Canada Revenue Agency 101: 3 Legal Ways to Lower Your Taxes

Description

Tax efficiency is one of the most important — yet overlooked — aspects of investing. You can never be sure that you'll get a great return on stocks. But getting the lowest tax rate possible is entirely within your power.

The Government of Canada provides a number of tax-free and tax-deferred accounts that allow you to lower your tax rate. The most notable of these are Tax-Free Savings Accounts (TFSAs) and Registered Retirement Savings Accounts (RRSPs). By holding your investments in these accounts, you can legally lower your tax rate over the course of your working life.

In addition, there are ways to lower your taxes even outside of registered accounts. As you're about to see, different types of investment income are treated differently under the Canadian tax code.

By buying the right asset categories, you can dramatically reduce your investment taxes even outside of your RRSP or TFSA. We can start by looking at one of the most obvious ways to do this.

Buy dividend stocks instead of bonds

Dividends generally get a much more favourable tax treatment than bond interest in Canada, as dividends have a tax credit applied to them, whereas interest does not.

As an example, consider an investor holding $100,000 worth of **Enbridge Inc** (TSX:ENB)(NYSE:ENB) stock. Enbridge is a dividend stock that yields about 6.2% at current prices. That means you get around $6,200 in pre-tax dividends a year from $100,000 worth of ENB stock.

To calculate your tax credit on those dividends, you "gross up" the $6,200 by 38%, giving you a figure of $8,556. You then apply a 15% credit to that amount, giving you a credit of $1,283.

Your ultimate tax on the dividends depends on your income level, but the dividend tax credit (on eligible dividends) always results in lower dividend taxes compared to interest taxes.

Max out your TFSA

Buying dividend stocks is a great way to minimize taxes outside of a tax-free savings account. Within a TFSA, on the other hand, you can hold whatever you want, so it goes without saying that you should maximize your TFSA balance, ideally reaching the maximum contribution room you're entitled to.

Here, you can hold bonds without having to worry about the severe tax treatment they get outside of a registered account. You can also hold dividend stocks, growth stocks, and exchange-traded funds (ETFs) inside your TFSA, making it a flexible account to lower your tax rate no matter what you invest in.

Hold U.S. funds in your RRSP

A final and often overlooked way to reduce your tax rate is to hold U.S. funds of U.S. stocks in your RRSP. If you're looking to get U.S. exposure in your RRSP, it's always best to just buy the U.S.-listed fund rather than buy a Canadian equivalent, because Canadian-listed funds of U.S. stocks pay a withholding tax that your RRSP can't save you from.

Buying the equivalent U.S. fund spares you this tax, making U.S. funds obvious choices for RRSPs.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. NYSE:ENB (Enbridge Inc.)
2. TSX:ENB (Enbridge Inc.)

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