Asset Allocation and Asset Location

We have talked about Asset Allocation. This is a primary decision. A secondary decision is described by the term Asset Location. Asset location attempts to lower the tax burden of investing.

Asset location is irrelevant if you have an RRSP (and derivative) account only. It has some relevance if you hold an RRSP and a TFSA account. Its true relevance is when a non-registered account, along with the other two, hold investments.

Asset location is relevant because dividends from Canadian corporations and capital gains have preferential tax rates in a non-registered account. I'll use the Ontario tax brackets to explain. And, I'll use the 29.65% tax bracket (marginal tax rate). You can bring up the rate card for province you live in at the bottom of this page.

Note that all income in this bracket is taxed at 29.65% except for dividends from Canadian corporations and triggered capital gains. They are taxed at 7.56% and 14.83% respectively. For example, if you receive $100 of interest income you get to keep $70.35 versus $92.44 of dividend from Canadian corporations or $85.17 of capital gain. Note the difference between income, dividends from Canadian corporations, and capital gains at various income levels.

A main premise of asset location is that it is best if interest income earning investments are skewed away from a non-registered account. A secondary premise is that an investment that grows into a huge capital gain is best held within a TFSA account. Even though capital gains receive preferential tax treatment within a non-registered account, capital gains can grow huge over decades. The TFSA is the only account where the capital gain is tax free.

The challenge with asset location is that the TFSA account has limited room and the RRSP account may be full or closed. If one has a lot of financial wealth, or if retired, it is likely that some investments must be held in suboptimal accounts. There isn't any getting away from this.