Eligible Dividends

Given the changes in the taxation of dividend income over the last few years, it's a good time to revisit the taxation of all investment income, including interest, dividends and capital gains. If you compare the different tax rates on these sources of investment income, it's clear that not all investment income is equal on an after-tax basis. Even tax-conscious investors may not appreciate how the changes to the taxation of eligible dividends may impact their after-tax returns.

Introduction of the Concept of *Eligible Dividends*

In the past, capital gains have been taxed at lower rates than other types of investment income such as interest and dividends. In 2006, when the federal government introduced the concept of *eligible dividends,* which are subject to lower tax rates, the preferential tax treatment of capital gains versus dividends substantially narrowed. (Eligible dividends include taxable dividends that are received by a Canadian resident individual paid after 2005 by public Canadian corporations and designated as an eligible dividend — which encompasses most dividends from Canadian public corporations).

The revised dividend tax regime originally increased the dividend gross-up from 25% to 45% and originally increased the dividend tax credit from 13⅓% of the grossed-up dividend to 18.966%. As a result, an eligible dividend of $100 was reported as $145 as the taxable amount on your tax return (versus $125 for non-eligible dividends). Dividends received which are not "eligible" dividends remain subject to the prior 25% gross-up and 13⅓% credit mechanism.

Changes Effective for 2010 to 2012

As a result of subsequent reductions in the federal general corporate income tax rate, the 2008 federal budget introduced reductions to the gross-up and tax credit mechanism annually from 2010 to 2012 on eligible dividends, thereby increasing the effective tax rate on eligible dividends beginning in 2010. This change was

Combined Top Marginal Tax Rates - 2012

	Salary and Interest	Capital Gains	Non-Eligible Dividends	Eligible Dividends
British Columbia	43.70%	21.85%	33.71%	25.78%
Alberta	39.00%	19.50%	27.71%	19.29%
Saskatchewan	44.00%	22.00%	33.33%	24.81%
Manitoba	46.40%	23.20%	39.15%	32.26%
Ontario[1]	46.41%	23.20%	32.57%	29.54%
Quebec	48.22%	24.11%	36.35%	32.81%
New Brunswick	43.30%	21.65%	30.83%	22.47%
Nova Scotia	50.00%	25.00%	36.21%	36.06%
Prince Edward Island	47.37%	23.69%	41.17%	28.70%
Newfoundland & Labrador	42.30%	21.15%	29.96%	22.47 %
Yukon	42.40%	21.20%	30.41%	15.93% to 19.29%
NWT	43.05%	21.53%	29.65%	22.81%
Nunavut	40.50%	20.25%	28.96%	27.56%

Note: Earning eligible dividend income could reduce OAS benefits and may result in Alternative Minimum Tax.

[1] The Ontario government's 2012 budget introduced a 2% surtax on taxable incomes exceeding $500,000. This new surtax takes effect July 1, 2012 but is scheduled to be eliminated once the budget is balanced (expected to be in 2017/2018). The impact of this 2% surtax on taxable incomes exceeding $500,000 is as follows:

Top Marginal Tax Rates

Salary and Interest	Capital Gains	Non-Eligible Dividends	Eligible Dividends
47.97%	23.98%	34.52%	31.69%

introduced since the dividend tax credit is intended to compensate individual taxpayers for the income tax paid by the corporation paying the eligible dividend, thus a reduction in corporate tax 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.

The continuing impact of these federal changes to the taxation of eligible dividends in 2012 was to decrease the dividend gross-up further to 38% (from 41% in 2011 and 44% in 2010) and to further reduce the federal dividend tax credit to 15.02% from 16.44% in 2011 and 17.97% in 2010. The Combined Top Marginal Tax Rates for 2012 in the table on the preceding page compares specific tax rates by province for each type of investment income, taking into account these changes.

As outlined in this table, the tax rate for eligible dividends varies significantly depending on the province in which you reside. In Alberta and the Yukon, eligible dividends incur a lower top rate of tax than capital gains in 2012. In several other provinces, the tax rate differential between dividends and capital gains is not significant, although the gap is widening in other jurisdictions.

Other Considerations

One often overlooked implication of these recent changes 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), the age and medical tax credits and other provincial benefits. For these individuals, an understanding of any potential impact on income-tested benefits would be required for 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 following table provides the maximum actual amount of Canadian dividends that can be received by an individual resident in Canada based on the current 2012 tax rates, assuming that the individual has no other sources of income.

"Tax-Free" Dividend Summary - 2012

Province[1]	Non-Eligible Dividends	Eligible Dividends
British Columbia	$27,687	$47,888
Alberta	$21,270	$47,888
Saskatchewan	$18,784	$47,888
Manitoba	$9,244	$23,447
Ontario[2]	$39,428	$47,888
Quebec[3]	$21,850	$33,897
New Brunswick	$21,862	$47,888
Nova Scotia	$28,339	$30,509
Prince Edward Island	$9,140	$44,680
Newfoundland & Labrador	$18,793	$47,888
Yukon	$24,091	$47,888
NWT	$42,563	$47,888
Nunavut	$42,563	$47,888

See footnotes at the end of this article.

Conclusion

Because of the ongoing changes to the taxation of eligible dividends, this is an ideal time to discuss the types of investment income your investment portfolios earn to understand and consider the potential impact of these tax changes to your portfolio. Recognizing your investment objectives, your BMO Nesbitt Burns Investment Advisor 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 what's left in your portfolio after taxes.

For more information or to discuss your personal situation, please contact your BMO Nesbitt Burns Investment Advisor.

For more information contact us at
519-646-2308 / 1-800-265-4195

Mark J. Berry
Vice-President
Wealth Advisor

Bill Smyrnios
Vice-President
Wealth Advisor

The Berry – Smyrnios Group

BMO Nesbitt Burns
Private Client Division

Footnotes to "Tax-Free" Dividend Summary:

1 – General
For illustrative purposes only. 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. Therefore, for example, the individual has no dependent children and cannot claim the age amount. 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.

The table reflects the actual amount of Canadian dividends received, before applying the gross-up factor.

This schedule does not apply for 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 the 'kiddie-tax' rules (e.g., for dividends paid by a private corporation to a child under the age of 18) which may defeat income splitting objectives.

Note also that the amounts in the table do not reflect the possible application of federal or provincial Alternative Minimum Tax.

2 – Ontario Health Premium
In Ontario, Ontario Health Premiums of $600 will be payable.

3 – Quebec Health Contribution
In Quebec, Health Services Fund Contributions of $81.90, Health Contributions of $200 and Quebec Prescription Drug Plan Premiums of $581.50 will be payable for a total of $863.40.

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