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 article discusses 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, you will be taxed on your worldwide income regardless of where it is earned. Although residency is determined based on the facts, in general, you will be considered a resident of Canada if you consider Canada to be your home (i.e. it is the place you normally or customarily live).

This article deals with the taxation of Canadian resident individuals. For more information regarding your residency status, contact your tax advisor or 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 agreements 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 also be other tax implications in the foreign jurisdiction of owning foreign securities, such as the possible exposure to US estate tax on US 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. Below are the federal income tax rates that will be used for illustrative purposes throughout this article.

Federal Tax Brackets & Rates 2011	
$0 – $41,544	15%
$41,544 – $83,088	22%
$83,088 – $128,800	26%
over $128,800	29%

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, 2010 issue date, you must report interest earned from February 1, 2010 to January 31, 2011 on your 2011 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.

For investments acquired before 1990, accrued interest must generally be reported on each third anniversary.

Tip

Consider holding interest bearing investments in an RRSP where the income grows tax-deferred until withdrawn from the plan.

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.

As a result of recent changes in the Canadian tax legislation, a new dividend tax regime exists for qualifying dividends paid by a Canadian corporation to a Canadian investor after 2005. Specifically, the effective tax rate on an "eligible" dividend has been reduced as a means of leveling the playing field on distributions from income trusts and corporations.

Eligible dividends are distributions to Canadian resident investors out of income subject to the general corporate income tax rate, i.e. generally, all dividends paid by public Canadian corporations. In addition, as a result of recent legislation concerning income trusts, eligible dividends may also include certain distributions from affected publicly traded flow-through entities (e.g. income trusts and partnerships) received after 2006 by Canadian residents.

The new dividend tax regime increased the dividend gross-up and the dividend tax credit percentages. (See the table at the end of this article for specific combined top tax rates by province). Dividends received which are not "eligible" dividends will remain subject to the prior 25% gross-up and 13⅓% federal credit mechanism.

As a result of planned reductions in the general corporate income tax rate, the 2008 federal budget introduced reductions to the gross-up and tax credit annually from 2010 to 2012 on eligible dividends, thereby increasing the effective tax rate on these dividends. In theory, the lower corporate tax rates should increase the amount of dividends paid out or lead to higher share valuations in these corporations, effectively offsetting the higher personal tax rates on eligible dividends that began in 2010. These recent changes are noteworthy in designing a tax-efficient investment strategy. For more information, please see our publication entitled *Eligible Dividends*.

The dividend tax credit reduces the overall tax rate and at low income levels, can completely eliminate the income tax on Canadian dividends. For 2011, the actual dividend received is grossed-up by 41% for eligible dividends. So, if you receive

a $100 eligible dividend, you will include $141 on your tax return and will receive a dividend tax credit that will reduce the actual income tax you pay on that dividend.

Tip

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

Federal Tax Payable on Canadian Eligible Dividends – 2011

Tax Rate	15%	22%	26%	29%
Dividend	$100	$100	$100	$100
Gross-Up	$41	$41	$41	$41
Taxable Dividend	$141	$141	$141	$141
Federal Tax	$21.15	$31.02	$36.66	$40.89
Less:				
Dividend Tax Credit	$23.17	$23.17	$23.17	$23.17
Net Federal Tax	$ nil	$7.85	$13.49	$17.72

Note: Excludes potential impact of federal Alternative Minimum Tax.

Interest Income vs. Eligible Dividend Income

You may want to earn dividend income because of the preferential tax treatment provided by eligible dividend income. The following table provides the 2011 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 $128,800 ($150,000 in Nova Scotia).

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 2011) to equate this after-tax interest income to the amount of after-tax income retained from earning an eligible dividend.

For example, in 2011 for an individual resident in PEI, eligible dividends are taxed at an effective top marginal rate of 27.33% whereas interest is taxed at the top individual rate of 47.37%. Accordingly, a PEI investor would have to earn approximately $1.3808 of interest for each $1 of eligible dividends to be in the same after-tax position, as follows:

- $1,380.80 interest income x .4737 = $654.08 tax which leaves $726.70 after tax (ie. $1,380.80 – $654.08)
- $1,000 eligible dividends x .2733 = $273.30 tax which leaves $726.70 after tax (ie. $1,000 – $273.30)

Interest Income vs. Eligible Dividend Income

	Top Marginal Tax Rates		
Province	**Interest & Ordinary Income***	**Eligible Canadian Dividends***	**Multiplier**
Alberta	39.00%	17.72%	1.3489
British Columbia	43.70%	23.91%	1.3515
Manitoba	46.40%	26.74%	1.3668
New Brunswick	43.30%	20.96%	1.3940
Newfoundland and Labrador	42.30%	20.96%	1.3698
Nova Scotia	50.00%	34.85%	1.3030
Ontario	46.41%	28.19%	1.3400
Prince Edward Island	47.37%	27.33%	1.3808
Quebec	48.22%	31.85%	1.3161
Saskatchewan	44.00%	23.36%	1.3686

* As of May 31, 2011

Stock Dividends

Not all dividends are received in the form of cash. Occasionally, corporations may choose to issue a stock dividend rather than a cash dividend. A stock dividend from a Canadian corporation is taxed as an ordinary dividend and is eligible for either dividend tax regime outlined above. The cost base for the shares received is the actual amount of the dividend, not the grossed-up amount. A stock dividend is not the same as a stock split which is not taxable. In a stock split you have proportionately more shares but your total cost base does not change.

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 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 income trust investments where the taxable capital gains realized by the funds 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 (eg. qualified small business corporation shares) may be offset by a lifetime capital gains exemption of up to $750,000.

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 (currently 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 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. For additional information on capital losses ask your Investment Advisor for our article titled *Understanding Capital Losses*.

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).

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. As a result of the enhanced dividend tax credit, the marginal tax rate on eligible dividends is now comparable to the rate on capital gains, both of which are lower than that of interest income. The following table 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*

Province	Interest at 5% after Tax Return	Equivalent Eligible Dividend	Equivalent Capital Gain
B.C.	2.82%	3.71%	3.61%
Alberta	3.05%	3.71%	3.79%
Saskatchewan	2.80%	3.65%	3.59%
Manitoba	2.68%	3.66%	3.49%
Ontario	2.68%	3.73%	3.49%
Quebec	2.59%	3.80%	3.41%
New Brunswick	2.84%	3.59%	3.62%
Nova Scotia	2.50%	3.84%	3.33%
P.E.I.	2.63%	3.62%	3.45%
Newfoundland	2.89%	3.66%	3.67%

* Based on top marginal tax rates for 2011 as of May 31, 2011.

Return of Capital

Income trusts may 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 trust's taxable income. A distribution in excess of the trust's taxable income is called a return of capital and is not considered taxable income.

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.

In addition to income trusts, many mutual funds designed to provide tax-efficient income may also pay distributions in the form of return of capital.

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 Nesbitt Burns Investment Advisor can work together to develop a tax efficient portfolio suitable for you.

Combined Federal and Provincial Top Marginal Tax Rates for Individuals – 2011

Province	Salary & Interest	Capital Gains	Non-Eligible Dividends	Eligible Dividends
BC	43.70%	21.85%	33.71%	23.91%
AB	39.00%	19.50%	27.71%	17.72%
SK	44.00%	22.00%	32.08%	23.36%
MB	46.40%	23.20%	39.15%	26.74%
ON	46.41%	23.20%	32.57%	28.19%
QC	48.22%	24.11%	36.35%	31.85%
NB	43.30%	21.65%	30.83%	20.96%
NS	50.00%	25.00%	36.21%	34.85%
PEI	47.37%	23.69%	41.17%	27.33%
NF	42.30%	21.15%	29.96%	20.96%
YK	42.40%	21.20%	30.41%	14.28% to 17.72
NWT	43.05%	21.53%	29.65%	21.31%
NU	40.50%	20.25%	28.96%	25.72%

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