How to Pay No Tax on Passive Income in Canada!

Description

Did you know that in Canada, you can earn passive income and pay no taxes on it?

It may sound incredible, but it's true. By holding dividend stocks, you generate automatic passive income that comes in four times per year. And if you hold your stocks in a certain special bank account, you pay no tax on them. In this article, I will explore how you can achieve tax-free passive income — potentially several thousand dollars' worth every year!

Hold dividend stocks in a TFSA

The best way to generate tax-free passive income is to hold dividend stocks in a Tax-Free Savings Account (TFSA). A TFSA is a special kind of tax-sheltered account that exempts your stocks from dividend and capital gains tax. Both dividends and capital gains are normally taxable. You can avoid capital gains tax by not selling, but dividends create an automatic income stream that is taxable automatically. You can't avoid dividend taxes in a taxable account. You can, however, hold dividend stocks in a TFSA. This spares you all the taxes you would normally pay on them.

One great TFSA play for dividend investors

If you like the idea of establishing tax-free passive income in a TFSA, you need to decide what kinds of assets you're going to invest in. Not all stocks pay dividends, and some divided stocks have paltry yields. So, you need to be selective about what you buy. The maximum cumulative contribution room for TFSAs in 2022 is $81,500. If you were younger than 18 in 2009, you may have less room than that. So, you need a significant yield in order to pull big income out of a TFSA.

One play that would seem to fit the bill is **BMO Covered Call Utilities ETF** (TSX:ZWU). It's a utilities ETF that uses covered calls to enhance the payout. As a result, it has a truly astronomical 7.4% yield. With $81,500 invested at 7.4%, you get $6,031 back in dividend income every single year! That's a pretty significant little cash bonus for less than $100,000 invested. However, you need to keep two things in mind:

- ZWU has a fairly high management fee. Its MER (0.71%) is much higher than what you would get with a broad market index fund.
- Covered calls limit upside. They do produce high cash income, but they also limit capital gains.

These two downsides are big enough to justify making ZWU just a small position, not a whole portfolio. However, you could easily put together a diversified portfolio consisting of ZWU, plus a smattering of other high-yield stocks/funds, and achieve a similar yield with more potential upside.

Foolish takeaway

Everybody wants passive income. But not everybody is able to achieve it. Affiliate marketing, influencing and blogging sound nice on paper, but most of the time they take a lot of work, and therefore aren't truly passive. Dividend stocks are one income source that is truly passive. Once you buy, you simply collect payments for as long as the stock (or fund) keeps paying them out. And if you hold your dividend-paying assets in a TFSA, you pay no taxes on them whatsoever. Talk about a win-win!

CATEGORY

1. Investing

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1. TSX:ZWU (Bmo Covered Call Utilities ETF)

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andrewbutton