Tax Efficient Investing

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Canadians have a few tax sheltered or tax preferred vehicles available to invest for medium and long term goals. These are primarily registered plans like RRSPs, DPSPs, RRIFs, etc. The income or growth in such plans is tax sheltered and is taxed when you withdraw it.

A Tax Free Savings Account (TFSA) is another registered plan where the income and growth is tax-free and is subject to no taxation. Tax Free Plans have grown in popularity as the contribution limits are cumulative and for someone who fully qualifies for the cumulative limit since TFSA plans started in 2009 can contribute a maximum of $75,500 till the end of 2021, if never contributed before.

When it comes to non-registered funds (investments outside registered plans), the type of Investment Income you generate will decide what kind of tax treatment it will receive. Different types of investment income are taxed differently. Let's look at some of the different types of Investment Income in a non-registered account and how they are taxed:

1. **Interest income**
   Interest you earn from bonds or GICs is considered ordinary income and is taxable at your marginal rate as it accrues.
2. **Dividends**
   There are two types of dividends – eligible dividends and non-eligible dividends – and the tax liability is calculated differently for each type.
3. **Capital gains**
   The increase in the value of your investments is considered a capital gain, and it is taxable when the investment is sold. 50% of the capital gains is included in your income and taxable at your marginal tax rate.
4. **Return of capital**
   A payment from a portion of an investor's original investment. A return-of-capital payment is not considered a taxable event as it is not a capital gain or income.

Tax efficiency is an important consideration for building wealth outside of registered plans such as RRSPs, RESPs and TFSAs. By minimizing and deferring tax on their unregistered investments, investors can build wealth faster.

The Marginal Tax Rate Calculator below highlights the comparative tax impact on these different types of income in a non-registered portfolio:

https://www.ey.com/ca/en/services/tax/tax-calculators

For example, an individual who makes $100,000 taxable income in BC in a calendar year has a Marginal Tax Rate of 38.29% which means that for the next 100 dollars earned over their current taxable income, this individual will pay $38.29 in taxes. The calculator also shows the effective tax rates on the type of income generated for this individual. Let's look at what happens if this individual generates $100 in investment income on top of their $100,000 taxable income for 2021.

1. $100 earned in Interest Income — Tax on Interest income: $38.29
2. $100 earned in Eligible Dividends — Tax on Eligible Dividend: $15.55
3. $100 earned in Capital Gains — Tax on Capital Gains: $19.15

As you can see, based on the example above, income generated in the form of eligible dividends gets the most favorable tax treatment while interest income is the least tax efficient.

The amount of tax you pay on the investment income also determines what you get to keep after paying taxes on that income. Continuing from the example above, the investment income of $100 will result in an after-tax income of $84.45 (100-15.55) if the income was generated as eligible dividends. However, the same $100 investment income will result in an after-tax income of $61.71 if generated as interest income. This results in a net surplus of $22.74 in case of eligible dividend tax treatment versus interest income tax treatment.

The taxation of your income plays a major role in your overall savings plan especially when you are looking at a long-term investment plan as it will impact your overall portfolio value. It is imperative that you explore these tax efficient options with your Investment Advisor and if suitable, incorporate these in your investment plan.

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