Dividend-Paying Stocks: Should You Hold Them in Your TFSA or RSP?

Description

You need to consider many things when investing in the stock market, including what type of accounts you should hold your stocks in. You can use non-registered accounts, TFSAs or RSPs. Which is the better option? One thing to consider when deciding where to keep your money is what type of income you expect to make from it, as not all income is treated the same at tax time.

Interest income

If your investments generate interest, such as from GICs or bonds, that interest is taxed 100% at your marginal tax rate, making it the most expensive income you can generate. Because of this, interest income does well in a TFSA and sometimes your RSP. In your TFSA, you won't have to pay any taxes on your interest gains. If your TFSA already holds the maximum contributions, you won't be able to add new investments to it until the next tax year. In this case, it can make sense to put interest-earning money into your RSP. You will have to pay tax on your interest eventually, but hopefully, that will be when you are at a lower marginal tax rate in retirement.

Dividend income

Dividends in Canada are not charged tax at 100%, like interest. The CRA lists two types of dividends: eligible and non-eligible. Eligible dividends pay a lower rate of tax. Companies that wish to have their dividends deemed eligible need to designate them as such. The rules around this declaration vary for public and private companies. An example of a regular dividend-paying stock is **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD).

Eligible dividends in 2016 were subject to a gross-up of 38% on the dividend, but then received a federal dividend tax credit of 20.73%. This means dividends at the highest federal marginal tax rate paid 24.81% in taxes in 2016. Dividends have the most favourable federal tax treatment over all income, with the exception of capital gains. Because dividends pay a higher tax rate than capital gains, they also do well in a TFSA. Dividends received in a TFSA account never pay taxes.

Capital gains income

Our final type of investment income is capital gains. This happens when you buy a stock and then sell it at a higher price. When you realize a capital gain (sell your stock), you only pay tax on 50% of that gain at your marginal tax rate. This means if you bought a stock such as **Canada Goose Holdings Inc** . (TSX:GOOS)(NYSE:GOOS) in the last year at its low of $20.32, and then sold it at its high of $32.80, you would have realized a capital gain of $12.48 per share. Because it was a capital gain, you would only be paying tax on $6.24 per share.

Because capital gains pay the lowest taxes, you could hold them in any type of account. Just be careful if you tend to trade in speculative, or volatile, stocks. You may end up with losses instead of gains, as can happen to any investor. If you have a capital loss in a non-registered account, you can use it to offset your gains and reduce your tax bill. But if you have a loss in your RSP, you just have to take the loss. You can't use it to help your tax bill anywhere else.

It's possible to earn both dividends and capital gains from a stock, so you will need to decide where you expect most of your income to come from when choosing where to keep your stocks.

Bottom line

There are advantages and disadvantages to all type of investment accounts. Tax treatment is just one of many factors that will help you decide where to keep your money. If you want to lower your tax bill, pay close attention to what type of income you think you will make from your investments. As investors, we don't want to pay more taxes than we need to.

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1. Bank Stocks
2. Dividend Stocks
3. Investing
4. Stocks for Beginners

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2. NYSE:TD (The Toronto-Dominion Bank)
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sportelance