Types of Investment Income

Investors are always looking to generate a return on their investments. Generating income on their investments in a key tax planning tool and one that can significantly affect your overall rate of return on your investments. Below is a brief description of the tax characteristics of the various types of investment income and how to plan around them.

Interest Income

Interest income is generated from a loan or bond at a specified interest rate. Interest income is taxable as it is earned even if it isn't received in the calendar year. Interest bearing investments are best served within a tax-deferred account (RRSP & TFSA) due to its higher personal tax treatment.

Foreign investment income (interest or dividends) is taxed in a similar fashion as interest income.

Rental income

Net rental income has a similar income tax treatment as interest income. There are two major differences with rental income is one the investor has the option to deduct various expenses (insurance, property taxes, maintenance, accounting fees etc.) against the rental revenue. After deducting the cash expenses, individuals can depreciate the capital property (furniture, building costs etc.) against the net rental income.

The downside of deducting depreciation against the rental income is that this can be recaptured in the event that the property is sold. If a building was purchased for $200,000 and was depreciated by $100,000 over the life of the investment, the $100,000 depreciation will be recaptured on the sale of the property if the building is sold for $200,000 or more.

Capital gains on the sale of a rental property will occur if the property is sold for more than the original purchase price.

Dividend income

Large corporations will payout a portion of their annual earnings as a dividend to shareholders. Dividend income is unique because you receive a dividend gross up and a dividend tax credit. The dividend grosses up in 2025 for eligible dividends is 38% which means that $100 in dividends will show up as income of $138. The dividend gross up is meant to replicate the fact that a corporation had to earn greater than $100 to payout a dividend of that amount. The dividend tax credit will lower the overall tax rate on dividends to make it less than interest income. One planning concern for individuals with high dividend income is that the this can increase their net income for purposes of any benefit or clawback calculations (OAS clawback, age credit & GST credit calculations etc.)

Capital Gains

Capital gains are generated when you sell an investment for more than the original purchase price. Capital gains are taxable at half of the total gain annually. This makes $1,000 of capital gain only taxable as $500 of taxable income. This makes capital gains much more tax-efficient than interest or dividend income

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Return of Capital

Some investments offer a periodic payment that is simply a return of the investor's original investment. This type of payment is not taxable when received, but instead is treated as a reduction of the original cost of the investment. This could enhance the claim for capital gains if the investment is sold in the future.