business meeting

TAXATION OF INVESTMENT INCOME

Taxpayers who are looking for a place to invest income or savings, whether within a registered plan or outside of one, are faced with a bewildering array of options from which to choose. As well, new and often increasingly complex investment vehicles seem to be offered in the marketplace on an almost daily basis.

It isn't often that the tax aspects of a transaction are the easiest part, but the basic tax rules with respect to investment income can actually be relatively straightforward. While variations within each category abound, most investment income (except in certain specialized industries) can be characterized as falling into one of three categories of income — interest, dividends, or capital gains. This article summarizes the basic tax rules that govern each type of income.

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An important caveat: it's an old tax truism, but still a valid one, that tax considerations alone should never drive an investment decision. While the tax treatment of income (or losses) arising from an investment can and should figure into the decision of whether and how much to invest, those considerations should always be secondary to the perceived worth of the investment, independent of any tax consequences.

All investment income, from all sources, is taxable. That said, some types of investment income may provide a better after-tax return than others, through lower inclusion rates, special credits, or other beneficial tax treatment.

Interest income

Of the three basic types of investment income, interest is by far the most straightforward, but also the least tax-advantageous, as no special tax treatment attaches to such income.

Interest, in a legal sense, is simply compensation paid for the use of borrowed funds. For most taxpayers, such interest income will be earned on funds deposited in bank accounts, on guaranteed investment certificates (GICs), and perhaps on purchases of Canada Savings Bonds, or their provincial equivalents, or on corporate bonds. It is important to note that all interest income, no matter how small the amount, is taxable, and must be reported on the annual tax return. There's a common misperception that interest income need be reported only where a T5 information slip has been issued in respect of that income. That's not the case; although a payor must issue a T5 only where the amount of interest paid during a particular tax year is $50 or greater, any amount of interest paid or received must be reported. The onus is on the taxpayer to keep track of interest received and to include all such amounts on the annual tax return. Interest income earned is reported on line 121 of that return.

When interest income must be reported

Generally speaking, all interest received or earned must be reported annually. For interest earned on bank accounts, GICs with a term of one year or less, and regular interest bonds, the computation of interest earned will not pose a problem. Where the interest paid for the year is $50 or more, a T5 slip will be issued by the payor, and the interest payment for the year will be indicated on that T5. Where interest is earned on GICs having a term of more than 12 months or on compound interest bonds, the holder of the GIC or bond must still report and pay tax on the "notional" amount of interest paid for the year, as in the following simplified examples.

> *On January 1, 2010, John buys a $1,000, three-year GIC that pays interest at a rate of 5% per year, compounded annually, with all interest paid at maturity. On his 2010 tax return (with a filing due date of April 30, 2011), John must report and pay tax on $50 of interest income (5% of $1,000), despite the fact that he has not actually received any interest payments from the issuer of the GIC.*

Of course, it's usually the case that investments are made at different times throughout the year, and interest that accrued but that was not paid on such investments is reported for the taxation year during which the anniversary date falls. For example, a taxpayer who makes a long-term investment on June 1, 2009, will report on his or her return for 2010 the interest that accumulated to the end of May 2010, whether or not a T5 slip is received. Similarly, interest earned from June 2009 to May 2010 will be reported on the taxpayer's 2010 return.

Like most tax rules, the rules governing the treatment of interest income have changed and evolved through the years. The annual reporting requirement outlined above applies generally to investments made after 1989. The minority of taxpayers still earning interest income on investments made before that date can obtain information on how to report such income on the Canada Revenue Agency (CRA) Web site at www.cra-arc.gc.ca/E/pub/tp/it396r/it396r-e.html.

Foreign-source interest income

Most interest income earned by Canadians likely still arises from Canadian sources. However, the availability of Internet-based banking and investing means that investors can easily seek out the best returns, regardless of national boundaries. Consequently, funds can easily be invested offshore, and interest on those funds paid from foreign sources. The general rule in Canadian tax is that Canadian taxpayers are taxable on their worldwide income, and interest income is no exception to that rule. The CRA expects all interest

income to be reported on the annual tax return, in Canadian dollars. Where interest is denominated in a foreign currency, it's up to the taxpayer to make the conversion to Canadian funds. Technically, the conversion to Canadian dollars is to be made using the exchange rate in effect on the day the interest is received, but the CRA is prepared to be somewhat flexible in this regard. While the actual conversion rate for the day of receipt can be obtained from the Bank of Canada Web site at www.bankofcanada.ca/en/rates/exchform.html, the CRA will also accept conversions done at the average annual exchange rate for the year for the currency in question (also available on the Bank of Canada Web site at http://www.bankofcanada.ca/en/rates/exchange_avg_pdf.html), as any difference is likely to be minimal. There is one restriction: a taxpayer who adopts a particular method, whether day-of-receipt or annual average, must use that method on a consistent basis from year to year. Switching from one method to the other to obtain the best result isn't allowed.

Joint accounts

Very often, bank accounts, or even bonds and GICs, are held jointly by two or more taxpayers — perhaps a husband and wife or an elderly parent and adult child — and the question arises regarding how interest income from joint holdings should be reported and, especially, how to avoid double reporting of such income. The rule in such cases — a rule that is more easily applied in theory than in practice — is that the interest income is to be reported in the same proportions as the original contribution to the investment. So, in the simplest of cases, where a husband and wife each contributed exactly one-half of the balance in a bank account, each would be required to report and pay tax on 50% of the interest paid or accrued during the year on that balance. Of course, the bank will not be tracking deposits to determine who contributed what; it will simply issue a T5 slip for the full amount of interest earned. The practical solution is for each spouse to report his or her share of that interest income, perhaps with a note explaining the breakdown of such interest as between joint account holders. In other cases — typically, the case of an elderly parent and adult child — the account is actually that of the parent, and funds in the account are entirely those of the parent, with the adult child added as a joint account holder only for administrative purposes — usually to allow him or her to carry out banking transactions on the elderly parent's behalf. In such cases, only the parent would report and pay tax on any interest income accrued in the account.

Tax rates applied to interest income

Interest income is accorded the least favourable tax treatment of any of the three major types of investment income, as it benefits neither from special credits nor from reduced inclusion rates. As with all types of income, the marginal rate applicable to interest income will vary according to the recipient's income and province or territory of residence. That said, a taxpayer having taxable income sufficient to put him or her in the highest tax bracket (that is, over about $127,000 for 2008) will pay tax on interest income at rates ranging from about 39% to 48%.

Dividend income

While not quite as common as interest income, income in the form of dividends is received each year by millions of Canadian taxpayers. Such income simply represents a share of the after-tax profits of a corporation distributed to the corporation's shareholders. Dividend income can, in many cases, receive preferential tax treatment. Like regular interest payments, dividends are reported on the tax return for the year in which they are received and will be summarized on a T5 provided to the shareholder by the company issuing the dividend. Shareholders may hold either common or preferred shares of the company, and dividends declared on either kind of shares are treated identically for tax purposes.

What does differ, however, is the treatment of dividends received from Canadian, as distinct from non-Canadian, companies. Dividends received from non-Canadian companies (foreign-source dividends) are simply converted by the shareholder recipient into Canadian dollars (at the exchange rate in effect when the dividend was received) and that Canadian dollar amount is reported on the shareholder's tax return for the year at line 121.

Where the dividend has been issued by a Canadian company, much different and better tax treatment results, through a mechanism known as the "dividend gross-up and tax credit". Although the details of that credit can be convoluted, its purpose is straightforward. Corporations pay tax on income as it is earned. When such income is paid out to the corporation's shareholders in the form of dividends, the money paid out is after-tax income — that is, income on which tax has already been paid by the corporation. The dividend gross-up and tax credit is the means by which our tax system tries to ensure that credit is given at the shareholder level for tax already paid by the corporation on income subsequently distributed as shareholder dividends. Ideally, the total amount of tax paid on income from which a corporate dividend is paid should be same as that which would have been paid by the shareholder if the income had been earned directly.

Complicating matters further, the calculation of the dividend tax credit and gross-up will differ, depending on the rate of tax paid by the corporation on the distributed income. Dividends (known as eligible dividends) paid from income taxed at the higher "general" corporate rate get greater credit at the shareholder level than those (ineligible dividends) paid from income which was taxed to the corporation at the lower small business rate.

Fortunately for the shareholder/taxpayer, the details of what constitutes an eligible as opposed to an ineligible dividend and the intricacies of calculating the dividend tax credit in each case are largely a matter of concern only to professional tax practitioners and the tax authorities. For the shareholder, all of the necessary characterizations and computations have been done, and the required information summarized on a T5 information slip. The income tax return guide provided by the CRA will then guide the taxpayer on how to transfer the information found on the T5 to the tax return form. Alternatively, the taxpayer can consult the online version of the guide on the CRA Web site at www.cra-arc.gc.ca/tax/individuals/topics/income-tax/return/completing/reporting-income/menu-e.html and www.cra-arc.gc.ca/tax/individuals/topics/income-tax/return/completing/deductions/lines409-485/425-e.html.

Dividend tax rates

Because of differences in provincial tax rates, there is a great deal of variation in the tax rate applied to dividends. However, for taxpayers in the highest income bracket (i.e., those having taxable income of about $136,270 or more in 2014), it is generally the case that eligible dividends will be taxed at between 19% and 35%, while ineligible dividends will be taxed at rates ranging from 29% to 41%.

Capital gains and losses

A capital gain or loss is, at its most basic, simply the difference between the amount received

on the sale of an asset and the amount paid for that asset when it was originally acquired. Under Canadian tax law, only one-half of that amount (referred to as a "taxable capital gain") is required to be included in income.

For example, Shareholder A, who purchased shares for $1,000 and sold them one year later for $1,500, has generated a capital gain of $500. Since only one-half of the capital gain is required to be included in income, the taxable capital gain (and therefore the amount to be included in income) is actually $250.

The taxable capital gain, once included in income, is treated as "regular" income and taxed at the taxpayer's usual tax rate. However, because only one-half of the gain has been included in income, capital gains are effectively taxed at 50% of the rate that would have applied, for instance, to salary or interest income.

Where a loss is sustained on the sale of an asset, the resulting capital loss is similarly reduced by one-half, as follows:

If the shareholder in the above example sold his or her shares for $800, then a capital loss of $200 ($1,000 - $800) would result. One-half of that amount, or $100, represents the "allowable capital loss" arising from the transaction.

Where a taxpayer has incurred a capital loss, that loss can be deducted in the computation of income for the year, but only against taxable capital gains earned during the year, and not against any either kind of income (i.e., salary or interest income).

Let's say Shareholder A undertook two share-sale transactions during 2010. The first sale generated a capital gain of $1,000 and a taxable capital gain of $500. The second sale, however, resulted in a loss of $200 and, therefore, an allowable capital loss of $100. In calculating income for the year, the taxpayer can deduct the $100 allowable capital loss from the $500 in taxable capital gains, giving him or her $400 in net capital gains for the year. That amount is then reported on the tax return for 2010 at line 127.

While allowable capital losses incurred in a particular tax year may only be deducted against taxable capital gains earned in that year, taxpayers who incur "excess" losses may carry over those losses and claim them in the same way in any of the three previous taxation years or in any subsequent taxation year.

Capital gains exemption/special treatment

From 1985 to 1994, all individual Canadian residents were eligible for a lifetime capital gains exemption of up to $100,000. That exemption was eliminated in 1994, but a similar exemption for capital gains earned in relation to the disposition of shares of small business corporations and qualifying farm property was retained.

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Time Frame

As is the case in other areas of the Canadian tax system, investments in such entities remain eligible for more favourable tax treatment in a number of ways.

Every Canadian taxpayer is allowed to claim a tax exemption on up to $800,000 for 2014 (the former limit was $750,000) in capital gains earned on qualifying small business corporation shares. A similar exemption is available with respect to capital gains earned on the sale of qualifying farming and fishing property. However, it should be noted that the lifetime limit of $800,000 applies to total gains earned on all such qualifying property, both small business and farming and fishing. The rules governing the types of property that qualify for the exemption and the mechanics of claiming the exemption are exceptionally complex, and professional tax advice should be sought by anyone seeking to take advantage of these rules.

Taxpayers who incur losses on dispositions of shares of a small business corporation may also benefit from beneficial tax treatment. Such losses are characterized as "business investment losses", and one-half of such losses, known as "allowable business investment losses", can, unlike regular capital losses, be deducted from ordinary income, such as income from employment or investment income. The definition of what constitutes a small business corporation for this purpose is complex, as such corporations must satisfy tests involving corporate residence, corporate control, and, most important, the nature of the corporation's business. Once again, taxpayers who believe that they have incurred capital losses which might qualify as business investment losses should seek professional tax advice.

Capital gains tax rates

As is the case with dividends, there is a good deal of variation in the tax rates applied to capital gains, owing to differences in provincial tax rates. However, in the case of capital gains, the top marginal rate can be easily calculated as one-half of the rate that would apply to salary or interest income received by the same taxpayer, as a result of the one-half inclusion rate. Consequently, for 2008, the top marginal rate applied to capital gains income would range from about 19% to 25%, depending on the taxpayer's province or territory of residence.

Sheltering investment income from tax

An announcement made in the 2008 federal Budget will give Canadians an unprecedented opportunity to make investments and earn investment income on a tax-free basis. While Canadians can currently invest funds in tax-deferred savings vehicles — Registered Retirement Savings Plans and Registered Education Savings Plans being the best known — any investment income earned within such plans is eventually taxed on withdrawal. Such is not the case with the Tax-Free Savings Accounts (TFSAs).

Beginning in 2013, each Canadian resident over the age of 17 is eligible to invest $5,500 ($5,000 prior to 2013) per year in a TFSA, and investment income of any type earned in such accounts will be tax-free, both on a current basis and on withdrawal. Where (tax-free) withdrawals are made from a TFSA, the account holder will be permitted to re-contribute the amount withdrawn, either in the current year or any future year. As well, where contributions are not made in any year, or less than the maximum contribution is made, any unused contribution room is carried forward indefinitely.

While the $5,500 amount which may be contributed to a TFSA each year may be relatively small, the ability of contributed funds to compound on a tax-free basis within the account creates the potential for significant capital accumulation over the long term.

Conclusion

It is apparent from the foregoing that the nature of an investment can have a significant impact on the after-tax return enjoyed by the investor, owing to the different tax treatment accorded different types of investment income (or, less optimistically, investment losses). However, the caveat outlined at the beginning of this article bears repeating: no investment should be undertaken or refused solely, or even primarily, because of the perceived tax benefits; it is the value of the underlying investment that should in all cases drive the investment decision.

A further caveat: at any given time, there are investment vehicles being promoted in the marketplace that purport to offer extraordinarily beneficial tax treatment and, thus, a significantly better after-tax return. However, the Canadian tax net is a comprehensive one, and offers that seem too good to be true generally are. In all cases, professional investment and tax advice are warranted where significant investment decisions are being weighed.