Understanding how investment income is taxed

When investing outside of the tax-sheltered environment of an RRSP or RRIF, it is important to consider an investment's after tax rate of return in conjunction with your risk tolerance and investment goals. To reduce the tax paid on your investment income, you should consider investments that generate capital gains or Canadian source dividends as they are taxed more favourably than interest income.

Interest income earned from investments such as T-Bills, bonds, and GICs are generally taxed at the highest marginal tax rate. The marginal tax rate is the rate applied to each additional dollar of income you earn.

Dividends earned from a Canadian Corporation are taxed at a lower rate than interest income. This is because dividends are eligible for a dividend tax credit, which recognizes that the corporation has already paid tax on the income that is being distributed to shareholders. This however only applies to dividends from a Canadian corporation. Dividends paid from a foreign corporation are not eligible for the dividend tax credit.

In November 2005, the federal government proposed an enhancement to the dividend tax credit for dividends paid by large Canadian corporations. Assuming the proposal becomes law, the new dividend tax credit will reduce personal tax rates on dividend income earned in 2006.

The change involves an increase in the dividend gross-up from 125 percent to 145 percent, along with an increase in the federal credit from 13.333 percent to 19 percent. As illustrated in the table below, this change will reduce the current marginal tax rate on dividends for an investor in the top tax bracket from 31.34 percent to 20.89 percent. Moreover, if the provinces decide to follow suit and increase their respective dividend tax credits, the marginal rate would be reduced even further.

The proposed change was introduced in order to provide a more balanced tax treatment between corporations and income trusts. Currently income trusts are not taxed on any income allocated to the unit holder, whereas dividends paid by a Canadian corporation are paid out of after tax earnings. This had lead many businesses ventures to restructure as income trusts rather than as corporations.

Capital gains result when you sell an asset for more than you paid for it. This gain is offset by any losses and can be further reduced by any expenses that are incurred by the purchase or sale of the asset. The result is your net capital gain, however only 50 percent of that net gain is taxable at the appropriate federal and provincial rates.

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The table below illustrates the tax treatment on the different types of investment income, including the effect of the proposed change on $100 of dividend income.

	Interest	Capital Gains	Canadian Dividend current	Canadian Dividend proposed
Income earned	$100	$100	$100	$100
Inclusion rate	100%	50%	125%	145%
Taxable income	$100	$50	$125	$145
*Tax at 46.41%	46	23	58	67
Dividend tax credit			(27)	(46)
Net tax payable	46	23	31	21
Net cash after tax	$54	$77	$69	$79
Effective tax rate	**46.41%**	**23.21%**	**31.34%**	**20.89%**

* Ontario top marginal tax rate in 2005

In addition to earning tax effective investment income to minimize your tax liability, it is also important to implement appropriate tax deferral strategies. The best and simplest strategy available is contributing the maximum amount to your RRSP, which gives you an immediate tax deduction and tax sheltered growth as long as it remains in the plan. Other less commonly used strategies include:

Universal Life Insurance is a policy that combines life insurance coverage with a tax deferred investment component. Premiums paid are first used to insure life coverage and the balance accumulates in an investment account where it grows tax deferred.

Registered Education Savings Plan (RESPs) is a plan where contributions are used to fund a child or grandchild's post secondary education costs. The initial contributions are not tax deductible and any income earned within the plan is only taxable in the hands of the student at time of withdrawal.

With knowledge and resources throughout the Scotiabank Group, your ScotiaMcLeod advisor can work with you and your professional tax advisor to recommend and implement a tax-effective investment strategy that is right for you.

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