A portfolio less taxing: Understanding the taxation of investment income

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Various types of investment income are taxed differently. From fully-taxed interest income and foreign dividends, to preferably-taxed Canadian dividends and capital gains, the type of investment income that you earn can greatly impact your after-tax return on a particular investment. The tax consequences will also differ depending on whether or not the investment is held in a registered account. This report will review the tax implications related to the most common forms of investment income and will go through what expenses may be deducted against such income to reduce your taxes payable.

Types of Investment Income

The type of investment income you earn will determine the tax rate you pay. Chart 1 shows the top marginal tax rates for 2025 of the four main types of investment income an investor might earn in a non-registered account.

Chart 1

Province / Territory	Interest Income / Foreign Dividends	Eligible Dividends	Capital Gains
Alberta	48.00%	34.31%	24.00%
British Columbia	53.50%	36.54%	26.75%
Manitoba	50.40%	37.78%	25.20%
New Brunswick	52.50%	32.40%	26.25%
Newfoundland and Labrador	54.80%	46.20%	27.40%
Nova Scotia	54.00%	41.58%	27.00%
Northwest Territories	47.05%	28.33%	23.53%
Nunavut	44.50%	33.08%	22.25%
Ontario	53.53%	39.34%	26.76%
Prince Edward Island	52.00%	36.54%	26.00%
Quebec	53.31%	40.11%	26.65%
Saskatchewan	47.50%	29.64%	23.75%
Yukon	48.00%	28.93%	24.00%

Source: Tax Templates Inc., April 2024.

Interest income

Interest income from sources such as bank accounts, guaranteed investment certificates (GICs), bonds and notes (including principal protected notes or PPNs), whether received from Canadian or foreign sources, is taxed at your full, marginal income tax rate. Where fixed-income investments are issued at a discount, such as commercial paper or Treasury Bills, and pay accrued interest at maturity, the difference in value between the discounted price and the maturity value is fully taxed as interest income at maturity (and not as a capital gain!) If you sell the investment before maturity at a profit (or loss), part may be taxed as a capital gain (or allowed as a capital loss), while the rest is considered interest income.

Interest must generally be included in income when it is received. If you're considering buying a GIC with a term of less than one year, note that if you do so late enough in the year so that it matures in the following year, tax on the interest earned will be deferred to the subsequent calendar year.[1] For longer term instruments, however, you may be required to include interest in income as it accrues, rather than only when it is received. Where an interest-bearing investment does not pay interest out at least annually, in most cases you will be required to include in income the interest earned on the investment for each 12-month period that you own it.[2]

Taxation of accrued interest

As a bond investor, however, you also need to be aware that if you're not careful, you could be paying tax twice on your interest income. The culprit? Something called accrued interest.

Most bonds pay interest income semi-annually. When you purchase a bond in the bond market, chances are that you will not be buying that bond on one of the interest payment dates, but rather at some point in between those dates.

Consequently, you are required to compensate the seller of the bond for the interest earned from the last interest payment date to the date of purchase. For example, let's say on March 1, 2025, you purchased a

[1] Other factors would need to be considered when determining the timing of a GIC purchase.

[2] Certain exceptions apply where the amount of interest accruing is not ascertainable until the maturity of the investment, such as an index-linked GIC or a PPN linked to the performance of a stock portfolio, where the amount of interest is not known until maturity as it is (generally) tied to the positive increase in an underlying stock market index or portfolio.

$100,000 bond with a 5% coupon that pays interest semi-annually on June 1 and December 1. In addition to paying the purchase price of the bond, which could be trading at a discount or premium, you must also pay accrued interest to the vendor from December 1, 2024 (the last interest payment date) to March 1, 2025 (the date of purchase). This is equal to three months of interest or approximately $1,250 ($5,000 x 3/12).

On the next coupon date, June 1, 2025, you will receive the bond's semi-annual interest payment of $2,500, which must be included in your 2025 income. But remember, you didn't really earn the full $2,500 since you only purchased the bond on March 1. You are therefore entitled, under the *Income Tax Act*, to deduct the accrued interest you paid when you bought the bond from your income for the year.

A technical problem arises when you purchase a bond with accrued interest in the last part of calendar year, but before the first interest payment from that bond is received. For example, if you purchased a bond some time in December, 2024, and paid accrued interest to the vendor, the first coupon payment date may not occur until sometime in 2025. Technically speaking, you're only allowed to deduct the accrued interest purchased as an expense in the year you receive income from the bond — in this example, 2024.

Capital gains

Capital gains are only taxed when realized, which in most cases means when an investment is actually sold. As such, the tax on an accruing gain is deferred while the investment is held. Postponing the sale of an investment to January of the following calendar year, rather than selling an investment late in the year, means the tax would be deferred for an additional year.[3]

If an investment is sold for a profit, you will have a capital gain that is equal to the difference between the sale amount and the investment's cost for tax purposes, which is called the adjusted cost base (the “ACB”).[4] Where you hold a number of identical securities, then the ACB is averaged amongst those securities for purposes of calculating the gain or loss on the sale. A capital loss arises if the sale amount is less than the ACB.

Your net capital gain or loss for a particular tax year is calculated by subtracting total capital losses from total capital gains. Only 50% of your net capital gain is taxable, effective cutting in half whatever tax rate applies to these capital gains in your hands. If, instead, you have a net capital loss, it can either be carried back to offset taxable capital gains in the prior three years, or carried forward for use in any future year.

When disposing of a capital property at a loss, the superficial loss rules in the *Income Tax Act* may apply. These rules can apply when you sell property for a loss and buy (or have bought) identical property in the 30 days before or after the sale date. The rules apply if property is repurchased within 30 days and is still held on the 30th day by you or an “affiliated person,” including a spouse or partner[5], a corporation controlled by you or your spouse or partner, or a trust for which you or your spouse or partner are a majority interest beneficiary (such as your Registered Retirement Savings Plan (“RRSP”) or Tax Free Savings Account (“TFSA”)). Under the rules, the capital loss will be denied and added to the ACB of the repurchased security. That means any benefit of the capital loss could only be obtained when the repurchased security is ultimately sold.

The Canada Revenue Agency (CRA) considers exchange traded funds (ETFs) from different financial institutions to be identical property if they track the same index (e.g., S&P/TSX.) It also considers different series of the same mutual fund to be identical property.

Finally, in calculating a capital gain or loss, you can include any sales commissions you pay as part of your purchase price when determining your ACB. Similarly, if you pay a sales commission to sell the property, you can deduct this commission from your proceeds of disposition. Both of these adjustments can reduce your capital gain (or increase your capital loss) at the time of sale.

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[3] Other factors need to be considered when determining whether to defer a planned sale.

[4] If you're considered to be a trader or dealer in securities, then your gains will be considered fully taxable and your losses tax deductible. For the purposes of this report, it's assumed that all investments are held on capital account and any gain (or loss) will be a capital gain (or loss).

[5] In this report, spouse refers to someone to whom you are legally married. Partner refers to a common-law partner under the Income Tax Act, which means someone who cohabits with you in a conjugal relationship, provided the two of you have cohabited for the past 12 months or are jointly parents of a child.

Canadian dividends

Most dividends received from Canadian companies benefit from the dividend tax credit that can reduce the tax on this type of income, leading to favourable tax rates on Canadian dividends. The dividends are included in income at a grossed-up rate, which is then offset by the dividend tax credit. The overall tax rate depends on whether or not the dividend is considered an "eligible dividend", or is an "non-eligible dividend" for tax purposes. Most dividends received from Canadian publicly-listed companies or from mutual funds (see below) qualify as eligible dividends that have an enhanced dividend tax credit, which reduces the overall rate of tax on this income.

Foreign income

Interest and dividend income you receive from foreign companies are also taxed at your full marginal tax rate. These dividends do not benefit from the dividend tax credit, which is only available on Canadian dividend income.[6]

Foreign income must be reported on your income tax return in Canadian dollars. According to the CRA, investors should use the Bank of Canada's exchange rate in effect "on the day you received the income."[7]

If, however, the amount was essentially paid evenly throughout the year, then it's acceptable to use the Bank of Canada's average annual rate for that year.[8]

When foreign stocks or bonds are sold, you are supposed to use the actual foreign exchange rate that was in effect on the day of the transaction. In other words, to report a capital gain or loss on a foreign property properly, you would convert the proceeds to Canadian dollars using the exchange rate on the date of sale and compare that to the ACB of the property using the foreign exchange rate on the date the property was purchased.

CRA requires you to report the foreign-exchange gains (or losses) on your sale of foreign denominated securities even if the funds obtained from the sale aren't actually converted back to Canadian dollars.

For individuals, the net amount of foreign currency gains or losses in a year that exceeds $200 is taxable or deductible as a capital gain or loss. This, however, does not apply to foreign currency deposits, including GICs and term deposits, which can be transferred to any deposit of the same currency without needing to recognize a foreign currency gain or loss; however, once a deposit is used to purchase a "negotiable instrument" such as a note, bond, commercial paper, or other securities, such as common stock, then a capital gain (or loss) on foreign currency must be reported.

Some foreign income, such as foreign dividends, are subject to foreign non-resident withholding taxes when paid to a Canadian account. Any foreign taxes withheld on this foreign income, such as the 15% non-resident withholding tax on U.S. dividends, generally entitle you to claim a foreign tax credit when calculating federal and provincial or territorial taxes, so long as the payment is made to a non-registered account. The same foreign-exchange rates that were used to report the foreign income should be used to calculate the Canadian equivalent of the foreign taxes paid.

Mutual funds

Mutual funds (which include most ETFs and real estate investment trusts) are structured as either mutual fund trusts, where the investors purchase units, or mutual fund corporations, where the investor buys shares. The tax treatment to the investor in either structure is nearly identical.

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6 Some foreign income that is not treated as dividends in the foreign country may be recharacterized as foreign dividends for Canadian tax purposes. For example, distributions (including ROC) from a U.S. Master Limited Partnership are considered to be U.S. dividends in Canada.

7 See https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/tax-return/completing-a-tax-return/personal-income/line-12100-interest-other-investment-income.html.

8 The average annual foreign exchange rates can be found on the Bank of Canada's website at: bankofcanada.ca/rates/exchange/annual-average-exchange-rates/#table.

When you invest in a mutual fund[9], you may receive a distribution of the income and capital gains earned within the mutual fund, and you may also realize a capital gain (or loss) when you redeem your units (or shares) of the fund. In most cases, a switch from one fund to another is also considered a taxable disposition and any capital gain (loss) needs to be reported.

Distributions from a mutual fund trust generally retain their character for tax purposes when distributed to a Canadian resident. For instance, where interest income is earned within a mutual fund trust and then distributed, it will be fully included in the income of the investor. Similarly, when Canadian dividends are earned within a mutual fund trust and then distributed, the investor will be entitled to claim the dividend tax credit. Where the mutual fund is structured as a corporation, only Canadian dividends (and capital gains, discussed below) can be paid to investors.

Where the amount of distributions to unitholders / shareholders in the mutual fund exceeds the income earned and realized capital gains in the fund, part (or all) of the distribution may be considered a return of capital ("ROC".) A ROC is not included in income in the year received; rather, it decreases the ACB of the investment, so that when the investment is disposed of, any capital gain is increased (or capital loss is decreased.)[10]

Most mutual fund investors automatically reinvest their distributions in additional units or shares, rather than receive them in cash. As a result, occasionally, mutual fund investors may be surprised to receive a tax slip (T3 or T5) reporting income that they did not receive in cash. When a distribution of income or gains is reinvested, the overall ACB of the units or shares held is increased. This ensures that you don't pay tax a second time on a future sale of the investment.

Many mutual funds realize capital gains throughout the year but only distribute them, net of any realized capital losses, annually. This means investors who buy at year-end in taxable accounts may end up paying tax on the distributed capital gains for the entire year. Some investors delay their purchase until January so as to avoid paying tax on capital gains realized by the fund before they invested; however, this concern must be balanced against the opportunity cost of not being invested in the fund during this period of time.

Note that a mutual fund cannot flow out losses to its investors. Rather, those losses will be carried forward within the mutual fund to be used to offset income or gains in a subsequent year.

Partnership income

Some investments are structured as limited partnerships ("LPs".) If you hold units in an LP, you will need to include in your income the portion of the partnership income that is flowed to you from the partnership. The type of income may vary from business or rental income, to other investment income, depending on the activities or investments owned by the partnership. The partnership may also flow out a loss to you, or allocate various expenses to you, as is common with flow-through shares in the oil, gas and mining industries.

Real estate

If you own a rental property, then the rent received must be included in your income. Some expenses are currently deductible as incurred and may include property taxes, utilities, and expenses for repairs and maintenance. In contrast, capital expenses (sometimes called "capital costs") provide a long-lasting benefit over a number of years. These are generally added to the ACB of the rental property. For example, if you buy an older building and pay for renovations to bring it up to a condition suitable to rent, the renovation costs would likely be capital in nature. Capital expenses are deductible over a multi-year period as a form of depreciation for tax purposes called capital cost allowance ("CCA".)

Where you live in a property, and also rent some of it out, only a portion of your expenses will be deductible. All of the expenses that relate specifically to the rental area will be deductible. For the rest of the expenses, you will need to do a reasonable proration of the shared expenses and divide those between the area you used personally, and the area that you rent out.

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9 For a full discussion of the taxation of mutual funds, see CRA's publication RC4169: canada.ca/en/revenue-agency/services/forms-publications/publications/rc4169/tax-treatment-mutual-funds-individuals.html.

10 If the ACB ever becomes negative due to distributions of ROC, the negative amount is immediately included as a capital gain in that tax year.

When a rental property is sold, any gain will be taxable, unlike the gain when you sell your principal residence, which is generally tax-free. Most costs incurred to sell a rental property, such as real estate commissions or the cost of improvements to make the property more marketable, will be considered capital expenses. If no CCA has been claimed, the gain or loss will be a capital gain or loss; however, if you have claimed CCA on the property, the calculation will be more complicated. You may have to "recapture" some of that CCA and include it in income as regular income if the property is sold for more than its depreciated value.

If you incur a loss, it generally will be treated as a capital loss. If CCA was claimed, and the selling price is less than the depreciated value, then some of the loss may be fully deducted against other income as a "terminal loss." This loss represents depreciation in the value of your property that you were not previously allowed to deduct as CCA.

If you sell a home that you live in, which also contains a rental unit, you may need to allocate the selling price between the part you used for your principal residence and the part you used for rental purposes.

Further information regarding the tax consequences of owning a rental property is available in our report So… you wanna be a landlord? Tax considerations for rental properties.

Prescribed rate loans

Canadian income tax is levied at graduated rates, meaning that higher marginal rates of tax apply as your income level increases. For 2025, depending on your province or territory of residence, the combined marginal tax rates start at approximately 20% and range up to 55%. Because of this, there can be a significant spread between the marginal tax rates of family members, and there may be the desire to split investment income among family members.

Income splitting can be defined as the transferring of income from a high-income family member to a lower-income family member to reduce the overall tax payable by the family. The *Income Tax Act* has various anti-avoidance rules, known as the attribution rules, that generally prevent family members from income splitting by attributing the income back to the original source of the funds. There are, however, some exceptions to the attribution rules, one of which is a loan at the prescribed rate of interest. Where a loan is made to a spouse or partner to invest, and you charge, as a bare minimum, the CRA prescribed rate in effect at the time the loan was granted[11], you can split any excess returns. Interest on the loan must be paid by January 30th annually. As of January 1, 2025 the prescribed rate is 4%. It has, however, been as low as 1% in recent years.

Example

Assume Rebecca is in the top tax bracket, and her partner Andrew, is in the lowest tax bracket. In July of 2022, Rebecca loaned Andrew $500,000 at the then prescribed rate of 2% secured by a promissory note. Andrew invested the money and earns 5% income annually. Each year, he takes $10,000 of the $25,000 in income he receives to pay the 2% interest on the loan to Rebecca. The net tax savings to this couple will be having the net income of $15,000 taxed in Andrew's hands at the lowest tax rate instead of in Rebecca's hands at the highest tax rate. Note that the reason Andrew is only taxable on the net amount of $15,000 is that the $10,000 of interest he pays to Rebecca is tax deductible since the interest cost was incurred for the purpose of earning income. The net result is that $15,000 spread can be taxed in Andrew's hands, at a rate of say 20%, vs. Rebecca's hands, at a rate of, say, 53%, resulting in a $5,000 annual tax savings ($15,000 X (53% - 20%)).

When it comes to income splitting with minor children, capital gains earned on money gifted to those under age 18 are not subject to the income attribution rules. You may consider using the prescribed rate loan strategy, via a family trust, to income split interest or dividend income with minor children. The loan is made to the trust, and the funds invested by the trust. Any income the trust earns above the prescribed rate can be distributed to the minor children, or, more commonly, used to pay the children's expenses such as private school tuition and extracurricular activities. In most cases, minor children will have little or no other income and thus pay no (or minimal) tax on the trust income distributed to them.[12]

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[11] The CRA's prescribed rates are available online at canada.ca/en/revenue-agency/services/tax/prescribed-interest-rates.html.

[12] As the interest paid by the trust, and any fees for portfolio management, will only be eligible for a 50% tax deduction for alternative minimum tax purposes, this could be an issue to be address for prescribed rate loans made to a family trust.

Tax deductible investment expenses

If you paid fees to have your non-registered portfolio professionally managed, these portfolio management fees may be deducted for tax purposes. Similarly, you may be able to deduct interest (including margin interest) paid on a loan the proceeds of which were used to buy investments. The CRA's view is that interest is generally deductible on money borrowed to purchase investments provided the investment has the potential to generate income, even if it currently does not pay income (e.g. speculative penny stock which currently doesn't pay any dividends.)

Sometimes a line of credit (LOC) is used to purpose purchase investments, with the intention that interest paid will be deductible for tax purposes. There are a few matters to consider if you choose to go this route.

First, be careful if the LOC is used for both investment and non-investment (or personal) uses. That is, what happens if you were to use the same LOC for both the purchase of a stock portfolio as well as for financing the renovation of your kitchen in your principal residence? The CRA has stated: "In determining what borrowed money has been used for, the onus is on a taxpayer to trace or link the borrowed money to a specific eligible use, giving effect to the existing legal relationships."[13] In addition, the CRA takes a strict approach when an LOC used for both borrowing or other purposes is partially paid down as "any repayment of the principal portion of a borrowing would reduce the portions of the line of credit, mortgage or loan that are used for both eligible and ineligible purposes."[14] This can lead to problems, if your LOC isn't set up properly, as the example below demonstrates.

Example

Let's assume Doug has a secured line of credit that he took out last year to renovate his home. The balance owing on January 1, 2025, was $60,000. Since the interest paid on the line of credit is not deductible, the loan is often referred to as "ineligible."

On February 1, 2025 Doug decides to borrow money to begin a leveraged investment program and thus increases his line of credit by $40,000, bringing the new balance to $100,000. The $40,000 is invested in a broad range of securities for the purpose of earning income and thus is considered eligible for interest deductibility.

As a result, Doug should be able to deduct approximately 40% of the interest paid.

Now let's assume that on March 1, 2025, Doug receives a bonus and decides to pay down his line of credit by $20,000. The new balance owing on the line of credit at March 1, 2025 is now $80,000. The full $40,000 remains invested in income-producing securities.

The question is how much of the March, 2025, interest paid would be tax deductible? While you might conclude 50% of the interest would be tax deductible since $40,000 of the $80,000 outstanding balance remains invested for the purpose of earning income, this would not be in accordance with its statements above. In CRA's view, when the principal portion of a line of credit is repaid, such repayment reduces both the portions of the line of credit used for eligible and ineligible purposes. In other words, Doug cannot choose to allocate the $20,000 payment made on his line of credit to the ineligible use. Rather, any repayments are considered to be made pro rata. Since Doug's $100,000 line of credit was 60% ineligible and 40% eligible, the $20,000 payment made on March 1 must be allocated accordingly.

Doug should probably have established a separate line of credit in which the borrowings are used exclusively for investment purposes. That way, 100% of the interest paid would have been tax deductible.

Finally, be aware of the impact on interest deductibility where a ROC is received on investments, for instance on mutual fund investments. A 2018 decision of the Tax Court of Canada addressed this issue, and found that unless ROC distributions are reinvested in either the same fund or another investment, the interest on the portion of the borrowed money that was used to purchase the mutual funds that relate to those ROC

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13 See CRA Income Tax Folio S3-F6-C1, Interest Deductibility which can be found at canada.ca/en/revenue-agency/services/tax/technical-information/income-tax/income-tax-folios-index/series-3-property-investments-savings-plans/series-3-property-investments-savings-plan-folio-6-interest/income-tax-folio-s3-f6-c1-interest-deductibility.html.

14 Ibid.

distributions would no longer be tax deductible since the funds are no longer being used for an income-earning purpose.[15] The judge distinguished between income distributions and an ROC, saying the taxpayer would have continued to be able to deduct 100% of his interest payments on the loan he took to purchase the mutual funds if he had received income distributions from the mutual fund even if he used that income for personal purposes.

Registered plans

Registered plans allow for tax-deferred or tax-free investing. These include the RRSP, Registered Retirement Income Fund (“RRIF”), TFSA, First Home Savings Account (FHSA), Registered Education Savings Plan (“RESP”) and Registered Disability Savings Plan (“RDSP”.) Various limits apply to the amount that can be contributed to each of these plans.[16]

There is no tax owing on income and gains earned in an RRSP or RRIF while the amounts remain in the plan. Contributions to an RRSP may be deductible from income for tax purposes, and amounts withdrawn are included in income. An RRSP must be converted to a RRIF or annuity by the end of the year that the annuitant turns 71 years of age. Similarly, amounts withdrawn from a RRIF are taxable when withdrawn.

For a TFSA, contributions are made with after-tax income and there is no deduction for tax purposes for such contributions. Similar to an RRSP or RRIF, income and gains earned within the TFSA are not subject to tax. When any amount is withdrawn from a TFSA, it is not subject to tax either.

Contributions to an FHSA, but not transfers from an RRSP, are tax deductible. Just like RRSPs, RRIFs and TFSAs, income and gains earned in the FHSA are not subject to tax. In addition, if amounts withdrawn are used to purchase an eligible home, they are not subject to tax.

An RESP is used to save for post-secondary education. An RDSP is used to save for the needs of an individual with a disability. Government of Canada grants and bonds may also be made to these plans. No tax deduction is available for contributions made to either plan. As with the other registered plans, no tax applies to income and gains earned in an RESP or RDSP while the amounts remain in the plan. Contributions come out on a tax free basis. Income and gains, and government grants and bonds, end up being taxed when withdrawn.

Foreign withholding taxes

One trap with registered plans is the inability to claim a foreign tax credit if you hold foreign income-paying investments subject to non-resident withholding tax in a registered plan. This foreign tax, which is generally at a rate of between 15% and 25%, may decrease the effective yield on the investments.

The one exception is where U.S. dividend-paying stocks are held in an RRSP or RRIF. Under the Canada-U.S. tax treaty, these dividends, when paid to an RRSP or RRIF, are exempt from the 15% U.S. non-resident withholding tax. Note that this exception doesn’t hold true for any other country nor to other registered plans.

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[15] See Van Steenis v The Queen, 2018 TCC 78.

[16] Various penalty taxes may apply if income tax rules regarding investments are not followed.

Non-residents

Unlike Canadian residents who are taxable in Canada on their worldwide income, if you are a non-resident of Canada for tax purposes, then you are only subject to Canadian tax on your income from Canadian sources. Canadian non-resident tax will be withheld from most payments of investment income (other than most interest income) made to you by Canadian resident payors. The general withholding tax rate is 25%, but that rate may be reduced if there is a tax treaty in place between Canada and the country in which you are resident.

You also may be subject to Canadian tax when you dispose of certain Canadian property if it falls under the definition of “Taxable Canadian Property”. This includes Canadian real estate, Canadian insurance policies, resource properties or private company shares deriving more than 50% of their value from real estate or resource properties. Certain procedures are to be followed when selling these properties.

Conclusion

As we have shown above, there are a myriad of investment options available that have different taxation issues. Consult with your CIBC advisor on your investments. Consult with your tax advisor to make sure you are aware of the tax implications of your investment choices.

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