Eligible Dividend Income

In investing, it's important to remember that there are different tax rates depending on the type of investment income received – including interest, dividends and capital gains – and they are not equal on an after-tax basis. This report provides an overview on the taxation of eligible dividends and, specifically, the after-tax impact of the dividend gross-up and tax credit mechanism that is unique to Canadian dividend income.

What are "eligible dividends"?

Dividends from Canadian corporations received by Canadian resident individuals are entitled to preferential tax treatment by both the Federal and provincial governments by way of a dividend gross-up and tax credit mechanism. However, the dividend tax regime for dividends paid by a Canadian corporation varies depending on the taxation of the income from which the dividends are paid. Specifically, an "eligible" dividend encompasses distributions to Canadian resident investors out of income subject to the general corporate income tax rate (i.e., generally, all dividends paid by public Canadian corporations). Given the relatively higher tax rate on this income, higher dividend gross-up and the dividend tax credit percentages are provided for eligible dividends, which results in lower effective personal tax rates. On the other hand, dividends paid out of income subject to lower corporate tax, such as income qualifying for the "small business deduction" available to Canadian-controlled private corporations, receive lower dividend gross-up and dividend tax credit percentages and; as a result, these (latter) "ineligible" dividends are subject to higher effective personal tax rates. However, recent changes have increased the effective personal tax rate on these "ineligible" dividends by adjusting the gross-up to 15% and the corresponding Federal dividend tax credit to 9.0301%.

Taxation of eligible dividends

As a result of decreases in the Federal general corporate income tax rate in recent years, parallel reductions to the gross-up and tax credit mechanism on eligible dividends were also implemented which increased the effective personal tax rate on eligible dividends. These changes were introduced because the dividend tax credit is intended to compensate individual taxpayers for the income tax paid by the corporation distributing the eligible dividend. The reduction in corporate tax, therefore, leads to a reduced dividend tax credit. In theory, lower corporate tax should lead to higher dividend payments (or higher share valuations), thereby offsetting the effect of the increased personal tax on eligible dividends.

For eligible dividends, the actual dividend received is grossed-up by 38%. So, if you receive a $100 eligible dividend, you will include $138 on your tax return and will receive a dividend tax credit (equal to 15.02% of the grossed-up amount for Federal tax purposes) that will reduce the actual income tax you pay on that dividend.

The **2020 Combined Federal and Provincial Top Marginal Tax Rates for Individuals** table compares specific tax rates by province for each type of investment income.

2020 Combined Federal and Provincial Top Marginal Tax Rates for Individuals*

Province	Interest & Ordinary Income	Capital Gains	Canadian Dividends	
			Eligible	Non-Eligible
Alberta	48.00%	24.00%	31.71%	42.31%
British Columbia	53.50%	26.75%	36.54%	48.89%
Manitoba	50.40%	25.20%	37.78%	46.67%
New Brunswick	53.30%	26.65%	33.51%	47.75%
Newfoundland and Labrador	51.30%	25.65%	42.61%	44.59%
Northwest Territories	47.05%	23.53%	28.33%	36.82%
Nova Scotia	54.00%	27.00%	41.58%	48.28%
Nunavut	44.50%	22.25%	33.08%	37.79%
Ontario	53.53%	26.76%	39.34%	47.74%
Prince Edward Island	51.37%	25.69%	34.22%	45.22%
Quebec	53.31%	26.65%	40.11%	47.14%
Saskatchewan	47.50%	23.75%	29.64%	40.37%
Yukon	48.00%	24.00%	28.93%	42.17%

* This table shows the 2020 top combined marginal tax rates by province. The rates apply to taxable incomes over $214,368, with the following exceptions: $220,000 in British Columbia and Ontario, $314,928 in Alberta and $500,000 in Yukon.

As outlined in this table, the top tax rate for eligible dividends varies significantly, depending on the province in which you reside. For individuals in the top marginal bracket, eligible dividends incur a higher tax rate than capital gains in all provinces and territories, and the tax rate differential between eligible dividends and capital gains can be significant.

Other considerations

One often overlooked implication to the taxation of dividends is the impact that the gross-up of eligible dividend income can have on taxable income; particularly for individuals who receive income-tested benefits or credits. Although the dividend and gross-up tax mechanism can result in very low effective tax rates for individuals in the lower marginal tax brackets, the impact on the calculation of their taxable income resulting from the dividend gross-up can negatively affect income-tested benefits and tax credits, such as Old Age Security ("OAS"), Guaranteed Income Supplements ("GIS"), age and medical tax credits, in addition to other provincial benefits. However, the reduction in these benefits may be negated by the tax-efficiency of eligible dividend income. For affected individuals, an understanding of any potential impact on income-tested benefits would be required for a full analysis of the tax-efficiency of the various sources of investment income.

"Tax-free" dividend amounts

As previously discussed, the dividend tax credit can provide very low effective tax rates for individuals in the lower marginal tax brackets. In fact, individuals with no other sources of income can often receive significant amounts of dividend income without incurring any income tax because of the "power" of the dividend tax credit. The *Maximum Dividend Income Before Incurring Income Tax* table provides the maximum actual amount of Canadian eligible dividends that can be received by an individual resident in Canada, without triggering Federal or provincial/territorial income tax for 2020, assuming that the individual has no other sources of income. Note that the schedule does not apply to dividends received from a foreign source, and is only relevant for Canadian resident individuals (i.e., not applicable for trusts, corporations and non-resident individuals). Also, be aware that dividend income may be subject to the general income attribution rules or the expanded "tax on split income" ("TOSI") rules (i.e., for dividends paid by a private corporation), which may defeat income-splitting objectives.

"Tax-Free" dividend summary

Maximum Dividend Income Before Incurring Income Tax for 2020		
	Eligible Dividends[1]	
Jurisdiction	Actual	Taxable
Federal	$53,229	$73,456
Alberta	$53,229	$73,456
British Columbia	$53,229	$73,456
Manitoba	$25,933	$35,787
New Brunswick	$53,229	$73,456
Newfoundland and Labrador	$18,521	$25,559
Northwest Territories	$53,229	$73,456
Nova Scotia	$32,405	$44,719
Nunavut	$53,229	$73,456
Ontario	$53,229	$73,456
Prince Edward Island	$48,903	$66,368
Quebec	$39,786	$54,904
Saskatchewan	$53,229	$73,456
Yukon	$53,229	$73,456

Seek advice

Take time to review the types of investment income your investment portfolio earns to better understand and consider the potential impact of taxation to your portfolio. With an understanding of your investment objectives, your BMO financial professional will review your current portfolio with a view towards maximizing its after-tax return. After all, at the end of the year it's important to understand how taxes impact the after-tax return of your portfolio.

For more information, speak with your BMO financial professional.

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[1] For illustrative purposes only based on 2020 tax rates. Consultation with a tax professional is necessary to confirm the actual tax implications in each particular situation. This analysis assumes that the only tax credits available to the individual are the basic personal credit and dividend tax credit. It also assumes that the individual is single or, if married, the spouse's income is too high for any tax reduction from married status. This schedule does not apply to dividends received from a foreign source, and is only relevant for Canadian resident individuals (i.e., not applicable for trusts, corporations and non-resident individuals). Be aware that dividend income may be subject to the general income attribution rules or tax on split income ("TOSI") rules (i.e., for dividends paid by a private corporation), which may defeat income-splitting objectives. Provincial health and other personal tax levies are not reflected.

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