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Wealth Management

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Investor Insight

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Where You Hold Your Investments May Impact Your After-Tax Dollars!

While we may commonly associate “location” with real estate, for investors it may also be an important factor when it comes to choosing the type of account in which you hold your investments.

If you have multiple types of accounts such as non-registered, Registered Retirement Savings Plan (RRSP) and Tax-Free Savings Account (TFSA), remember that the same investment may be taxed very differently depending on the type of account in which it is held. This impacts the after-tax dollars that you have at your disposal.

Let’s look at it from an equity investment perspective. Equities within your investment portfolio can generate two types of income: dividends and capital gains. From a tax perspective, dividends received from Canadian corporations qualify for the dividend tax credit, resulting in an effective tax rate that is less than the tax on interest or other income.

However, dividends received from foreign corporations do not qualify for the dividend tax credit, and are therefore taxed in Canada at standard income tax rates. These dividends are also subject to foreign withholding tax, although this amount can potentially be claimed as a foreign tax credit to avoid double taxation. Only one-half of any realized capital gain is subject to tax, regardless of whether it is generated from a Canadian or foreign security.

Location is Important

For non-registered accounts, the lowest effective tax rate is on capital gains, followed by Canadian dividend income, and then foreign dividend income (except in provinces/territories where the effective tax rate on Canadian dividend income is less than the effective tax rate on capital gains).

Since any withdrawal from an RRSP account is subject to tax at standard rates, capital gains and Canadian dividend income may be taxed at significantly higher tax rates inside an RRSP. This depends on your marginal tax rate at the time of withdrawal and the amount of time that the income was able to grow tax-free within the plan.

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It may also be beneficial to hold foreign investments outside of an RRSP. Foreign stocks require special consideration when held inside an RRSP as the taxes withheld at source cannot be claimed on your personal income tax return as a foreign tax credit. Under the Canada-U.S. tax treaty, dividends on U.S. stocks held in an RRSP are exempt from withholding tax (not the case for a TFSA account), but for foreign shares outside the U.S., this may result in double taxation.

It may also be best to avoid holding foreign investments in a TFSA account. Foreign taxes withheld on non-Canadian stocks are a permanent cost as they cannot be claimed as a foreign tax credit. Therefore, capital gains and Canadian dividends are earned tax-free, while foreign dividends are taxed at the foreign withholding tax rate applicable in their jurisdiction.

All of this tax talk shows how important location can be when it comes to choosing the type of account that will hold certain types of equity investments. In many cases, this is applicable to mutual funds and other investments that you may hold. An investment advisor and tax accountant can help to determine the effective tax rates applicable to your situation so that you can make the best decision.

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