Lower Your Income Tax Rate by Investing

Description

You can pay a lower tax rate than someone who earns the same income as you. You can achieve that by simply investing a portion of your money in stocks and either selling for capital gains or holding to earn passive dividends.

Both capital gains and dividends are taxed lower than ordinary income earned from your day job.

How much tax do you pay?

How much tax you pay on your capital gains and dividends depends on your annual income and the province or territory you live in.

Let’s assume you earn an average Canadian income of $49,000 from your day job and you live in Ontario. Combining the federal and Ontario tax brackets, you would pay about $10,335, or 21%, in income tax.

What if instead you earned $41,536 from your job and $7,464 in dividends, so that you still earn an income of $49,000? You would pay income tax of $8,328 on your job’s income and $192.63 on your dividend income. In other words, you’d pay about $8,520.63, or almost 17.4%, for your income tax. This is 3.6% lower than before.

No matter which tax bracket you’re in, dividends and capital gains will always be taxed lower than your job’s income. Capital gains are taxed higher than dividends but are still lower than your job’s income.

So if you earn the same income as someone else, but some of your income is from investments, your income tax will be lower than someone who gets all of their income from their day job.

Businesses can profit or lose money

Of course, it’s easier said than done to invest and succeed.

When you invest in stocks, you invest in businesses. When a business profits, it becomes more valuable and appreciates in price. When it appreciates in price, you can sell it for capital gains. The business might also pay out some of its earnings as dividends, and you can also earn a nice income that way.

For example, utilities are typically one of the most stable type of earnings. That's why three of the top five dividend-growth companies in Canada are utilities. **Fortis Inc.** (TSX:FTS) has increased dividends for over four decades; it's about $36 per share and yields 4.1%, which is set to grow 6% per year.

However, when a business does poorly, not only could it earn less, but it could even lose money. In that case, a company that used to pay dividends could slash them or eliminate them altogether. Additionally, its share price would also fall until the business turns around.

Just pick a miner such as **Barrick Gold Corp.** (TSX:ABX)(NYSE:ABX) as an example. Since 2012, its dividend has fallen from 20 cents to under three cents, or over 85%. Worse, someone who invested in 2012 would have seen capital destruction of 79% if they bought at $48 and held it until now.

Conclusion

Typically, companies that have a track record of increasing dividends as Fortis has earn stable earnings. The longer you stay invested in these companies, the more dividends you receive and the more taxes you save. Now you just need to buy a basket of winners at good valuations.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. NYSE:B (Barrick Mining)
2. TSX:ABX (Barrick Mining)
3. TSX:FTS (Fortis Inc.)

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