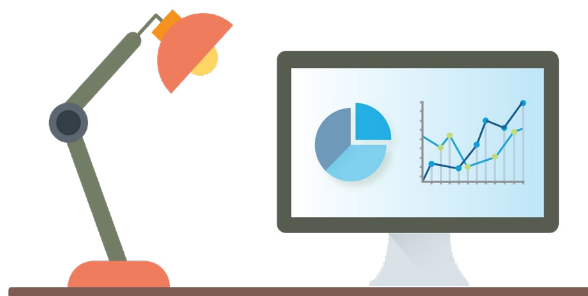
How to use non-registered accounts

There's more to investing than the RRSP and TFSA.



Registered accounts such as RRSPs, TFSAs, and RESPs get a lot of love in investment circles, and with good reason: unlike with non-registered investments, assets in these accounts can grow tax-free. But while non-registered accounts (also called taxable, investment, or margin accounts) are subject to annual taxes, they still have a place in a well-rounded portfolio, especially for those who have maxed out the contribution room on their registered accounts and still have money to invest.

Since non-registered investment vehicles don't get as much press as their registered counterparts, it can be hard to know how these accounts work. Here's what you need to know.

When to use a non-registered account

Most financial advisors recommend maxing out your RRSP and TFSA first, before investing in a non-registered account. That's because money inside these popular accounts can grow on a tax deferred (RRSP) and tax-free (TFSA) basis. But since these accounts also come with contribution limits ($6,000 a year for TFSAs and 18% of your salary up to a maximum of $27,230 in 2020 for RRSPs), if you have excess cash to invest, you'll most likely need to use a non-registered account.

There are other reasons to use a non-registered account.

- If you are borrowing to invest. With a non-registered account, you're able to invest on margin, which is using someone else's funds (money you borrow from, say, the bank) to boost investment gains. It's a risky strategy as you can also lose a lot of money if the market doesn't go your way. You should talk to an investment professional before trying this out, but it can be beneficial for the bold investors who can afford to take on risk.
- When you borrow money for the purposes of generating investment income, you can deduct the interest payments on the loan from your annual taxable investment earnings. Since there won't be any annual taxable earnings on investments held within a registered account, to make use of the tax deduction, you must have a non-registered account.
- If you want more flexibility. An RRSP must be converted to a RRIF during the year that you turn 71, and then you must follow a strict timetable of minimum withdrawals. Non-registered accounts have no contribution limits or withdrawal schedules.
- To avoid benefit clawbacks in retirement. Money that's withdrawn from a RRIF, LIF, or RRSP is considered income, which is taxed at your marginal rate in the year that you remove it. Some types of investment income generated in a non-registered account, such as capital gains, however, is only partially taxable, as explained in more detail below. By reducing your taxable income, but not your cash flow, you may be able to avoid clawbacks of income-tested benefits such as the Old Age Supplement.

Invest tax-effectively in a non-registered account

Those planning on using registered and non-registered accounts should think carefully (and talk to an advisor) about what investments they hold in each one. By allocating your portfolio's most tax-efficient investments to non-registered accounts and keeping potentially higher-taxed investments in registered ones, you may be able to lower your overall tax bill. This process is commonly referred to as asset location. Saying that, it's most important to be in the right asset mix, which is different for every investor. Tax is one thing to consider when investing, but it shouldn't drive all your investing decisions.

Here's how different investments are taxed and why you should (or shouldn't) prioritize them for your non-registered accounts.

- Bonds, treasury bills, and guaranteed investment certificates (GICs). Income from these investments are 100% taxable at your marginal rate. (If you're in the highest tax bracket, you'll owe about 50% in tax on the income generated.) As such, there is no benefit in keeping these assets in non-registered accounts. Put them in registered ones whe re those gains can compound on a tax-deferred or tax-free basis.
- Stocks, mutual funds, exchange-traded funds. If you sell an equity investment that's climbed in value while in your portfolio, you'll have to pay tax on that gain. Fortunately, you only have to pay tax on 50% of the money you've made. So, if you bought at stock for $100 and sold it for $200, you will only have to pay tax on $50. What you ultimately have to pay is based on your marginal tax rate.

One of the other benefits to using a non-registered account is that you can also claim capital losses. So, if a stock that you sell has fallen in value over the time you've held it, you can use 50% of that loss to offset any capital gains. It's a good idea to talk to a tax expert to ensure you're claiming gains and losses properly, but it is possible to sell enough losers to eliminate that tax you have to pay on the winners. Capital losses can also be carried forward indefinitely or offset gains claimed in the previous three years.

- Dividend paying Canadian companies. Investors who hold dividend paying companies in their non-registered portfolios are eligible to receive a dividend tax credit, which is applied against a certain portion of dividends paid by a Canadian company. The formula is complicated, but investors in the highest tax bracket will have to pay up to 29% tax on the dividends they collect. It's a good idea to talk to an accountant about how exactly dividends are taxed, but all you really need to know is that holding Canadian dividends in a non-registered account can be tax advantageous.
- Foreign equities. Dividends paid out by foreign companies, including American ones, are subject to a 15% withholding tax when that stock is held inside a taxable account or a TFSA. (Usually, the company you invest with holds that money back.) There is no withholding tax on foreign investments held inside of an RRSP or RRIF. If you own foreign securities in a non-registered account then you may be able to claim a foreign tax credit, which should allow you to recoup some of the taxes paid.

Although it's wise to tax shelter as much of your investment income as you can in registered accounts, non-registered investments can still be an important part of your portfolio. Talk to an advisor to make sure you're using all of your accounts in the most optimal way.

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