



Tax optimization for investment income

... or how to efficiently structure a portfolio

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These days, everyone agrees that the goal is to obtain the best possible return after fees and taxes. However, the proliferation of investment products and vehicles available to hold them in has made this task rather difficult. Provided that an investor's risk tolerance and investment horizon have been taken into account, it is possible to optimize the return of an overall portfolio by optimizing taxation on it as a whole.

Reminder of certain basic elements

Before even beginning an analysis to optimize the taxation of investment income, it is important to establish certain bases without which it will be difficult to draw the necessary conclusions.

First, taxation should not guide investment decisions. Although taxation is ubiquitous in the environment in which investors and their advisors are operating, taxation must remain a secondary factor for decisions, not the primary reason for them.

Next, to maximize the after-tax return of an investment portfolio, you first need to understand the nature of the investment income that various investments can generate, as well as their tax treatment when earned in a taxable environment. Portfolio investments are likely to generate the following income¹:

- ▶ Interest
Added to other income for the year when calculating net and taxable income.
- ▶ Income from foreign sources
Gross income added to other income for the year for calculating net and taxable income, while the amount received has generally been reduced through a foreign withholding tax levied at source. Canadian tax (including provincial tax) payable on the same income can be reduced through the Foreign Tax Credit (FTC).
- ▶ Dividends from taxable Canadian corporations
Various tax integration measures prevent the same dividends from being taxed multiple times when they transit through several taxable Canadian companies to the final beneficiary, the individual. An amount higher than the amount received is added to income for calculating net and taxable income. Tax reduction through dividend credits (federal and provincial). Lower tax burden for individuals than interest income.
- ▶ Capital gains (losses)
Half of the gain realized added to income for calculating net and taxable income.

The table below, from the 2020 Tax Planning guide published by accounting firm Raymond Chabot Grant Thornton, compares investor returns, taxed at the maximum marginal rate, in three Canadian provinces. It allows you to quickly view the less advantageous tax treatment applied to interest income.²

¹ For more details, see Info Advice Sheet 4.3.1.IC2 - The ABCs of Investment Income.

² Table from Raymond Chabot Grant Thornton's Tax Planning guide 2020, Section 7 - Investments, Investment Income Comparison.

Investment Income Comparison

A number of factors have to be considered when acquiring an investment, in particular the inherent risk as well as the individual's risk tolerance. The after-tax rate of return is still often a determining factor in this regard. The following table presents a comparison of pre-tax returns on various investment categories in 2020. These calculations are based on the maximum marginal tax rate. Thus, in Quebec, an eligible dividend of 3.12% before taxes is equal to a 4% interest return before taxes, for a net tax return of about 1.9% in both cases.

2020	Pre-tax interest rate of (%)	Provides the same after-tax return as		
		Capital gain	Eligible dividend	Other dividend
		at a pre-tax rate of: (%)		
Quebec	4	2.55	3.12	3.53
	5	3.18	3.90	4.42
	6	3.82	4.68	5.30
	7	4.46	5.46	6.18
Ontario	4	2.54	3.06	3.56
	5	3.17	3.83	4.45
	6	3.81	4.60	5.34
	7	4.44	5.36	6.22
New Brunswick	4	2.55	2.81	3.58
	5	3.18	3.51	4.47
	6	3.82	4.21	5.36
	7	4.46	4.92	6.26

This document is up to date as of September 3, 2020 and reflects the status of legislation, including proposed amendments at this date.

Next, investors may hold their investments in different vehicles that may have particular tax characteristics.

- Personal accounts that are not registered for tax purposes, such as bank accounts, margin accounts and cash accounts. All investment income is taxable in them as set out in tax legislation
- Tax-deferred plans, which include registered plans funded with pre-tax contributions to accumulate capital that can eventually be converted to retirement income (RRSPs, RRIFs, PRPPs, VRSPs, DC RPPs, IPPs and DPSPs), as well as Registered Disability Savings Plans (RDSPs) and Registered Education Savings Plans (RESPs).³
- Tax-Free Savings Accounts (TFSA). Accounts financed with after-tax contributions, but whose registration provides for non-taxation of investment income.
- Company accounts (unregistered by definition).⁴

Investment tax optimization requires that the tax treatment of different incomes be considered when selecting which vehicle to hold it in. Advisors must group all the client's accounts with the same time horizon and risk tolerance, establish the client's investor profile and distribute the investments between those accounts so that, together, they comply with the profile that has been established given the sought-after objective.

³ It is generally not possible to combine RESPs with a subscriber's other accounts to optimize investment taxation, since the beneficiary is another person.

⁴ For the tax characteristics of investment income earned by a corporation, see Info Advice Sheet 4.3.2.IC1 - Holding companies.

The purpose here is to take into account taxation to determine which of the client's vehicles is best suited to hold the previously selected investments. The content presented could also be useful in making a choice between two investments otherwise considered equivalent. It is also important to understand that the decision to invest in one vehicle over another, such as choosing to contribute to an RRSP rather than a TFSA, is also not being addressed here.

Registered plans

The tax assistance system for retirement savings includes several plans⁵ (or vehicles) that allow pre-tax capital to be saved each year for each worker, until it can be converted to retirement income. The best known are RRSPs, RRIFs and Registered Pension Plans (RPPs), commonly referred to as "pension funds." Investment income is not taxable as long as it remains in one of these plans. Both the capital and accumulated income will only be taxable when it is paid to the individual, ideally in retirement. This tax assistance is only available when the taxpayer has "earned income"⁶, primarily net employment, business or rental income. The total contributions to the different plans are limited based on these same incomes. When workers' contributions are less than the amount to which they are entitled, the unused portion remains available for subsequent years.

The Tax-Free Savings Account⁷ (TFSA) is more recent, having been introduced in 2009. Although they are new on the scene, they have become an essential financial planning tool for all Canadians and the cumulative amount of contribution room in 2021 is \$75,500.⁸ Annual contribution room is the same for all persons residing in Canada who are 18 years of age or older during the year. The account is funded with after-tax capital, but neither investment income nor withdrawals are taxable. What's more, unlike RRSPs, the amounts withdrawn in one year (including any accumulated return) are added to the next year's contribution room. As such, unless you make a withdrawal after suffering losses, withdrawals do not penalize investors with regard to their "tax-sheltered savings space." In this sense, they differ from RRSPs.

This vehicle is often used for short- and medium-term projects due to its great flexibility, but it is a very efficient accumulation tool for longer-term projects such as retirement planning.

Using an RRSP has the same effect as using a TFSA when the deduction rate is the same as the tax rate upon withdrawal.⁹ But choosing one or the other is not the goal here, so it is important to remember that there is a tax benefit to having the highest investment income earned in the TFSA rather than in the RRSP, but that negative returns also have a greater impact.

Corporations

Business income earned by a corporation is taxed at a fixed rate that is often lower than would apply to an individual if they earned it personally. However, this benefit is eliminated when the company pays its after-tax profits to shareholders who are individuals, who must be taxed on the dividends received. It is common for individuals to want to defer this second tax, so they keep the cash in the company and make investments. To reduce the attractiveness of such a strategy, Canadian-controlled private corporations (CCPCs) must pay a temporary tax on their investment

⁵ In this text, in the absence of a reference to the contrary, references to RRSPs must be understood to apply to all of the following registered plans: Registered Retirement Savings Plans (RRSPs), Registered Retirement Income Funds (RRIFs), Pooled Registered Pension Plans (PRPPs), Voluntary Retirement Savings Plans (VRSPs), Defined Contribution Registered Pension Plans (DC RPPs), Individual Pension Plans (IPPs), Deferred Profit Sharing Plans (DPSPs). Locked-in retirement accounts (LIRAs) and restricted and non-restricted locked-in retirement savings plans (RLSPs or LRSPs) are RRSPs and restricted or non-restricted Life Income Funds (RLIFs, LIFs), Locked-In Retirement Income Funds and prescribed RRIFs are RRIFs.

⁶ Section 146(1) ITA "Earned income"

⁷ For more information, see Info Advice Sheet 7.1.1.IC2_F Tax-Free Savings Accounts (TFSAs).

⁸ For individuals who turned 18 or older in 2009 and have been residents of Canada every year since.

⁹ IQPF Collection (ed. 2013; Rev. 2020), module 5, section 8.1.3, available online at www.solutioniqpf.org.

income in addition to the permanent tax. This tax is refunded to them when they pay taxable dividends to their shareholders. In order to discourage the accumulation of investments in companies, those that earn too much investment income experience a reduction in their active business income eligible for the small business deduction.

The dividends that the company receives from a Canadian public company can be paid to shareholders without a tax disadvantage because of the perfect tax integration for this type of income, regardless of whether the dividend is paid on a common share or preferred share. However, tax integration is not perfect for other investment income and often results in a tax disadvantage when the tax payable by shareholders on taxable dividends is taken into account, after income is paid in the form of a dividend.

Foreign investments¹⁰

When it is established that it is beneficial for an investor to include foreign securities in their portfolio, it is necessary to determine which of their accounts is most appropriate to hold them. Like interest income, dividends paid by a foreign corporation do not receive any special tax treatment in Canada, so they must be included in full in the individual's income. The specific tax treatment of dividends paid by Canadian corporations is intended to take into account the tax paid by the corporation in Canada, which does not apply to corporations that do not pay tax in Canada. You could therefore be tempted to conclude that it would be preferable to hold foreign shares in registered accounts. However, this is absolutely not true.

It is possible that taxes may be withheld at the source by payors residing outside Canada on the income paid to a resident of Canada. The withholding rate is determined by the source country's domestic legislation, and it can be reduced if a tax treaty between Canada and the payor's country of residence for tax purposes provides for it. This foreign tax entitles payors to the **Foreign Tax Credit (FTC)**, which is limited to Canadian tax payable on that income and, for income from property that is not rent earned by an individual, may not exceed 15% of foreign income.¹¹ The FTC may also not apply at all when income is not taxable in Canada, as is the case with investment income from registered accounts. It should be noted, however, that no tax is withheld on U.S. investments held in an RRSP.¹² An exemption is included in the tax treaty between the two countries.¹³ However, as soon as it is not possible to recover the foreign tax paid through the FTC, the return on the investment is reduced by the same amount, making it less attractive to investors.

Here is a table that summarizes the withholding tax that could be applicable to foreign source income and the possibility that it may be offset by the FTC.¹⁴

¹⁰ See the Foreign Investments and Deductions Info Advice Sheet (coming soon) for more details and for an example of calculating the Foreign Tax Credit (FTC).

¹¹ Subsection 126(7)b) "Non-business income" and Sec. 20(11) ITA

¹² Supra note 8.

¹³ [Sec. XXI\(2\) of the Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital.](#)

¹⁴ IQPF Collection (ed. 2013; Rev. 2020), Module 5, Section 4.4, adjusted to be consistent with how information is presented in this fact sheet. Available online at www.solutioniqpf.org.

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Taxpayer (CAN)	Registered account (RRSP¹⁵)	Registered account (TFSA, RESP, RDSP)	Non-registered account
U.S. equities directly	- No withholding	- Withholding (15%) - Can't be recovered via the FTC	- Withholding (15%) - Can be recovered via the FTC
U.S. equities via CAN mutual funds (CAN ETFs)	- Indirect U.S. tax (15%) - Can't be recovered via the FTC	- Indirect U.S. tax (15%) - Can't be recovered via the FTC	- Indirect U.S. tax (15%) - Can be recovered via the FTC
Foreign equities via CAN mutual funds	- Indirect foreign tax - Can't be recovered via the FTC	- Indirect foreign tax - Can't be recovered via the FTC	- Indirect foreign tax - Can be recovered via the FTC
U.S. equities via U.S. mutual funds (U.S. ETFs)	- No withholding	- Withholding (15%) - Can't be recovered via the FTC	- Withholding (15%) - Can be recovered via the FTC
Foreign equities via U.S. mutual funds	- Indirect foreign tax (can't be recovered via the FTC) - No U.S. withholding	- Indirect foreign tax (can't be recovered via the FTC) - U.S. withholding at source (can't be recovered via the FTC)	- Indirect foreign tax (can't be recovered via the FTC) - U.S. withholding at source (can be recovered via the FTC)
WARNING: Double withholding levels			
ADR	- Withholding (foreign domestic law) - Can't be recovered via the FTC	- Withholding (foreign domestic law) - Can't be recovered via the FTC	- Withholding (foreign domestic law) - Can be partially recovered via the FTC
MLP	- Withholding (35%) - Can't be recovered via the FTC	- Withholding (35%) - Can't be recovered via the FTC	- Withholding (35%) - Can be recovered via the FTC

- An American Depositary Receipt (ADR) is a security listed on a U.S. stock exchange, but that actually represents a predetermined number of shares in a foreign (non-U.S.) company. For administrative reasons, even if a tax treaty between Canada and the country of residence of the company whose shares are represented is in effect, the withholding in the United States generally does not take it into account and the withholding is higher. The overpayment does not entitle investors to the FTC.
- A Master Limited Partnership (MLP) is, in the United States, a publicly traded entity that is taxed as a partnership. Mainly used in the energy and natural resources sector, this type of vehicle combines the tax and legal benefits of a partnership with the access to capital offered by a public company.
- An ETF is an exchange-traded fund.

It should also be noted that foreign investment income earned by a CCPC and then redistributed to its shareholders will be taxed at a higher combined rate than if it had been personally earned by shareholders. Obtaining the FTC reduces the amount of Canadian tax that is refundable to the corporation when it pays a taxable dividend to its shareholders.¹⁶ Therefore, from a tax standpoint, it is better to avoid holding foreign securities in a company when it is possible to do so while complying with the investor profile.

We can see above that, apart from U.S. equities held directly or through a U.S. mutual fund in an RRSP, it is preferable to hold foreign securities in personal non-registered accounts.

Finally, whether through registered or non-registered accounts, direct ownership of U.S. securities by a Canadian resident who is neither a citizen nor a U.S. resident may subject their estate to U.S. estate taxes and, even if no taxes result, the estate may have an obligation to file a U.S. estate tax return after death.¹⁷ Holding these securities through

¹⁵ Supra note 8.

¹⁶ (French only) Mathieu Huot, "La surimposition des revenus étrangers dans une société de portefeuille. Voici comment l'expliquer." Conseiller, November 12, 2019: [https://www.conseiller.ca/archives/_magazine/la-surimposition-des-revenus-etrangers-dans-une-societe-de-portefeuille/ Voir la définition d'impôt en main remboursable au titre de dividendes non déterminés au par. 129\(4\) ITA](https://www.conseiller.ca/archives/_magazine/la-surimposition-des-revenus-etrangers-dans-une-societe-de-portefeuille/)

¹⁷ See Info Advice Sheet 8.1.5.IC3 U.S. Estate Taxes

a Canadian mutual fund or a corporation avoids this drawback, but is not suitable for an RRSP, as it is impossible to avoid withholding at the source.

Expected return

Debt securities are the main component of fixed-income securities. Since these securities generate mostly interest income, it is generally accepted that it is preferable to invest them in a registered account (RRSP or TFSA) rather than in a taxable environment. However, we are experiencing the lowest interest rates in the past 100 years and the gap between long-term return expectations of fixed income and growth securities (mainly equities) is particularly large. It is therefore relevant to consider whether this discrepancy is sufficient to justify holding the interest-generating securities in a non-registered account and the securities generating capital gains and dividends in registered accounts (TFSA and RRSP). Of course, management fees reduce the investor's return, so any difference in fees between asset classes should be part of the analysis.

A fundamental difference between RRSPs and TFSAs is that withdrawals from the former are taxable, while those from the latter are not. Therefore, with the exception of foreign equities, it is preferable to hold investments with the highest expected returns after fees in a TFSA rather than in an RRSP.

Also, in addition to a 50% income inclusion rate, the fact that capital gains become taxable only when they are realized makes equities attractive for investments made in a taxable environment. Indeed, investors who select their stocks with a long-term perspective and are not concerned about short-term market fluctuations benefit from a measure of tax deferral. However, the different asset classes do not fluctuate at the same rate or in the same direction, so it is necessary to rebalance portfolios periodically to maintain the investor profile. Therefore, even patient investors will have to sell securities from time to time.

In addition, a sound analysis should take into account the current marginal tax rate and the tax rate that could apply when funds are withdrawn from an RRSP, which will be higher the more the RRSP is worth.

There are many possible situations, which can lead us to some interesting scenarios about how to optimize the end result. Accordingly, although a custom assessment may conclude differently, the basic rule of holding interest-generating securities in registered accounts remains relevant.

Important tax characteristics of certain investments¹⁸

Beyond the traditional distinction between fixed-income and growth securities, some investments have their own characteristics that may influence the choice of the best vehicle to hold them.

Shares of a mutual fund corporation may only distribute taxable Canadian corporate dividends and capital gains. As a result, holding them in a non-registered account or in a company's account is preferable.

Bonds should never be **purchased with a premium** in a non-registered account. Premium bonds pay higher interest income than the market, which is offset by a capital loss when the bond matures. This results in a larger income inclusion than the return obtained, even if the holder is able to use the deductible portion of the capital loss to reduce a taxable capital gain on another asset.

Debt securities maturing in more than one year with returns paid only at maturity. Accrued interest must be included annually, although no cash flow will be collected before maturity, which can cause liquidity issues. Some examples of investments that should be held in a registered account:

- Compound-interest GICs

¹⁸ Taxation conditions for these investments are presented in Info Advice Sheet 4.3.1.IC2 - The ABCs of Investment Income.

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- Index-linked GICs or stock index-linked notes
- Detached-coupon bonds (principal or coupon)

Bonds acquired at a discount on the secondary market could be held in a non-registered account, since a portion of the income would take the form of capital gains.

Guidelines

The first thing to do is to determine the investor profile of the portfolio taking into account all relevant elements, including investment horizon and risk tolerance. These latter parameters may vary depending on the client's various plans, so it is necessary to group accounts that share the same time horizon and the same risk tolerance together in order to be able to distribute the selected investments between them. Here are some guidelines to help you optimize the tax treatment of each portfolio.

- ❑ Prioritize RRSPs for securities that generate Canadian-source interest income.
- ❑ Prioritize personal non-registered accounts for foreign (U.S. and international) equities. When this is not possible, prioritize directly holding U.S. securities in RRSPs and avoid Canadian mutual funds that invest in U.S. securities. Avoid including foreign equities in a company's portfolio or a TFSA.
- ❑ Prioritize the holding company account, TFSA or non-registered account for Canadian equities, including preferred shares.
- ❑ Individuals without U.S. citizenship or residency should avoid holding U.S. securities directly because they could potentially be subject to U.S. estate tax or the requirement to file an estate tax return in the United States. This obligation can be avoided when all assets located in the United States, including portfolio investments in registered and non-registered personal accounts, do not exceed USD 60,000.¹⁹

In closing, selling investments in a non-registered account or in a company's account leads to capital gains, which can be unnecessarily costly. Similarly, a capital loss could be characterized as a "superficial loss" if the same security is acquired in another account belonging to the same client or to an affiliated entity, such as their spouse or a company they control. This loss would only be recognized upon the final sale of the security in question or never, when the security is redeemed in a registered plan.

Conclusion

As the name suggests, this information is intended to be a guide and not a recipe that applies in all circumstances. Each situation is unique and several variables, whether human, financial or fiscal, can influence the optimal distribution of investments between accounts for a given investor. However, by considering these guidelines, advisors can provide the assistance investors need to improve the total return on their portfolio by minimizing the negative impact of taxation.

¹⁹ French only - Vanier, Carole, "Droits successoraux américains - Quand s'en préoccuper?" *Stratège*, vol. 25, 3 2020, APFF.

"Did you know that..."

This advice applies to investors who use multiple tax vehicles to hold their investments. In general, RRSP and TFSA contribution room should be fully utilized before investing in a non-registered account. Sound portfolio management also requires reducing management and administrative costs where possible, as they eat away at a portion of the return.

Ensuring tax optimization of an existing portfolio can result in a large volume of transactions that may result in taxable capital gains or non-deductible capital losses because they are deemed superficial losses. Caution is therefore required and strategies should be implemented gradually.

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