Manulife

Taxation of Investments 101

It's no secret that Canadians pay a lot of tax. However, understanding how we are taxed can help us minimize the tax we have to pay.

In Canada, we have a progressive tax system whereby individuals are taxed according to the level of their taxable income. As taxable income increases, we are taxed at a higher rate, up to a point. Each increment of taxable income that is taxed at a specific rate is referred to as a marginal tax bracket.

Tax rates vary by province and different types of income are included in taxable income at different rates. Salaries and professional income, for example, are fully taxed at your marginal tax rate while Canadian dividend income and capital gains receive preferential tax treatment.

YOUR MARGINAL TAX RATE

Your marginal tax rate is the tax rate applicable to the next dollar of taxable income you earn. Knowing your marginal tax rate is important for minimizing the tax you pay on additional income. See the *Tax Rate Card (MK2418)* for the latest marginal tax rates available by province.

UNDERSTANDING HOW YOUR INVESTMENT INCOME IS TAXED

One of your considerations when buying investments should be the amount of taxes you will pay on income from these investments[1].

The types of income you could earn from your investments, includes interest, dividends, foreign income and capital gains and losses.

Interest income from Canadian sources is fully taxable at your marginal tax rate making it one of the highest taxed types of income. Interest income is earned from bank accounts and from fixed-income investments, such as Canada Savings Bonds, guaranteed interest contracts (GICs), and government Treasury bills (T-bills) as well as allocations or distributions received from segregated fund contracts or mutual funds that you own.

Dividends are distributions paid by corporations to their shareholders from after-tax earnings. You may also receive allocations or distributions of dividends from the segregated fund contracts or mutual funds that you own if the funds own shares of Canadian corporations that pay dividends.

Compared to interest income, Canadian dividend income gets preferential tax treatment through the gross-up and dividend tax credit mechanism. The grossed-up amount is included on your tax return but the tax you pay is reduced by the dividend tax credit.

Dividends from Canadian corporations are reported as either "eligible" or "non-eligible" dividends. Eligible dividends typically will be received from larger publicly traded corporations in Canada and are grossed-up so that 138 percent of the dividend is included in taxable income. Non-eligible dividends generally would be received as a distribution of corporate income that has been taxed at lower corporate rates, such

[1] Information in this document provides an overview of the taxation of personally owned non-registered investments. Income from registered plans is generally either fully taxable at your marginal tax rate when received (from deferred plans such as RRSP, RRIF, RPP, or DPSP) or is not taxable (from a TFSA).

as income from a corporation entitled to the small business deduction. Non-eligible dividends are grossed-up so that 117 percent of the dividend is included in income.

Because the grossed up amount is reported on the tax return, it can be the least income friendly for Canadians who qualify for valuable government benefits such as Old Age Security and the Age Credit.[2] If the income reported on one's tax return is too high, these benefits can be clawed back, or forfeited altogether. For more information on how to reduce the clawback of these benefits, see *Tax Managed Strategy 2 - Fight the Clawbacks -- Reduce Line 234 (MK1379).*

Capital gains arise when you sell a capital asset for more than its adjusted cost base (ACB). The increase in value is a capital gain, and 50 per cent of the gain (called the taxable capital gain) is included in your taxable income. A capital loss arises when you sell a capital asset for less than its ACB.

Your ACB is the amount of your investment that has already been taxed. It begins as the original purchase price, but subsequent events such as purchases, allocations or distributions and elections will impact your ACB. For further information see, *An investor's adjusted cost base: a moving target (MK2434)*.

There are two types of capital gains and losses: realized and unrealized. An unrealized capital gain or loss consists of the accrued gain or loss on an asset before the asset is sold or deemed to be sold. A realized capital gain or capital loss generally results when the asset is actually sold or is deemed to be sold, as is the case on death.

Foreign income consists of income, such as dividends and interest from foreign investments, whether owned directly or through a segregated fund contract or mutual fund. Foreign income receives no special tax break, making it equivalent to interest from Canadian sources in terms of the high rate of tax that it attracts.

Interest income is usually taxable annually as earned, whether or not it's actually received. Dividends are generally taxed when received. Capital gains, however, are taxable when realized. A realized capital loss must be applied against any capital gains realized that year and the excess, if any, can be used to reduce capital gains realized in any of the three preceding years, or in any future year. This means that you can minimize your tax bill by taking into consideration the accrued gain or loss when deciding whether to realize a capital gain or loss.

UNDERSTANDING THE TAXATION OF SOME COMMON ASSETS

So far, we've discussed how individuals are taxed, along with the taxation of certain types of income. Now let's discuss the taxation of specific types of assets that are owned in a non-registered account.

MUTUAL FUNDS

The difference between your ACB and the market value of your mutual fund units results in a capital gain or capital loss when the units are sold or deemed to be sold.

Distributions from a mutual fund trust are taxed according to the nature of the distribution (dividends, interest, capital gain etc.). This distribution is taxable to you whether you

[2] The gross-up together with the DTC means that eligible dividends are generally taxed more favourably at the personal level than non-eligible dividends. However, due to the higher grossed-up amount that is included in taxable income, eligible dividends are more detrimental than non-eligible dividends in the calculation for income tested benefits.

receive the distribution in cash or reinvest it in additional units. If you reinvest this distribution to purchase additional units of the same fund, the amount of the reinvested distribution is added to the ACB of your investment. Mutual fund corporations pay dividends which can be either eligible dividends or capital gains. Dividends are taxable to you whether you receive the dividend in cash or reinvest it in additional shares of the mutual fund corporation. Reinvested dividends are added to the ACB of your investment and used to purchase additional shares of the same fund.

A common mistake for investors is forgetting to keep a record of these reinvested mutual fund distributions or dividends. The reinvested distributions or dividends are added to their ACB, thereby reducing the amount of any capital gain that arises when the fund is ultimately sold.

Return of capital (ROC) may also be reported as part of a distribution from a mutual fund. It represents a return of your original investment and results in a reduction of your ACB. As long as your ACB is positive, a distribution that is identified as a ROC is non-taxable. Once your ACB reaches zero (you have received the amount of your original investment back), all further distributions that are reported as ROC are taxable as capital gains.

SEGREGATED FUND CONTRACTS

Segregated fund contracts offer protective features only available through an insurance company including death benefit and maturity guarantees, potential creditor protection and the ability to bypass your estate. From a tax perspective, the difference between a segregated fund contract's value and its ACB results in a capital gain or capital loss when sold. Allocations received from segregated fund contracts are taxed according to the nature of the allocation (dividends, interest, capital gain, capital loss, etc.). The amount of the allocation is reflected as an increase (or decrease in the case of a capital loss) to your ACB that is tracked by the insurance company. Furthermore, allocations can not be paid in cash like mutual fund distributions or dividends.

STOCKS

The difference between your ACB and the market value of your stock holding results in a capital gain or capital loss when the stock is sold or deemed to be sold. Any dividends received from the stock are taxed at rates applicable to Canadian or foreign dividends.

MARKET-TRADED BONDS

Bonds that are actively traded in the market are taxed according to the type of return they generate. Since these bond investments are market traded, their value can rise and fall according to economic conditions. Consequently, as they are bought and sold in your portfolio, capital gains or capital losses can result. Other income generated from these investments is taxed separately as interest.

GICS AND CANADA SAVINGS BONDS

Non-market-traded fixed income investments, like GICs and Canada Savings Bonds, are taxable only on the interest earned.

THE IMPORTANCE OF UNDERSTANDING THE BASIC TAX ASPECTS OF INVESTING

Because we pay so much tax, every precaution we can take to minimize tax counts.

Investment taxation is an often overlooked but very important area of personal tax planning. Contact your advisor for more information about taxation and investment issues that concern you.

For more information, please contact your advisor or visit manulife.ca/investments

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