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 to 17% and the corresponding dividend tax credit to 10.52%. Although the 2015 Federal Budget announced further changes to the taxation of "ineligible" dividends to be phased in between 2016 to 2019, the new Liberal government announced in its 2016 Federal Budget that it will not be proceeding with this phase-in beyond 2016. Accordingly, the dividend gross-up and tax credit factors will be maintained at the above amounts for 2016 and subsequent years.

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

The **2016 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 for taxable income in excess of $200,000 effective for 2016.

2016 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%	40.25%
British Columbia	47.70%	23.85%	31.30%	40.61%
Manitoba	50.40%	25.20%	37.78%	45.69%
New Brunswick	53.30%	26.65%	36.27%	45.37%
Newfoundland and Labrador	49.80%	24.90%	40.54%	41.86%**
Northwest Territories	47.05%	23.53%	28.33%	35.72%
Nova Scotia	54.00%	27.00%	41.58%	46.97%
Nunavut	44.50%	22.25%	33.08%	36.35%
Ontario	53.53%	26.76%	39.34%	45.30%
Prince Edward Island	51.37%	25.69%	34.22%	43.87%
Quebec	53.31%	26.65%	39.83%	43.84%
Saskatchewan	48.00%	24.00%	30.33%	40.06%
Yukon	48.00%	24.00%	24.81%	40.18%

* This table shows the 2016 top combined marginal tax rates by province (updated to reflect the new 33% top federal tax bracket). The rates apply to taxable incomes over $200,000 except that the thresholds are $220,000 in Ontario, $300,000 in Alberta and $500,000 in Yukon. The rates reflect the impact of the 2016 Federal Budget and all provincial budgets released as of May 9, 2016.

** Rate applies to non-eligible dividends received after June 30, 2016. Before July 1, 2016 the rate is 41.16%.

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 now incur a higher tax rate than capital gains in 2016 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 **"Tax-Free" Dividend Summary – 2016** 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 2016, assuming that the individual has no other sources of income.

"Tax-Free" Dividend Summary – 2016

Province or territory[1]	Eligible dividends	Non-eligible dividends
Alberta	$51,474	$22,789
British Columbia	$51,474	$22,709
Manitoba	$24,271	$9,448
New Brunswick	$51,474	$19,493[3]
Newfoundland and Labrador[2]	$18,679	$18,447[4]
Nova Scotia	$30,509	$14,671
Ontario[2]	$51,474	$32,848
Prince Edward Island	$45,309	$14,359
Quebec[2]	$35,835	$22,060
Saskatchewan	$51,474	$19,195
Northwest Territories	$51,474	$32,848
Nunavut	$51,474	$32,848
Yukon	$51,474	$19,253

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 2016 tax rates as of May 9, 2016. 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 and other personal tax levies at the dividend levels shown will be:

		Eligible dividends	Non-eligible dividends
Newfoundland and Labrador Temporary Deficit Reduction Levy		**$150**	**$47***
Ontario Health Premiums		**$600**	**$446**
Quebec	Health Services Fund contribution	$150	$76
	Health contribution	$175	$50
	Quebec Prescription Drug Plan premium (to be adjusted July 1, 2016)	$640	$640
	Quebec total premiums	**$965**	**$766**

* In Newfoundland and Labrador, the levy shown for non-eligible dividends assumes the dividends are received after June 30, 2016. If they are received before July 1, 2016, the levy is $67 (also see footnote 4).

[3] New Brunswick's non-eligible dividend threshold is based on the provincial non-eligible dividend tax credit rate of 3.625%, stated in New Brunswick Bill 32, which received first reading on March 29, 2016. Although it is our understanding that the Canada Revenue Agency (CRA) rounds provincial dividend tax credit rates to two decimal points, a New Brunswick Finance official confirmed that the CRA will permit a rate of 3.625%

[4] In Newfoundland and Labrador, the amount shown for non-eligible dividends assumes the dividends are received after June 30, 2016. If they are received before July 1, 2016, the amount is $18,998.

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