How Investment Income is Taxed

When it comes to investment income, all is not equal after tax. Knowing how tax rules affect your investments is essential in order to maximize your after-tax return. This publication explains the taxation of investment income held in a taxable account as it pertains to an individual resident in Canada.

Canadian income tax system

If you are a resident of Canada for tax purposes, you will be taxed on your worldwide income regardless of where it is earned. An individual's residency status for tax purposes is determined on a case by case basis, and the individual's entire situation and all the relevant facts must be reviewed. Generally, a determination of the significance of residential ties maintained in Canada, the purpose and permanence of your stays abroad, and your ties abroad will be considered.

For more information regarding your residency status, contact your tax advisor or the Canada Revenue Agency ("CRA").

Foreign income tax

When a Canadian resident purchases a foreign investment such as shares or bonds issued by a foreign corporation or government, any income or capital gain from that investment will generally be taxable in Canada. However, the income may also be taxed in the country of source. In order to avoid double taxation, many countries have entered into reciprocal income tax treaties that determine which country may tax various types of income and the withholding tax rates to be applied. In general, the foreign country in which the income is earned has priority in taxing that income; however, Canada may allow a foreign tax credit which would reduce the Canadian tax otherwise payable on the foreign income.

There may also be other Canadian tax implications of owning foreign property, including various reporting obligations and potential deemed income inclusions prior to the receipt of any actual income from the investments. There may be other tax implications in the foreign jurisdiction of owning foreign securities, such as the possible exposure to U.S. estate tax on U.S. securities held at death.

These rules are quite complex so please contact your tax advisor to determine the potential tax implications of holding specific foreign properties.

Tax brackets

There are two levels of income tax in Canada; federal and provincial, that together determine your overall income tax liability. Under the tax on income system for determining provincial income tax, the provinces have the ability to set their own tax brackets, tax rates and income tax credits. Under this system, generally the more you earn, the higher your marginal income tax rate.

A new top federal tax bracket was recently introduced at a rate of 33%, which is 4% higher than the previous top federal personal tax rate of 29%. Please see the following table on page 2 for the 2018 federal income tax brackets and rates.

2018 Personal Federal Income Tax Brackets and Rates

Taxable Income	Rate (%)
Up to $46,605	15.0%
$46,605 - $93,208	20.5%
$93,208 - $144,489	26.0%
$144,489 - $205,842	29.0%
Over $205,842	33.0%

Investment returns

There are three basic types of investment income: interest, dividends and capital gains. Because these three investment returns are taxed very differently, it's the after-tax earnings that should be compared. However, all investments have their own level of risk and return that should be taken into consideration when structuring your portfolio.

Interest income

Investments such as Canada Savings Bonds, GIC's, T-bills or strip bonds, pay interest income which is taxed at your marginal tax rate without any preferential tax treatment. For individuals, interest must be reported on your tax return in the year you receive it and at least annually on the anniversary day of the investment.

For example, if you purchased a five year compounding GIC on its February 1, 2017 issue date, you must report interest earned from February 1, 2017 to January 31, 2018 on your 2018 income tax return even though you have not yet received the income payment. This can cause cash flow problems if a majority of your portfolio is invested in long-term compound interest investments.

Dividend income

If you own shares of a corporation either directly or through a mutual fund, you may receive a distribution in the form of a dividend. Dividends from Canadian corporations receive preferential tax treatment by both the federal and provincial governments by way of a dividend gross-up and tax credit mechanism.

TIP

Consider holding interest bearing investments in a TFSA where the income grows tax-free, or in an RRSP where the income grows tax-deferred until withdrawn from the plan.

Specifically, lower effective tax rates apply to "eligible" dividends which encompass distributions to Canadian resident investors from income that has been subject to the general corporate tax rate, (i.e., generally most dividends paid by public Canadian corporations). Dividends received which are not "eligible" dividends are subject to higher effective tax rates.

Lower corporate tax rates resulting from past federal budgets led to reductions to the gross-up and credit mechanism for eligible dividends, which effectively increased the tax rate on eligible dividends beginning in 2010. Changes originating from more recent federal budgets have also increased the effective tax rate on "ineligible" dividends through changes to the dividend gross-up and tax credit factors. Please see the chart at the end of this publication which reflects the current top marginal tax rates for individuals and ask your financial professional for a copy of our publication entitled **Eligible Dividends** for more information on the taxation of dividend income.

The dividend tax credit reduces the overall tax rate and at low income levels, can completely eliminate the income tax on Canadian dividends. For 2012 and later years, the actual dividend received is grossed-up by 38% for eligible dividends. So, if you receive a $100 eligible dividend, you will include $138 on your tax return and will receive a dividend tax credit that will reduce the actual income tax you pay on that dividend.

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TIP

Where appropriate, consider including Canadian preferred shares as part of your income portfolio for an income stream that is taxed at a lower effective tax rate than interest.

Interest income vs. eligible dividend income

Because of the preferential tax treatment provided by eligible dividend income, you may want to ensure your investment mix includes Canadian dividend-paying securities. The table to the right provides the 2018 top marginal tax rates by province and the "multiplier" which equates interest income to eligible dividend income. The top rates apply to taxable incomes over $205,842 except that the thresholds are $220,000 in Ontario and $307,547 in Alberta.

The "multiplier" column calculates the additional amount of interest income that would have to be earned by an individual resident in each province (who is subject to tax at the top marginal rates for 2018) to equate this after-tax interest income to the amount of after-tax income retained from earning an eligible dividend.

For example, in 2018 for an individual resident in Alberta, eligible dividends are taxed at an effective top marginal rate of 31.71% whereas interest is taxed at the top individual rate of 48.00%. Accordingly, an Alberta investor would have to earn approximately $1.3132 of interest for each $1 of eligible dividends to be in the same after-tax position, as follows:

$1,313.27 interest income x 0.48 = $630.37 tax which leaves **$682.90** after tax (i.e., $1,313.27 – $630.37)

$1,000 eligible dividends x 0.3171 = $317.10 tax which leaves **$682.90** after tax (i.e., $1,000 – $317.10)

Interest Income vs. Eligible Dividend Income

	Top Marginal Tax Rates		
Province	Interest & Ordinary Income*	Eligible Canadian Dividends*	Multiplier
Alberta	48.00%	31.71%	1.3132
British Columbia	49.80%	34.20%	1.3108
Manitoba	50.40%	37.78%	1.2544
New Brunswick	53.30%	33.51%	1.4238
Newfoundland and Labrador	51.30%	42.61%	1.1784
Nova Scotia	54.00%	41.58%	1.2700
Ontario	53.53%	39.34%	1.3054
Prince Edward Island	51.37%	34.22%	1.3527
Quebec	53.31%	39.83%	1.2887
Saskatchewan	47.50%	29.64%	1.3402

* As of March 2018

Foreign dividends

If you receive a dividend from a foreign corporation, it is not eligible for any dividend tax credit. The actual amount of dividends received must be converted to Canadian dollars and included in your income tax return when received. The income tax rate applicable on foreign dividends is the same as your marginal rate for interest income. If foreign income tax has been withheld from your dividend payment, you should include the gross amount of the dividend in your tax return and claim a foreign tax credit for the taxes withheld. The foreign tax credit will reduce the Canadian income taxes owing on the foreign dividend but is generally limited

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to the lesser of: 15% of the foreign income and the amount of Canadian tax otherwise payable on the foreign income.

The foreign tax paid that is not allowed as a tax credit may be deductible from income. If the actual tax withheld is more than the rate agreed to in the treaty, the taxpayer should contact the withholding country for a possible recovery of the excess withholding tax.

Capital gains

Investments such as common shares of a corporation may increase or decrease in value over time. When shares are sold for more than the adjusted cost based ("ACB"), the difference is considered a capital gain. When shares are sold for less than the ACB, there is a capital loss. The ACB is generally the amount you paid for the investment including related costs such as commissions. The ACB of a particular investment is calculated as an average cost of all purchases. A capital gain is very different from other investment income because you must dispose (or be deemed to have disposed of) the investment in order to realize a capital gain or loss. Exceptions to this rule include mutual fund and Exchange-traded Fund ("ETF") investments where the taxable capital gains realized by the funds/ETFs are allocated to the unitholders at year-end and income tax is paid by each investor even if the investor has not sold any units.

Since October 2000, only 50% of capital gains are included in income making this type of return very attractive.

In addition, capital gains realized on certain investments (e.g., qualified small business corporation shares) may be offset by a lifetime capital gains exemption of up to $848,252 for 2018 (indexed thereafter).

Capital gains dividend

A capital gains dividend that is paid by a mutual fund is taxed as a capital gain and not as a dividend. Rather than a gross-up and dividend tax credit, a capital gains dividend is included in income at the applicable capital gains inclusion rate (i.e. 50%).

Capital loss

If you sell an investment for less than the ACB you will incur a capital loss. A capital loss is deductible only against capital gains. If there are more capital losses than gains in a particular year, the net loss may be carried back up to three tax years to reduce net capital gains reported previously. This may result in a refund of taxes already paid. Alternatively, a capital loss may be carried forward indefinitely to offset future capital gains.

Capital gain/loss on foreign investments

When a Canadian resident sells a foreign investment, the sale must be reported on his or her Canadian income tax return in Canadian dollars, even if the proceeds from the sale remain in the foreign currency. The net return will be a combination of the actual return on the investment and the gain or loss in the exchange rate. The fluctuation of the exchange rate will impact the net capital gain or loss on the sale and can either increase a capital gain or turn a profitable investment into a net loss. A capital gain or loss on a foreign investment is taxed in the same manner as a gain or loss on a Canadian investment (i.e., 50% inclusion rate for capital gains).

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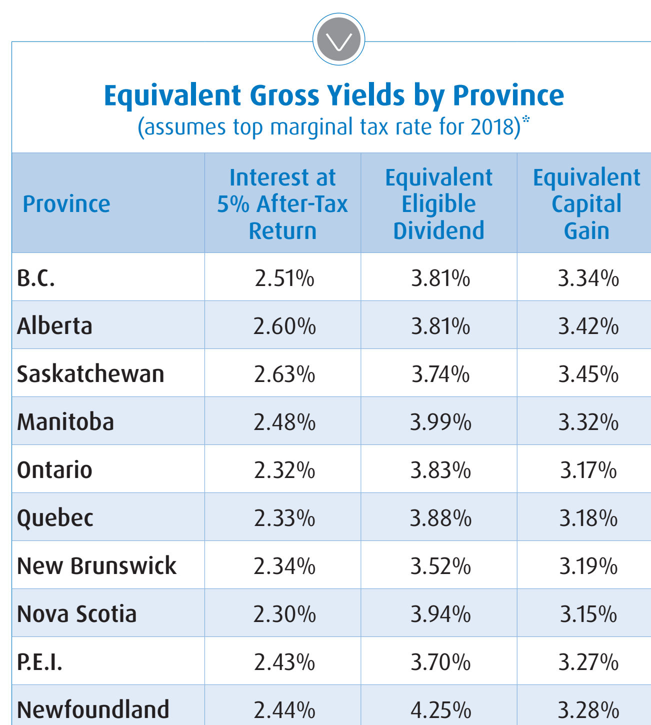
Interest/dividend/capital gain comparison

Because each type of investment income is taxed differently, it is important to look at the after-tax rate of return and not only the stated interest rate, yield or projected growth rate. In this regard, we have prepared the following table, which illustrates the approximate rate of return, by province, for eligible dividends and capital gains that will result in the same after-tax return as an investment that pays interest income at five per cent.



Equivalent Gross Yields by Province
(assumes top marginal tax rate for 2018)*

Province	Interest at 5% After-Tax Return	Equivalent Eligible Dividend	Equivalent Capital Gain
B.C.	2.51%	3.81%	3.34%
Alberta	2.60%	3.81%	3.42%
Saskatchewan	2.63%	3.74%	3.45%
Manitoba	2.48%	3.99%	3.32%
Ontario	2.32%	3.83%	3.17%
Quebec	2.33%	3.88%	3.18%
New Brunswick	2.34%	3.52%	3.19%
Nova Scotia	2.30%	3.94%	3.15%
P.E.I.	2.43%	3.70%	3.27%
Newfoundland	2.44%	4.25%	3.28%

* See page 6 for top marginal rates.

Return of capital

Many mutual funds (and ETFs) pay a distribution to an investor (called a unitholder) that is referred to as a return of capital. This term can be misleading because it is a tax concept and not necessarily the actual return of one's capital. For tax purposes, a unitholder is only required to include in income their portion of the fund trust's taxable income. A distribution in excess of the trust's taxable income is called a return of capital, which is not taxable to the unitholder.

A return of capital usually arises when the trust is able to claim a tax deduction, such as capital cost allowance (CCA) that reduces the trust's taxable income without affecting the cash available for distribution to unitholders.

Distributions that are considered a return of capital are considered a reduction in the cost base of the unit for tax purposes. Therefore, a unitholder must reduce the cost base of their investment by the cumulative amount of the return of capital received. If an investment is held for many years, it is possible that the return of capital distributions will have reduced the cost base to zero. From that point on, any further return of capital distribution will be considered a capital gain in the year it is received. When the investment is sold, a capital gain or loss will be realized using the revised cost base.

Conclusion

We all want to reduce the taxes payable on investment income. However, because everyone's investment objectives and risk tolerance are different, investments should not be chosen based on income taxation alone. Understanding how various types of investment income is taxed is the first step, then you and your BMO financial professional can work together to develop a tax efficient portfolio suitable for you.

2018 Combined Federal and Provincial Top Marginal Tax Rates for Individuals*

Province	Interest & Ordinary Income	Capital Gains	Canadian Dividends	
			Eligible	Non-Eligible
Alberta	48.00%	24.00%	31.71%	41.64%
B.C.	49.80%	24.90%	34.20%	43.73%
Manitoba	50.40%	25.20%	37.78%	45.92%
New Brunswick	53.30%	26.65%	33.51%	46.88%
Newfoundland and Labrador	51.30%	25.65%	42.61%	43.81%
Northwest Territories	47.05%	23.53%	28.33%	35.98%
Nova Scotia	54.00%	27.00%	41.58%	47.34%
Nunavut	44.50%	22.25%	33.08%	36.78%
Ontario	53.53%	26.76%	39.34%	46.84%
P.E.I.	51.37%	25.69%	34.22%	44.25%
Quebec	53.31%	26.65%	39.83%	43.94%
Saskatchewan	47.50%	23.75%	29.64%	39.75%
Yukon	48.00%	24.00%	28.93%	41.42%

* This table shows the 2018 top combined marginal tax rates by province as of March 2018. The rates apply to taxable incomes over $205,842 except that the thresholds are $220,000 in Ontario, $307,547 in Alberta and $500,000 in Yukon.

For more information, speak with your BMO financial professional.

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