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WealthWisdom

The Taxation of Investments: A Primer

Dale Gagnon

Senior Wealth Advisor,
Senior Investment Advisor
613.788.2188
Dale.Gagnon@raymondjames.ca

Emily Gray

Client Service Specialist
613.788.2189
Emily.Gray@raymondjames.ca

Tax efficiency is a critical factor in building wealth for investors. Minimizing the amount of taxes you pay can significantly enhance total investment returns over time. (See chart – inset.)

As a start, understanding how investments are taxed is important since not all investment income is taxed the same way. Equally important is understanding how the location of your investments – the accounts in which they are held – can affect your overall tax bill. Here are some reminders:

How Is Investment Income Taxed?

Your investments generate various types of income, including interest, dividends and capital gains. Each may be subject to differing tax treatment. Here is an overview of the more common types of investment income and the way each is taxed, based on an individual who owns the investment within a non-registered account:

Interest Income – This is income earned from interest-producing bank accounts and fixed-income investments, such as guaranteed investment certificates (GICs), government Treasury bills, bonds and fixed-income mutual funds/exchange-traded funds (ETFs). Interest income is taxed as ordinary income, fully taxable at your marginal rate, making it one of the highest-taxed (or least tax-efficient) types of investment income. Generally, interest income is taxable annually as earned, even if it is not actually received.

Dividends – Corporations pay dividends to their shareholders, often as a share of profits, from their after-tax earnings. From a tax perspective, dividends are taxed differently depending on their source, as follows:

From Canadian Corporations – Canadian dividend distributions are designated as either "eligible" or "non-eligible" dividends. These dividends are included in income at a grossed-up rate but then qualify for the dividend tax credit, which reduces the taxes you pay. Eligible dividends – typically those received from larger publicly-traded Canadian corporations – qualify for an enhanced tax credit. Non-eligible dividends are typically received from Canadian private corporations that are small businesses paying corporate tax at a lesser rate. In general, Canadian dividend income receives preferential tax treatment compared to interest income. However, because the grossed-up amount will be reported on a tax return, it can potentially impact income-tested government benefits, like Old Age Security.

- **From Foreign Corporations –** Dividends from non-Canadian corporations are fully taxable at your marginal rate and do not qualify for a dividend tax credit. In addition, these dividends are usually subject to foreign withholding taxes at source. A foreign tax credit may be available to reduce the taxes payable.

Capital Gains – When a capital asset, such as an equity investment, is sold for more than its adjusted cost base (ACB), generally the cost of the property plus any expenses to acquire it, the profit from the sale is considered a capital gain when it is realized. Since the year 2000, one-half of a capital gain (50 percent) has been included in computing a taxpayer's income. This is referred to as the capital gains inclusion rate. In 2024, the federal government announced an increase in the capital gains inclusion rate from one-half to two-thirds for corporations and trusts, and from one-half to two-thirds on the portion of capital gains realized in the year that exceed $250,000 for individuals.[1]

When comparing how investment income is taxed, in general, dividends from Canadian corporations and capital gains receive preferential tax treatment relative to interest income.

The Tax Treatment of Mutual Funds and ETFs

There may be additional considerations for the tax treatment of mutual funds and ETFs. In general, when held in non-registered accounts, two situations require you to report information on an annual tax return: i) when a fund makes a distribution, and ii) when you dispose of some or all of your holdings in the fund.

Distributions – A distribution represents the earnings of a fund being passed onto the investor or unitholder of the fund. Distributions are taxed based on the type of distribution (dividends, interest, capital gains, etc.). This distribution is taxable to you whether you receive the distribution in cash or reinvest it in additional units. However, if you do reinvest the distribution, the amount of the reinvested distribution is also added to the ACB of your investment.

Return of Capital (ROC) – A return of capital may be reported as a distribution from a fund and represents a return of your original investment. This generally occurs when the amount distributed by the fund exceeds the fund's earnings (income, dividends and capital gains). A ROC is not considered income and is non-taxable, but generally reduces the price paid for the fund (the ACB, so long as the ACB is positive).

It is important to keep records of any changes to the fund's ACB as a result of reinvested distributions and ROC. When the fund is eventually sold, it must be reported on your tax return and any capital gain or loss resulting from the disposition will be based on the ACB of your holdings.

Location Matters: Non-Registered vs. Registered Accounts

While different types of investment income may be subject to different tax treatment, as described above for a non-registered account, how this affects your overall tax bill may also depend on where these investments are held.

In general, if you hold investments in a registered account, such as the RRSP or TFSA, any income received or growth within the account will not be subject to

NOTES:

1. At the time of writing, the bill to enact legislation has not achieved royal assent.
2. Under this treaty, there is an exemption from U.S. withholding tax on interest and dividend income earned from U.S. investments through a trust set up exclusively to provide retirement income. This includes RRSPs, RRIFs, PRRIFs, LIRAs, LIFs and LRIFs. However, it does not include RESPs, TFSAs and RDSPs.

Canadian taxes. However, the tax treatment for contributions to or withdrawals from each account varies based on the type of account. For example:

Registered Retirement Savings Plan (RRSP) – Provides a tax deduction for funds contributed to the plan. Any income or dividends earned or growth realized within the plan is not subject to Canadian tax. However, any withdrawals from the plan are taxable on the full withdrawal amount at your marginal tax rate.

Tax-Free Savings Account (TFSA) – Contributions to a TFSA are not deductible for income tax purposes, but any withdrawals from the plan are not subject to tax. Any income or dividends earned or growth realized within the plan is not subject to Canadian tax.

In addition, foreign securities require special consideration when held within registered plans, particularly as it relates to dividend-paying securities. Foreign taxes withheld at source on foreign dividends cannot be claimed on your personal tax return for the foreign tax credit. However, for the RRSP, under a Canada-U.S. tax treaty, there is an exemption from U.S. withholding tax on interest and dividend income earned in the RRSP; yet, this does not apply to the TFSA.2 As such, holding U.S. dividend-paying stocks in the TFSA will generally incur a 15 percent withholding tax on the dividend when received. Therefore, for tax purposes, it is generally better to hold U.S. dividend-paying investments in the RRSP rather than the TFSA. For other foreign securities, it may be better to hold these securities outside of registered accounts if taxes are imposed on the income received, in order to claim any foreign tax credit.

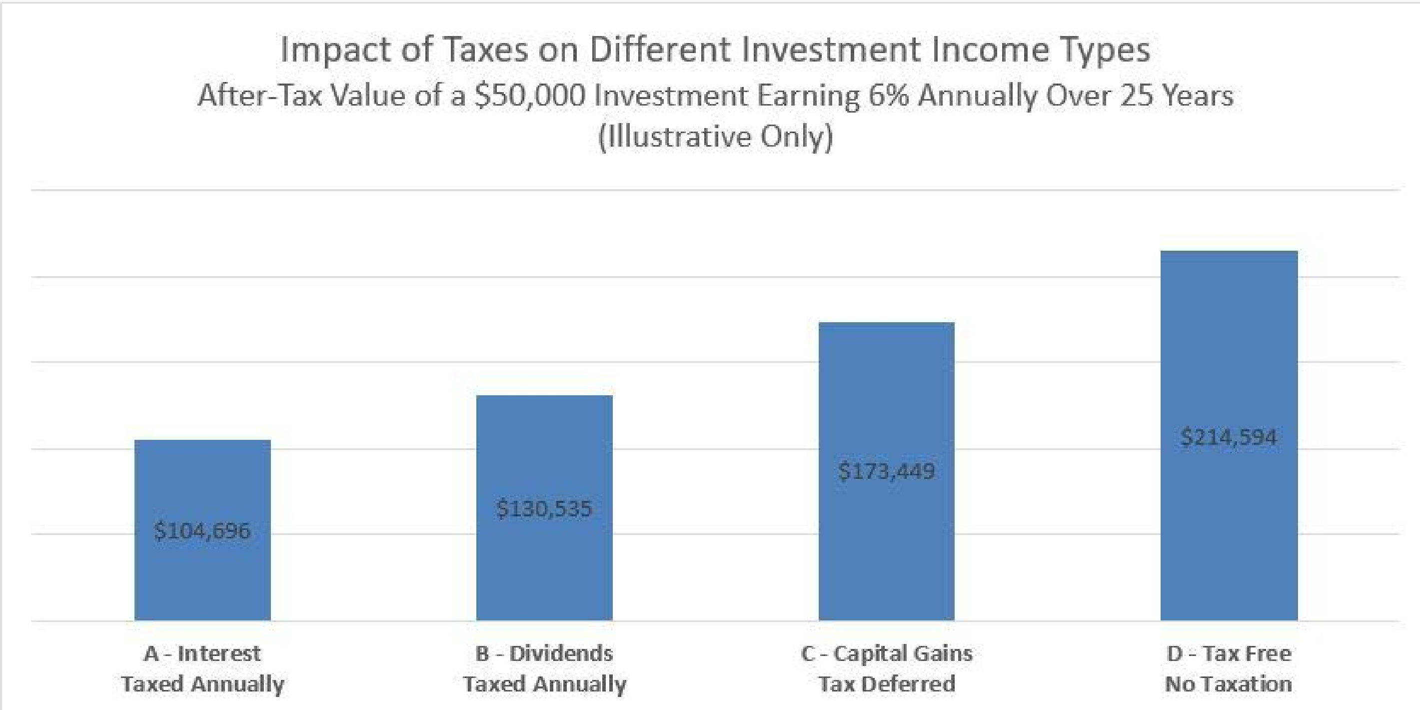
The Bottom Line

Tax efficiency is a key consideration in maximizing investment returns over time. The overall tax efficiency of your portfolio is impacted by the types of investments you own and where you hold these investments – in registered or non-registered plans. Keep in mind that the rates, levels and bases of taxation, both in Canada and abroad, can change over time. As you look to optimize your after-tax returns, there are other considerations – including the appropriate mix of asset types based on your investment objectives, your income needs, your investment time horizon and when you expect to withdraw funds. This is where we at Raymond James can provide assistance, providing perspectives on tax-efficient investing opportunities relating to your investment portfolio. For help with understanding how certain investments are taxed or for a review of investment asset location, please get in touch.

This article is intended to provide a general overview of investment taxation and should not be considered as tax or investment advice. As always, please seek the support of a tax advisor based on your situation.

Not All Income Is Taxed the Same – The Impact on After-Tax Returns Over Time

The chart illustrates the impact that different tax rates can have on capital accumulation over time. Four investors each invest $50,000 and earn 6% annually on different types of income, compounded over 25 years. Investors A and B pay tax each year, at different rates based on the type of income earned: interest and dividends from eligible Canadian corporations. Investor C pays no annual tax, but will pay tax at the end of year 25 when capital gains are realized. Investor D invests in a Tax-Free Savings Account (TFSA) so no taxes will apply. After 25 years, the after-tax difference is significant.



Notes: Assumes 6% compounded annual growth over 25 years. Tax rates are based on the average of 2024 combined federal, provincial and territorial marginal tax rates for an individual with $250,000 of ordinary income, eligible dividends or capital gains: 50.00%, 34.78% and 25.00%, respectively.

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