Canaccord Genuity Wealth Management

Financial Focus

Becker Orr Wealth Management

October 2019

Asset Location

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You have probably heard of asset allocation but what about asset location? Asset allocation is the mixture of stocks, bonds, real estate and other investments that make up your portfolio. The asset allocation will determine the overall risk level of your portfolio. The asset location is all about tax. The tax you most pay on your investment growth depends on the type of investment and the type of account it is held in. Asset location tries to get the correct investment in the right account to minimize your tax bill.

Tax minimization should not be the highest item on your investment to do list. We need to ensure you are comfortable with the risk level of the investment and that the investment is appropriate for your overall financial plan. For example, as a general rule, low risk investments are not very tax efficient. If you are comfortable with low risk investments and they meet your financial goals, don't worry about the tax! It would not make any sense to suddenly move to high risk investments to solely save a bit of tax. We must ensure you are comfortable with the risk of the investment and your goals are being met before we worry about the tax situation.

Also, asset location only comes into play if you have non-registered investments. If all your funds are in RRSPs or TFSAs, you do not have to worry about asset location. Once those accounts are topped up, the tax situation becomes a little more complex and a strategy is in order. To understand the strategy behind asset location, let's look at how different investment returns are taxed:

Interest: GICs and bonds are two good examples of investments that pay interest. Interest is treated as regular income and is fully taxed. From a tax perspective interest is the least efficient type of return. Most low risk investments are in this category.

Canadian Dividends: If you own shares of a Canadian company you could receive a dividend. If you receive a dividend you will receive a dividend tax credit. There is a formula involved that requires you gross up the dividend and then apply the credit, but the net result is that you pay less tax on dividends then you do on interest.

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Foreign Dividends: Only dividends from Canadian companies are eligible for the dividend tax credit. Dividends received from a foreign company are treated as interest and are fully taxable. In addition, the other country may charge a withholding tax. Canada has a treaty with the US to avoid this double taxation, US shares held in a RRSP, for example, do not have to pay the withholding tax. The treaty does not apply to TFSAs. If you own shares of a US company in your TFSA and receive a dividend, you will have to pay the withholding tax.

Capital Gains: If you sell an investment for more than you paid for it, you will realize a capital gain. For example, if you purchase 100 shares of a Canadian company for $10 and later sold them for $12, you realized a gain of $2 a share, or a total capital gain of $200. Capital gains are very tax efficient. You only pay tax on half of the gain. In our example $100 would be tax free and the other $100 would be added to your income. The withholding tax mentioned above does not apply to capital gains. It does not matter if the capital gain is the result of the shares of a foreign company or a Canadian company, the same favourable tax treatment applies.

As a general rule you want to keep your interest-bearing investments in your tax-sheltered accounts (RRSPs and TFSAs). You want to have your Canadian dividend paying investments in your non-registered accounts and your foreign dividend paying investments in your RRSP. Investments with the potential for capital gains should be held in your non-registered account. Essentially your most heavily taxed investments should be in your tax-sheltered accounts (RRSP and TFSA) and your more tax efficient investments in your non-registered account. This strategy can be applied not only for an individual's holdings but for the portfolio of a couple. If the spouses are in different tax brackets an asset location strategy can save them a pretty penny.

No one likes to pay tax, so tax minimization strategies are attractive, but it must make sense in the context of your overall plan. Asset location can also get quite complex. It is worthwhile chatting with your financial advisor and accountant before implementing this strategy.

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