Eligible Dividends

Given the changes in the taxation of dividend income over the last few years, you should 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. However, even tax-conscious investors may not appreciate how changes to the taxation of eligible dividends may impact their after-tax returns. 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 receive preferential tax treatment by both the federal and provincial governments by way of a dividend gross-up and tax credit mechanism. A new dividend tax regime exists for qualifying dividends paid by a Canadian corporation to a Canadian investor 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, changes originating from the 2013 Federal Budget have increased the effective tax rate on these 'ineligible dividends' by adjusting the gross-up from 25% to 18%, and the corresponding dividend tax credit from 13.33% to 11.02%, beginning in 2014.

Changes effective for 2010 to 2012

As a result of decreases in the federal general corporate income tax rate, reductions to the gross-up and tax credit mechanism on eligible dividends took effect annually from 2010 to 2012. This increased the effective tax rate on eligible dividends, beginning in 2010. These changes were introduced because the dividend tax credit is intended to compensate individual taxpayers for the income tax paid by the corporation paying 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) that will reduce the actual income tax you pay on that dividend.

The Combined Top Marginal Tax Rates for 2014 in the table on the next page, compares specific tax rates by province for each type of investment income, taking into account these changes, as well as the recent 2014 federal and provincial budgets. As outlined in this table, the top tax rate for eligible dividends varies significantly, depending on the province in which you reside. In Alberta and the Yukon, despite the impact of these recent federal changes, eligible dividends incur a lower top tax rate than capital gains in 2014. However, in most other provinces the tax rate differential between eligible dividends and capital gains is widening.

Other considerations

One often overlooked implication of these changes 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), the 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.

2014 Combined Federal and Provincial Top Marginal Tax Rates for Individuals*

Province	Salary and Interest	Capital Gains	Non-Eligible Dividends	Eligible Dividends
B.C.	45.80%	22.90%	37.98%	28.68%
Alberta	39.00%	19.50%	29.36%	19.29%
Saskatchewan	44.00%	22.00%	34.91%	24.81%
Manitoba	46.40%	23.20%	40.77%	32.26%
Ontario(1)	49.53%	24.76%	40.13%	33.82%
Quebec	49.97%	24.98%	39.79%	35.22%
New Brunswick	46.84%	23.42%	36.02%	27.35%
Nova Scotia	50.00%	25.00%	39.07%	36.06%
P.E.I	47.37%	23.69%	38.74%	28.70%
Newfoundland	42.30%	21.15%	32.08%(2)	30.19%(2)
Yukon	42.40%	21.20%	32.04%	15.93%
NWT	43.05%	21.53%	30.72%	22.81%
Nunavut	40.50%	20.25%	31.19%	27.56%

* Applies to taxable income over $136,270 ($150,000 in British Columbia and Nova Scotia and $220,000 in Ontario)

(1) Reflects impact of changes proposed in November 7, 2013 Fall Economic Statement and May 1, 2014 Ontario budget (re-introduced in July 2014) which creates additional tax brackets for taxable incomes exceeding $150,000 and $220,000 (shown above).

(2) For dividends paid after June 30, 2014.

"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, without triggering federal or provincial/territorial income tax for 2014, assuming that the individual has no other sources of income.

"Tax-Free" Dividend Summary – 2014

Province[1]	Non-Eligible Dividends	Eligible Dividends
Alberta	$21,846	$49,284
British Columbia	$22,282	$49,284
Manitoba	$9,368	$24,271
New Brunswick	$23,025	$49,284
Newfoundland and Labrador[2]	$18,640	$20,810
Nova Scotia	$21,636	$30,509
Ontario[3]	$35,546	$49,284
Prince Edward Island	$12,824	$44,680
Quebec[4]	$21,409	$35,076
Saskatchewan	$18,862	$49,284
Nunavut	$35,546	$49,284
Northwest Territories	$35,546	$49,284
Yukon	$22,077	$49,284

See Footnotes at the end of this article.

Conclusion

Due to the ongoing changes to the taxation of eligible dividends, 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.

For more information, speak with your BMO financial professional.

"Tax-Free" Dividend Summary Footnotes:

1 **General** – For illustrative purposes only based on 2014 tax rates as of June 2014. 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 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 the 'kiddie-tax' rules (i.e., for dividends paid by a private corporation to a child under the age of 18), which may defeat income splitting objectives.

2 In Newfoundland or Labrador, the amounts shown assume the dividends are paid after June 30, 2014.If the dividends are paid before July 1, 2014, the amounts are:

Non-eligible dividends	Eligible dividends
$20,732	$49,284

3 In Ontario, the amounts shown assume that the measures introduced in Ontario's November 7, 2013 fall economic statement are enacted. If these measures are not enacted, the amounts are:

Non-eligible dividends	Eligible dividends
$31,116	$49,284

The Ontario Health Premiums will be:		Non-eligible dividends	Eligible dividends
Ontario's November 7, 2013 fall economic statement measures are:	enacted	$450	$600
	not enacted	$343	

4 In Quebec, the following premiums will be payable:

	Non-eligible dividends	Eligible dividends
Health Services Fund contribution	$73	$150
Health contribution	$100	$200
Quebec Prescription Drug Plan premium (To be adjusted July 1, 2014)	$607	$607
Total	**$780**	**$957**

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