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TAX**PLANNING**

Get the most out of your investment income

Tax-efficient income

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In the August issue of *The TaxLetter* I wrote about the importance of having the right type of income when you retire. In the September issue, David West discussed some of the tax advantages of corporate class mutual funds.

This month, I would like to go into more detail about the various types of investment income that is most tax-efficient before and after retirement. I will also explain how to use corporate class mutual funds to convert investment income in a similarly tax-efficient manner.

Types of investment income

There are four main types of investment income:

- **Interest:** Interest, foreign dividends and net rent are all fully taxed as income.
- **Dividends:** 138 per cent of the dividend is taxed, less a dividend tax credit.
- **Capital gains:** 50 per cent of the gain is taxed. Note there are a variety of ways to defer capital gains.
- **Return of capital:** Tax-free for 10-15 years. This is really a type of deferral of capital gains.

Tax on Dividends

Tax on dividends may appear complex, but this is because of its integration with corporate tax. Without going into too much detail, a dividend is "grossed up" to approximately the income the corporation you received it from originally earned.

You are taxed on that grossed-up dividend. Then you receive a dividend tax credit, which is supposed to be for an amount similar to the tax paid by the corporation.

For example, an eligible dividend of $1,000 received from a publicly traded company will be grossed-up by 38 per cent; this means you will add $1,380 to your taxable income, which is taxed at your regular rate.

If your tax rate is 46.4 per cent, your tax is $640.32. Then you receive a dividend tax credit of 29.56 per cent of the dividend, or $295.60. Your net tax, therefore, would be $344.72.

Dividend tax quirks

When planning to minimize tax, you need to be aware that tax on dividends can be very low or very high, especially for Canadians with low incomes.

Before age 65, dividends can actually have negative tax. Income between $13,703 and $39,020 is taxed anywhere from negative two per cent- to-negative four per cent.

After age 65, however, dividends can be taxed at nearly 70 per cent. When you include the clawbacks on benefits to seniors, tax on incomes up to $33,883 are taxed between 65 and 69 per cent.

This is because the Guaranteed Income Supplement (GIS) is clawed back at 50 per cent of the gross-up dividend. For example, a dividend of $1,000 is grossed-up to $1,380 and then the GIS income is reduced by 50 per cent, or $690.

Similarly, for seniors with incomes between $69,563 and

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Tax-efficient investment income – A comparison

Which type of investment is more tax efficient? The answer is very different before and after age 65. Note: the table below applies to 2012 taxes for a single Ontario resident unless otherwise indicated.

Before age 65		After age 65	
Taxable income	Best Income type	Taxable income	Best Income type
$0 to $13,702	No difference	$0 to $23,052*	Capital gains
$13,703 to $78,043	Dividends	$23,053* to $42,707	Dividends
$78,044 and above	Capital gains	$42,708 and above	Capital gains

* $17,542 if you are married

$113,160, their Old Age Security (OAS) is clawed back at 15 per cent of their gross-up income. This makes their tax, plus the clawback, total 38 to 46 per cent of dividend income.

In short, tax on dividends (in most cases) is not much different than tax on capital gains.

However, before age 65, dividends are taxed very favourably for those with low income, and after age 65, taxes are very high for those with low incomes or moderately high incomes.

Income from capital gains

Capital gains tax is much simpler compared to dividends – and quite favourable too, with only 50 per cent of any realized gain being taxable. The taxable amount is called “taxable capital gain.”

For example, $500 would be the capital gain on $1,000. If you are in a 46 per cent tax bracket, you would pay tax of $230.

Receiving income from investments that pay capital gains can be even more tax efficient, because in most cases a portion of your income is from your original capital invested.

There are two common ways to receive income from capital gains:

✓ Systematic withdrawal plans (SWPs): Essentially you sell a bit of your investment each month. With stocks, this is manual. With mutual funds, it can be automatic.

To understand the tax-efficiency, here is an example: If you invested $100,000 that has now doubled to $200,000 and you take $10,000 per year income from it, $5,000 of that income is your cost and $5,000 is the gain. Since only 50 per cent of that gain is taxable, you would pay only $2,500 of your $10,000 a year.

This is, however, a type of deferral. If you take your $10,000 per year SWP, you will generally find that the portion that is taxable increases a bit each year, because your cost for tax purposes on the investment slowly declines.

✓ Fixed payments (T-SWPs or T8 income): Many mutual funds will pay out a fixed per cent of your investment each year. For example, if you have $100,000 invested in a “T8” fund, it will pay out eight per cent of your investment each year, or $8,000, divided into monthly installments. The amount remains the same, regardless of the actual return of the fund.

Your income is adjusted automatically each year to eight per cent of the January 1 value of your investment, which makes this a low-maintenance income strategy.

How is this $8,000 taxed? At the end of the year, any taxable income from within the fund is distributed to the shareholders. If, for example, your portion of the taxable income is $1,000, then the remaining $7,000 is not taxable. This is called "return of capital," which means it is considered to be your invested capital.

Many corporate class mutual funds are very tax-efficient, meaning there is little or no taxable income distributed by the fund each year. If you receive T8 income from a tax-efficient fund, the entire $8,000 per-year income can be tax-free.

This is essentially another type of deferral. The return of capital payments is only tax-free until your cost reaches zero.

For example, if you receive $8,000 per year tax-free, after 12.5 years, you have received all of your $100,000 investment back. After that point, the entire $8,000 is considered to be a capital gain each year.

This is still not that bad,

since only 50 per cent (or $4,000 a year) is taxable. However, if you eventually sell your investment and it is still worth $100,000, the entire amount is considered to be a capital gain, since your cost is zero.

In short, T-SWPs or T8 funds are often used because they provide income with little or no tax for 10 to 15 years, and tax-efficient income after that. They essentially defer much of the capital gain until you eventually sell your investment. ❑

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