CRA 101: How Canadian Investors Can Turn $20,000 Into $525,000 and Pay No Tax

Description

Big gains on investments always sound great, and they are, but investors have traditionally given the Canada Revenue Agency a piece of the profits.

Taxable investment accounts require us to pay tax on dividends that are earned and then on capital gains when the stocks are sold. The gross-up provision for dividends and a reduced rate on capital gains make these forms of income more appealing than regular employment income, but they are still taxed.

Using a Registered Retirement Savings Plan gives investors a chance to grow a portfolio tax-free while the funds remain inside the RRSP, but taxes are paid on the money when it is withdrawn. The advantage, however, is that taxable income can be reduced for the tax year the contributions are made.

A relatively new option for growing investments tax-free while also being able to keep all the earnings and capital gains is to hold the stocks inside a Tax-Free Savings Account. The TFSA has been around for more than a decade and the cumulative contribution space is now at a level where Canadians can build a significant retirement fund.

The TFSA limit increased by $6,000 for 2020, bringing the maximum available space to $69,500 per person.

Which stocks are attractive?

History suggests that owning companies that are industry leaders and enjoy wide competitive moats is a good strategy. In addition, the stock should have a long track record of paying rising dividends supported by steady revenue and earnings growth.

Let's take a look at **Canadian National Railway Company** (TSX:CNR)(NYSE:CNI) to see why the stock might be a good pick and to get a sense of how a small investment can become a large retirement fund.

Limited competition

The railways emerged in Canada and the U.S. when populations were sparse and cities were just beginning to form.

CN's origins go back a long way and it is somewhat unique in the rail industry as the company is the only rail carrier in North America that owns tracks connected to ports on three coasts.

Today, it would be nearly impossible for a competing company to build new tracks along the same routes.

CN still has to fight for business with the trucking industry and some other railways on certain routes. As a result, management works hard to improve the company's efficiency and CN invests heavily in new locomotives, rail cars, and network upgrades. The company spent nearly $4 billion in 2019 on capital projects.

Dividends

Despite the large investment budget, CN still has ample cash left over to share profits with investors. The board raised the dividend by 18% in 2019 and another generous hike should be on the way in 2020. Over the past 20 years, the company has increased the payout by a compound annual rate of about 16%.

This is important for buy-and-hold investors who use the distributions to acquire new shares as the compounding effect can have a significant impact on how the investment grows.

For example, a $20,000 investment in CN stock 20 years ago would be worth about $425,000 today. That same investment with all the dividends reinvested would now be worth $525,000.

Had the TFSA been in place at that time, all of the gains would go straight into your pocket!

The bottom line

There is no guarantee that CN will deliver the same returns in the next two decades but the stock remains an attractive pick.

Owning reliable dividend stocks and investing the payouts in new shares is a proven system to build wealth, and the TSX Index is home to many companies that have generated fantastic returns using this approach.

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