



Why Asset Location Is as Important as Asset Allocation

Description

You are probably familiar with the concept of asset allocation, which is to divide your investments between stocks and bonds in a certain proportion to generate a particular return and risk.

While asset allocation is important, asset location is also very important if you own both [registered](#) and non-registered accounts. Asset location is how you distribute your investments between your registered and non-registered accounts.

Asset location is important because capital gains, dividends, and interest income are taxed in different ways. In addition, RRSPs, TFSAs, and taxable accounts have different tax rules.

If you hold an investment in an account that is not tax efficient for that kind of investment, you will pay more taxes than necessary. Over the long term, this can result in large amounts of money taken in taxes, and that reduces your return. You can thus save on taxes and generate higher returns by buying the right investments in the right account.

Let's look at the different kinds of investment income and their particular tax treatment.

Interest income

Interest income is the most taxed investment income, because it is taxed at your full marginal rate the year you earned it. Interest comes from bonds, GICs, and savings accounts. Therefore, you should avoid buying fixed-income investments in a taxable account; rather, buy them in a TFSA or an RRSP to avoid the unfavourable treatment of interest income in a taxable account.

Dividend income

Canadian dividends get a special treatment when they are owned in taxable accounts, because companies have already paid taxes on them. To avoid double taxation, you can gross up the dividend amount, then claim a generous dividend tax credit.

Toronto-Dominion Bank ([TSX:TD](#))([NYSE:TD](#)) is a Canadian stock that pays a dividend and is thus [eligible for the dividend tax credit](#)

. This bank pays a dividend of \$2.68 per share annually for a yield of 3.5%.

However, foreign dividends don't benefit from the same favourable treatment. They are fully taxed at your marginal rate, just like interest. In addition, many countries, like the U.S., impose a withholding tax on dividends paid to foreign investors.

U.S. stocks paying dividends should be held in an RRSP because they will be exempt from withholding taxes in this investment vehicle due to a tax treaty concluded between Canada and the U.S. That means owning a stock like **AT&T Inc.** ([NYSE:T](#)) in an RRSP will allow you to keep entirely the generous dividend of US\$2.00 per share paid by the company.

Capital gains

You have a capital gain when the market value of your investment is higher than the price you paid for it. Capital gains benefit from the most favourable tax treatment. You pay taxes only when you sell your investment, so you can defer the payment of taxes for many years. When you sell it, you will be taxed on only 50% of the gain.

Because they are taxed so favourably, if you have to keep investments in a taxable account, investments that generate capital gains are the best choice. Stocks are preferable to bonds because they don't pay interest. Furthermore, by holding stocks in a taxable account, you can reduce your gains by offsetting them with capital losses, thus reducing your taxes.

For example, if you'd bought **Canada Goose Holdings Inc.** ([TSX:GOOS](#))([NYSE:GOOS](#)) a year ago and decided to sell your shares now, you'd make a return of 111%, giving you a juicy capital gain. But if you'd also bought shares of **Barrick Gold Corp.** ([TSX:ABX](#))([NYSE:ABX](#)) one year ago, which had a return of -33% during that period, you can offset some of your gains on Canada Goose by selling your shares of Barrick Gold to realize a loss.

So, if you invest in risky stocks that could result in a loss, it is preferable to hold them in a taxable account, since capital losses cannot be claimed in a TFSA or in an RRSP.

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2. NYSE:GOOS (Canada Goose)
3. NYSE:T (AT&T)

4. NYSE:TD (The Toronto-Dominion Bank)
5. TSX:ABX (Barrick Mining)
6. TSX:GOOS (Canada Goose)
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