You then apply a DTC to the grossed-up amount. The federal, provincial, and territorial governments set their own DTC rates. Therefore, the combined DTC varies by province and territory. The combined DTC reduces your tax owing on this income.

It's possible to receive eligible dividends at little to no personal tax. If you have no other income in the year, the DTC can sometimes eliminate the personal tax altogether. Depending on your province or territory, the amount ranges from approximately $21,000 to $65,000 of eligible dividends. These amounts account for the basic personal amount and DTC. Your personal situation may increase or decrease this amount.

Foreign income

Your investments may also produce foreign income. For example, stock in a foreign company may pay a dividend. Or your mutual fund or ETF may invest in foreign investments that produce dividends or foreign income. For Canadian tax purposes, dividends paid by foreign companies is treated as foreign income, not a dividend. Foreign income is fully taxable, like interest, and not eligible for preferential treatment.

For Canadian tax purposes you report all income in Canadian dollars (CAD). Therefore, you need to determine the appropriate exchange rate for your reporting obligations. Generally, you use the exchange rate quoted by the Bank of Canada for the day you receive the income. For practical purposes, the CRA also accepts the Bank of Canada average rate for income received during a period. This helps if you have income received several times during the year.

Foreign income withholding taxes

Foreign income may be subject to withholding taxes in the foreign country before it is paid to you. You may be able to recoup some or all of the foreign taxes withheld on your Canadian return. Claiming foreign taxes paid is complex and subject to rules in the ITA. One method includes claiming a foreign tax credit (FTC) which lowers your Canadian tax.

However, the FTC is limited. The FTC is the lesser of: (1) 15% of the foreign income, and (2) the amount of Canadian tax otherwise payable on this income. If the foreign withholding tax exceeds 15%, you may be able to claim a deduction for the remainder. Further, a treaty between Canada and the foreign country may affect the FTC. Please discuss foreign withholding tax and methods to recoup the amount paid with your professional tax advisors.

Foreign exchange gains or losses

If you invest in foreign denominated currency, you may incur a foreign exchange capital gain or loss. This is true even if the underlying investment hasn't changed in value. This is because the exchange rate may fluctuate between the time you purchase and dispose of the investment.

For example, say you invest $10,000 in a US dollar (USD) denominated mutual fund. At the time of investment, the exchange rate between USD and CAD is par. Therefore, your ACB on the investment for Canadian tax purposes is $10,000 CAD. When you dispose the fund two years later, the value of the mutual fund remains at $10,000 USD. However, the exchange rate is now $1.20 USD for every $1 CAD. For Canadian tax purposes, you report a disposition of $12,000 CAD. This produces a $2,000 capital gain which you report on your Canadian tax return subject to the inclusion rates set out above.

Unlike foreign income, foreign gains and losses use the exchange rate in place at the time of the transaction. The CRA indicates you cannot use an average for purposes of calculating capital gains or losses like with income. If the gain relates solely to foreign exchange on cash, the first $200 is exempt. As an example, where you own USD cash and convert it to CAD cash.

Return of capital

Mutual funds and ETFs provide you with frequent distributions. The fund distributes cash created through its own investment activity for the year. They classify the distribution as interest, capital gains, dividends, and foreign income. However, some funds provide a distribution known as return of capital (ROC). ROC occurs when the fund makes a distribution more than the fund's income for the year. ROC is essentially a return of a portion of your original investment or capital.

An ROC distribution to you isn't income for tax purposes. Therefore, you don't pay tax on these cash distributions. This can produce a very tax efficient annual return. However, the receipt of ROC does impact the ACB of your investment. The ROC distribution reduces your ACB by the amount of the ROC. For example, assume you make an original $10,000 investment on which you receive a $400 distribution classified as ROC. After you receive the ROC, your investment now has a $9,600 ACB. As ROC distributions continue, the ACB adjustments continue. Finally, when you sell investment, the updated ACB determines your gain or loss. If your ACB decreases to nil and becomes negative, the negative ACB produces a capital gain.

Effect of various investment accounts

The above focuses on various forms of income your investments can generate. However, when investing and saving money, you can choose among different types of accounts. The account can alter the ultimate taxation of investment income and after-tax returns to you. By allocating different investments among your accounts, you may increase tax efficiency. Below are some considerations for common investment accounts in Canada.

Non-registered accounts

Non-registered investment accounts don't alter the taxation of investment income. Therefore, when you invest in a non-registered account, you pay tax on investment income as outlined above. Interest income and foreign income is fully taxable. Eligible dividends and capital gains have preferential tax treatment. Finally, return of capital is tax free.

There is no deferral like registered accounts as outlined below. Therefore, your focus turns to tax-efficient investments. Consider allocating those investments that meet your risk profile but also provide after-tax efficient income. These include investments that produce eligible dividends, capital gains, and return of capital. If you need to create cash by selling an investment, you may also realize a capital gain or loss. So, when making withdrawals, consult your tax and investment professionals.

The chart below shows the tax on all forms of income in a non-registered account. For illustration purposes, we use the top marginal tax rates in Alberta. Keep in mind, it also takes differing amounts of capital and risk to produce these income streams. We put that aside for the moment to provide contrast on the impact of taxation.

	Interest	Capital gains (50% / 66²/₃%)	Eligible dividend	Foreign income	Return of capital
Income amount	$1,000	$1,000	$1,000	$1,000	$1,000
Individual taxation	$480	$240/$320	$343	$480	-
Tax rate	48%	24%/32%	34.31%	48%*	0%

*assuming you can recoup foreign withholding tax, if any.

Retirement plans

Common retirement accounts include registered retirement savings plans (RRSP) and registered retirement income funds (RRIF). You deduct contributions to an RRSP, thereby allowing you to invest more upfront. You also defer tax on the earnings within the accounts. When you withdraw from an RRSP or RRIF, the withdrawal is fully taxable. Given the tax deferral, good candidates for these accounts include investments producing highly taxable income. Income like interest and foreign income produce higher taxes compared to capital gains and dividends. When allocating among your accounts, consider giving preference to investments that produce interest and foreign income* in your RRSP/RRIF. Given the withdrawal is fully taxable, all income and capital produce the same tax when leaving the plan.

The chart below shows the tax on all forms of income inside an RRSP or RRIF. For illustration purposes, we use the top marginal tax rates in Alberta. You benefit from a tax deferral on all forms of income while inside the account. You then pay tax at your marginal tax rate on all withdrawals. Therefore, keeping tax preferred income out of the RRSP may produce greater tax-efficiency.

	Interest	Capital gains	Eligible dividend	Foreign income	Return of capital
Income amount	$1,000	$1,000	$1,000	$1,000	$1,000
Taxation on income inside the account	-	-	-	-	-
Tax on withdrawal	$480	$480	$480	$480	$480
Tax rate	48%	48%	48%	48%*	48%

*assuming you recoup foreign withholding tax, if any.

Foreign income withholding tax within an RRSP
As discussed above, foreign income may be subject to withholding tax in the foreign jurisdiction before paid to you. In general, you cannot use the FTC provisions to recoup withholding tax that occurs inside a registered account.

Luckily, U.S. stocks, mutual funds and ETFs held directly within an RRSP/RRIF have a special exemption from withholding tax. This treaty exemption doesn't apply to other international investments (e.g. non-U.S.). Further, the exemption doesn't apply to U.S. investments held directly or indirectly in Canadian mutual funds or ETFs.

If your RRSP/RRIF includes foreign investments, we recommend you review the potential withholding tax with your advisors. If withholding tax isn't exempt, consider allocating these investments to your non-registered portfolio. This may allow you to claim the FTC discussed above. Please consult with your professional tax advisors.

Savings plans
A tax-free savings account (TFSA) is also a registered account. However, you contribute with after-tax funds, subject to limits. TFSAs also benefit from tax deferral on income earned, but you don't pay tax upon withdrawal. As such, you have different considerations when choosing investments in these accounts.

Foreign income withholding tax within a TFSA
Unlike RRSPs, TFSAs don't benefit from the special treaty exemption for withholding tax on US foreign investments. No exemption exists for any foreign withholding tax in other countries either. As the income is not taxable inside the TFSA, the FTC is also not allowed. This means that you cannot recover a portion of the foreign income withheld, if any. Ultimately the lost withholding tax reduces your return on investment.

The chart below shows the tax on all incomes inside a TFSA. There is one big difference compared to the RRSP/RRIF above. There is no tax payable on withdrawal. This increases the tax efficiency of earning investment income inside a TFSA. Therefore, consider giving preference to holding investments that produce significant income or gains in your TFSA. The one exception compared to retirement accounts is foreign income. If foreign withholding taxes apply, you may earn less on the same investment and have less to reinvest.

	Interest	Capital gains	Eligible dividend	Foreign income	Return of capital
Income amount	$1,000	$1,000	$1,000	$850	$1,000
Taxation on income inside the account	-	-	-	15%*	-
Tax on withdrawal	-	-	-	-	-
Tax rate	-	-	-	15%	-

*We illustrate a hypothetical 15% withholding tax. Withholding taxes may vary by country and be subject to treaty provisions.

When allocating funds to a TFSA, keep in mind your purpose for the savings in the account. Unlike RRSPs, you frequently use a TFSA for short term savings like buying a car or saving for a vacation. Your purpose may dictate how you invest if you need the funds to be more secure or readily accessible.

Allocating among your various investment accounts
Allocating your investments among different accounts can impact your after-tax investment returns. US foreign income and interest income perform well in an RRSP. High yield and growth investments perform well in a TFSA. Lastly, capital growth, dividend producing, and return of capital income streams have tax preferential treatment, which allow them to perform better in a non-registered environment. The above analysis focuses on allocating among your various investment accounts to increase tax-efficiency. Choosing to invest in an RRSP, TFSA or non-registered account is a different analysis not covered in this article. Speak with your financial advisor to determine how these accounts fit within your financial plan.

Other considerations

Diversification
The discussion above reviews taxation of investment income. However, tax isn't the only consideration when choosing your investments. A well-diversified portfolio can help reduce your risk and ensure you limit your exposure to a single sector. Many investors diversify each account they own as opposed to creating diversity over their entire portfolio. For example, Investor A splits their investments 60% equities and 40% fixed income in each of their registered and non-registered accounts. Investor B also has a 60/40 split. However, they allocate fixed income investments inside their RRSP with equites investments in their non-registered account. Each investor is diversified similarly. However, Investor B has taken taxation and the account characteristics into consideration to increase tax efficiency. Investor B chose to shelter highly taxable interest income in the RRSP with tax preferred dividend income in their non-registered account, which will likely result in higher after-tax returns

Risk profiles

Choosing the right investments for your portfolio also involves more than reviewing the tax outcome. Each investor has their own risk tolerance that determines the appropriate asset allocation. If you're a low-risk individual, choosing a high-growth stock in your TFSA may not be appropriate. If you're saving money for a specific purpose, putting money at risk may not align with your goal. Your financial advisor can assist you in allocating your investments within your risk tolerance and goals.

Summary

Investment income comes in many forms with varying tax results. Further, the type of account in which you earn investment income may alter the after-tax return to you. Review your portfolio against your financial plan and consider restructuring your diversified investments tax-efficiently. By choosing the right income stream for the right investment account, you can increase your after-tax return on investment. For more information on the right investments for you, please contact your financial advisor.