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FINANCIAL ADVISORY SUPPORT

Dividend Income

How various types of dividend income is taxed

The following article provides an overview of the different types of dividend income and their respective income tax treatments for a resident of Canada. Certain tax treatments provide opportunities for financial planning strategies that may allow you or members of your family to receive Canadian dividend income “tax-free.” This article is for information only and is not intended to be or to replace legal or tax advice. Please consult your legal and tax advisor before acting on the information contained in this article.

Different types of dividends attract different income tax rates

As a Canadian resident, the income tax treatment of the dividend income you receive will depend on the type of dividend. For example, dividend income you receive from Canadian corporations is taxed at a preferential income tax rate. In comparison, foreign dividends are taxable at your marginal income tax rate for ordinary income.

Dividend income from Canadian corporations

Dividends received by residents of Canada from Canadian corporations receive preferential tax treatment because the profits being paid out as a dividend have already been subject to Canadian corporate income tax. Canadian corporations can pay both “eligible” and “non-eligible” dividends. This distinction and the different tax treatments of eligible and non-eligible dividends are meant to reflect the different corporate tax treatments this income was subject to prior to distribution.

Eligible dividends

For 2011, eligible dividends are subject to an enhanced dividend “gross-up” of 41% and a federal dividend tax credit of 16.4% of the grossed-up dividend. For 2012, the enhanced dividend gross-up will be 38% and the federal dividend tax credit will be 15%. There is also a provincial dividend tax credit available, which differs for each province.



The following table provides a typical example of how tax is calculated on eligible dividends assuming the individual is at the top marginal tax bracket. For illustration purposes, we have assumed a provincial tax rate of 15% and a provincial tax credit of 10% on the grossed-up dividend.

Eligible dividend income: How much you keep after tax per \$1,000

| | |
|--------------------------------|--------------|
| Dividend income | \$1,000 |
| Gross-up (41%) | \$410 |
| Subtotal | \$1,410 |
| Federal tax | \$409 |
| Dividend tax credit | \$231 |
| Net federal tax | \$178 |
| Provincial tax | \$212 |
| Provincial dividend tax credit | \$141 |
| Net provincial tax | \$71 |
| Combined tax | \$249 |
| Amount you keep | \$751 |

All amounts are approximate. This illustration ignores any additional surtaxes or credits that may be available in some provinces.

Non-eligible dividends

Non-eligible dividends use the same tax treatment that has been applied to Canadian dividends for many years. Non-eligible dividends are subject to a dividend gross-up of 25% and a federal dividend tax credit of 13.33% of the grossed-up dividend. Again, there is also a provincial dividend tax credit that varies for each province.

Comparing eligible and non-eligible dividends

The ability to pay an eligible dividend (vs. non-eligible dividend) is different for public corporations than for Canadian-controlled private corporations (CCPC). In general, dividends paid from 2006 onwards from a Canadian public corporation are typically classified as eligible dividends (however, there may be exceptions). In contrast a CCPC is only able to pay eligible dividends if its active business income is taxed at the higher general corporate tax rate, which is generally income that does not receive the \$500,000 small business deduction. It may also pay eligible dividends to the extent of any eligible dividends it receives from other corporations.

Tax-free dividends

If you are a Canadian resident and have little or no other income, you may be able to receive dividend income from a Canadian corporation “tax-free.” Though the dividends are not actually tax-free, under certain circumstances, you may be able to take advantage of the dividend tax credit and your basic personal amount (and other tax credits you may be entitled to) in such a way that even though you receive dividend income, you do not trigger an income tax liability. The amount of this potentially tax-free receipt depends on whether the dividend is an eligible or non-eligible dividend and on the province in which you reside.

The following table summarizes by province the actual eligible and non-eligible dividend amounts a Canadian resident may receive tax-free **if they have no other income**. These are the actual amounts of the Canadian-source dividend before it is grossed up.

| Province | Eligible dividend amount (actual dividend before the gross-up) | Non-eligible dividend amount (actual dividend before the gross-up) |
|---------------------------|--|--|
| British Columbia | \$50,500 | \$27,100 |
| Alberta | \$50,500 | \$20,900 |
| Saskatchewan | \$50,500 | \$21,300 |
| Manitoba | \$50,500 | \$9,000 |
| Ontario | \$50,500 | \$38,150 |
| Quebec | \$32,300 | \$21,250 |
| New Brunswick | \$50,500 | \$21,400 |
| Nova Scotia | \$29,850 | \$28,350 |
| Prince Edward Island | \$43,750 | \$9,150 |
| Newfoundland and Labrador | \$50,500 | \$18,250 |
| Yukon | \$50,500 | \$23,450 |
| Northwest Territories | \$50,500 | \$41,400 |
| Nunavut | \$50,500 | \$41,400 |

This table considers all regular federal and provincial taxes and surtaxes (with the exception of the Ontario Health Premium and Quebec Health Service Fund, Health Contribution and Prescription Drug Insurance Plan). Only the basic personal exemption and the dividend tax credit are reflected in the calculation.

As you can see from this table, the amount of eligible dividends that may be received tax-free ranges from the lowest amount of \$29,850 in Nova Scotia to the highest amount of \$50,500 in most other provinces. The dividend tax credit and the basic personal exemption in some provinces allow for a higher dividend amount; however, federal taxes, in particular the federal alternative minimum tax, will be triggered on any amount in excess of \$50,500.

Please note this planning opportunity exists only for individuals. Dividend income is taxed differently when received by a trust or corporation since they do not necessarily have the same tax credits. For example, although a trust is entitled to the dividend tax credit, it cannot claim the basic personal exemption.

The effect of receiving dividend income on other amounts

Please keep in mind that as you increase the amount of taxable dividends you receive, your taxable income also increases. This may affect your ability to claim income-tested credits or benefits such as the age amount or Old Age Security. Please contact your tax advisor to determine, based on your situation, what the most tax-efficient amount of dividend income would be.

Don't forget the attribution rules

To take advantage of this potentially tax-free dividend, you must be the owner of the share (or mutual fund unit) for income tax purposes. This means that the source of the shares must be considered for income tax purposes. If you did not pay for the shares — e.g. you received them from your spouse or your minor child received them from you or a relative — then the income you or your child earns might be subject to the attribution rules.

The income attribution rules require that all of the dividend income be taxed in the hands of the individual who gifted the shares. If the attribution rules apply to the dividend income received, then there may not be any tax-free income as the dividend would be attributed and taxable to the individual who gifted the shares, who may have other sources of income or be in the highest marginal tax bracket.

Split income tax (Kiddie Tax)

The split income tax (or Kiddie Tax) has existed since 2000 and was introduced to reduce the use of private family-owned businesses as a conduit for income splitting with minor children. The split income tax applies in situations where the shareholders are not dealing at arm's length with the corporation for Canadian tax purposes. A typical example of this is where the shares that pay the dividends are shares of a family-owned private company. The effect of the split income tax is that the top marginal tax rate is applied to the dividend paid to minor children, and the only available credit is the dividend tax credit.

The split income tax does not apply to dividend income received by a minor from stocks that are traded on a public exchange. However, the general attribution rules must still be considered.

Foreign dividends

Foreign dividends received by a Canadian resident are not subject to a gross-up, nor are they eligible for a dividend tax credit. Foreign dividends are included in your income and taxed at your marginal tax rate on ordinary income (in the same manner as interest). This tax treatment results in higher taxes on the foreign dividend than a Canadian-source dividend. If you are subject to foreign non-resident withholding tax, you may claim a foreign tax credit on your Canadian income tax return to avoid double tax on the income.

Foreign shares received as a result of a foreign spin-off are normally treated as a receipt of a foreign dividend, which is taxable for Canadian residents as ordinary income. However, the foreign spin-off may be non-taxable for Canadian residents if certain criteria are met and elections by the investor and the foreign corporation are filed and accepted by the Canada Revenue Agency.

Capital gains dividends

Capital gains dividends are usually paid by a mutual fund corporation, an investment corporation or a mortgage investment corporation. The capital gains dividends represent a distribution from the corporation's pool of realized capital gains. The capital gains dividends are not actual dividends and are not subject to the dividend tax credit — they represent capital gains and are subject to tax as any other capital gain, which includes benefiting from the 50% inclusion rate.

Capital dividends

A capital dividend is a tax-free amount received from a CCPC. The capital dividend is paid out of the corporation's Capital Dividend Account (CDA). In general, the CDA accumulates the non-taxable portion of capital gains less the non-taxable portion of capital losses plus proceeds from certain life insurance policies less the adjusted cost base of the policy. A positive balance in the CDA represents an amount that may be paid tax-free to the shareholders of the private corporation.

Stock dividends

Stock dividends are typically used by public companies to effect a stock split without the formal processes that are normally required for cash dividends. Stock dividends are also used on occasion as a method to distribute shares of standalone businesses to shareholders as part of a spin-off transaction.

For tax purposes, stock dividends result in a dividend equal to the investor's share of the increase in the paid-up capital of the corporation resulting from the payment of the stock dividend. In most cases this amount is negligible and not reported on a T5 slip. If the increase in paid-up capital is large enough to be reported on a T5 slip and it is received from a Canadian corporation, the deemed dividend is grossed up and subject to the dividend tax credit treatment. Foreign stock dividends are not grossed up and not subject to the dividend tax credit.



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