Eligible Dividend Income

It's important to revisit the taxation of investment income, especially given the changes in the taxation of dividend income 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 from 25% to 18%, and the corresponding dividend tax credit from 13.33% to 11.02%, beginning in 2014. The recent 2015 Federal Budget announced higher effective tax rates on "ineligible" dividends to be phased in between 2016 to 2019.

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 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) that will reduce the actual income tax you pay on that dividend.

Continued

The Combined Top Marginal Tax Rates for 2015 in **Table 1** compares specific tax rates by province for each type of investment income, taking into account these changes as well as tax rate changes announced in the recent 2015 provincial budgets. 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, eligible dividends now incur a higher top tax rate than capital gains in 2015 (except in the Yukon), and in most 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), 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.

Table 1

2015 Combined Federal and Provincial Top Marginal Tax Rates for Individuals*

Province	Salary and Interest	Capital Gains	Eligible Dividends	Non-Eligible Dividends
B.C.	45.80%	22.90%	28.68%	37.98%
Alberta	40.25%	20.13%	21.02%	30.84%
Saskatchewan	44.00%	22.00%	24.81%	34.91%
Manitoba	46.40%	23.20%	32.26%	40.77%
Ontario	49.53%	24.76%	33.82%	40.13%
Quebec	49.97%	24.98%	35.22%	39.79%
New Brunswick	54.75%	27.38%	38.27%	46.89%
Nova Scotia	50.00%	25.00%	36.06%	41.87%
P.E.I.	47.37%	23.69%	28.70%	38.74%
Newfoundland	43.30%	21.65%	31.57%	33.26%
Yukon	44.00%	22.00%	19.29%	35.18%
NWT	43.05%	21.53%	22.81%	30.72%
Nunavut	40.50%	20.25%	27.56%	31.19%

*The rates apply to taxable incomes over $150,000 in Nova Scotia, $151,050 in British Columbia, $175,000 in Newfoundland/Labrador, $220,000 in Ontario, $250,000 in New Brunswick, $300,000 in Alberta, $500,000 in Yukon and $138,586 in all other provinces and territories.

"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. **Table 2** 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 2015, assuming that the individual has no other sources of income.

Table 2

"Tax-Free" Dividend Summary – 2015

Province or territory[1]	Eligible dividends	Non-eligible dividends
Alberta	$50,122	$22,370
British Columbia	$50,122	$22,710
Manitoba	$24,271	$9,368
New Brunswick	$50,122	$19,905
Newfoundland and Labrador	$21,268	$19,050
Nova Scotia	$30,509	$14,787
Ontario[2]	$50,122	$36,150
Prince Edward Island	$44,680	$13,551
Quebec[2]	$35,448	$21,636
Saskatchewan	$50,122	$19,183
Nunavut	$50,122	$36,150
Northwest Territories	$50,122	$36,150
Yukon	$50,122	$19,020

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.

"Tax-Free" Dividend Summary Footnotes:

[1] **General –** For illustrative purposes only based on 2015 tax rates as of June 10, 2015. 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] Health levies at the dividends levels shown will be:

		Eligible dividends	Non-eligible dividends
Ontario Health Premiums		**$600**	**$450**
Quebec	Health Services Fund contribution	$150	$74
	Health contribution	$200	$100
	Quebec Prescription Drug Plan premium	$625.50	$625.50
	Quebec total premiums	**$975.50**	**$799.50**

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