Eligible Dividend Income

It's important to revisit the taxation of investment income, especially given the changes in the personal tax rates over the last few years. Even the most tax-conscious investor may not appreciate how these changes can impact their after-tax returns. It's also 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, in light of recent changes.

Introduction of the concept of 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 changed after 2005. Specifically, the concept of an "eligible" dividend was created to encompass 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. The revised dividend tax regime increased the dividend gross-up and the dividend tax credit percentages for eligible dividends.

Dividends received which are not "eligible" dividends will remain subject to higher effective tax rates. However, recent changes have increased the effective tax rate on these "ineligible" dividends by adjusting the gross-up to 16% and the corresponding federal dividend tax credit to 10.0313% for 2018.

Taxation of eligible dividends

As a result of decreases in the federal general corporate income tax rate in recent years, reductions to the gross-up and tax credit mechanism on eligible dividends were also implemented which increased the effective 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 2012 and later years, the actual dividend received is grossed-up by 38% for eligible dividends. 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 **2018 Combined Federal and Provincial Top Marginal Tax Rates for Individuals** table compares specific tax rates by province for each type of investment income, taking into account the new top federal tax bracket effective for 2016 and later years.

Continued

2018 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%	41.64%
British Columbia	49.80%	24.90%	34.20%	43.73%
Manitoba	50.40%	25.20%	37.78%	45.92%
New Brunswick	53.30%	26.65%	33.51%	46.88%
Newfoundland and Labrador	51.30%	25.65%	42.61%	43.81%
Northwest Territories	47.05%	23.53%	28.33%	35.98%
Nova Scotia	54.00%	27.00%	41.58%	47.34%
Nunavut	44.50%	22.25%	33.08%	36.78%
Ontario	53.53%	26.76%	39.34%	46.84%
Prince Edward Island	51.37%	25.69%	34.22%	44.25%
Quebec	53.31%	26.65%	39.83%	43.94%
Saskatchewan	47.50%	23.75%	29.64%	39.75%
Yukon	48.00%	24.00%	28.93%	41.42%

* This table shows the 2018 top combined marginal tax rates by province as of March 2018. The rates apply to taxable incomes over $205,842 except that the thresholds are $220,000 in Ontario, $307,547 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. As a result of these rate changes, 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 dividends that can be received by an individual resident in Canada, without triggering federal or provincial/territorial income tax for 2018, 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.

Maximum Dividend Income Before Incurring Income Tax for 2018

	Eligible dividends[1]		Non-eligible dividends[1]	
Jurisdiction	Actual[2,4]	Taxable[2,4]	Actual[3,5]	Taxable[3,5]
Federal	$51,810	$71,498	$30,735	$35,653
British Columbia	$51,810	$71,498	$22,330	$25,903
Alberta	$51,810	$71,498	$20,575	$23,867
Saskatchewan	$51,810	$71,498	$19,910	$23,096
Manitoba	$24,930	$34,403	$9,700	$11,252
Ontario	$51,810	$71,498	$30,735	$35,653
Quebec	$39,400	$54,372	$24,420	$28,327
New Brunswick	$51,810	$71,498	$18,640	$21,622
Nova Scotia	$32,400	$44,712	$16,710	$19,384
Prince Edward Island	$45,650	$62,997	$14,355	$16,652
Newfoundland and Labrador	$18,165	$25,068	$19,670	$22,817
Northwest Territories	$51,810	$71,498	$30,735	$35,653
Nunavut	$51,810	$71,498	$30,735	$35,653
Yukon	$51,810	$71,498	$15,755	$18,276

Conclusion

Due to the recent changes to the personal tax rates, this is an ideal time to discuss the types of investment income your investment portfolio earns, to better understand and consider the potential impact of these tax changes 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.

Footnotes

1. The table reflects budget proposals and news releases to February 28, 2018. The table illustrates the approximate amount of dividend income that may be received without incurring federal and provincial/territorial income tax where an individual receives only taxable dividends from taxable Canadian corporations during the year. The calculations include federal and provincial/territorial income taxes and surtaxes and exclude health care premiums and other levies (where applicable). The basic personal tax credits and the dividend tax credits are the only credits reflected in the calculations. This table should be used for general guidance only and does not replace the need to consider a client's specific circumstances, including whether the draft legislation relating to tax on split income may apply to any dividends paid.
2. Eligible dividends are those paid by public and private corporations out of earnings that have been taxed at the general corporate tax rate (the dividend must be designated by the payor corporation as an eligible dividend). The rate of gross-up for eligible dividends for 2012 and later years is 38%, and the amount of the dividend tax credit varies by jurisdiction.
3. Non-eligible dividends are dividends that do not qualify as eligible dividends (see note 2 above). The rate of gross-up for non-eligible dividends for 2018 is 16%, and the amount of the dividend tax credit varies by jurisdiction.
4. For eligible dividends, the amount of dividends that may be received without incurring provincial/territorial income tax in all provinces/territories (other than Manitoba, Quebec, Nova Scotia, Prince Edward Island, and Newfoundland and Labrador) exceeds the amount that may be received without incurring federal income tax. As a result, the provincial/territorial dividend amounts have been reduced to the federal dividend income amount. Where dividends are received in excess of the federal amount, federal income tax or provincial/territorial alternative minimum tax (AMT) (or both) will apply.
5. For non-eligible dividends, the amount of dividends that may be received without incurring provincial/territorial income tax in Ontario, Northwest Territories and Nunavut exceeds the amount that may be received without incurring federal income tax. As a result, the provincial/territorial dividend amounts have been reduced to the federal dividend income amount. Where dividends are received in excess of the federal amount, federal income tax or provincial/territorial AMT (or both) will apply.

Source: Ernst & Young LLP, last updated February 28, 2018. Used with permission.

This table contains high-level information in summary form, current as of the date set out above, and is intended for general guidance only. The information presented in this table should not be construed as legal, tax, accounting, or any other professional advice or service. Ernst & Young LLP can accept no responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this table. Before taking any particular course of action contact Ernst & Young LLP or another professional advisor to discuss these matters in the context of your particular circumstances.

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