The Navigator

Wealth Management

RBC Wealth Management Services

Dividend income

How various types of dividend income are taxed

On July 18, 2017 the federal government released a consultation paper proposing a number of strategies which target private corporations with regards to income splitting, multiplication of the lifetime capital gains exemption, holding a passive investment portfolio inside a private corporation, and converting a private corporation's regular income to capital gains.

Generally, effective for 2018 and later taxation years, the government has proposed to limit income sprinkling to family members receiving "reasonable" compensation from a private corporation. The proposed measures extend the tax on split income rules (often known as "kiddie tax") to adults and limit the multiplication of claims to the lifetime capital gains exemption.

The government is also seeking input on possible measures to eliminate the tax advantage of investing undistributed earnings from an active business in a private corporation. If enacted, these measures may result in a disincentive for investing passively within a corporation.

The strategies discussed in this article may be affected by the proposed measures in the consultation paper and the accompanying proposed legislation. If you are an owner of a private corporation you should consider the potential impact of the proposed measures and discuss the implications with your qualified tax advisor.

Please contact us for more information about the topics discussed in this article.

This 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."

The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax advisor before acting on any of the information in this article.

Not all dividends are the same

Corporations can choose to pay dividends to shareholders. You, as the shareholder, may receive dividends from different 'pools' of income within the corporation. The source of the dividend determines how you will be taxed on the income. Canadian corporations can pay both "eligible" and "non-eligible" dividends.

Non-eligible dividends are subject to a dividend gross-up that is smaller than the eligible dividends. The federal dividend tax credit for non-eligible dividends is also generally smaller. As with eligible dividends, you are also eligible for a provincial or territorial dividend tax credit.

As a Canadian resident, the tax rate that applies to dividend income depends on the type of dividend you receive. For example, eligible dividends from a Canadian corporation benefit from preferential tax treatment. In comparison, dividends you receive from a foreign corporation are taxable at your marginal income tax rate.

Dividend Income from Canadian Corporations

Eligible dividends

Eligible dividends are subject to an enhanced dividend "gross-up". Individuals who earn eligible dividends can claim a federal dividend tax credit. There is also a provincial or territorial dividend tax credit available, which differs for each province or territory. A list of gross-up factors and federal, provincial, and territorial dividend tax credit rates can be found in Appendix 1.

The following table provides an example of how tax would be calculated on $1,000 of eligible dividends received by a taxpayer whose federal marginal tax rate is 29% and provincial marginal tax rate is 15%. This example assumes that the federal gross-up is 38%, the federal dividend tax credit is 15% and the provincial tax credit is 10% of the grossed-up dividend.

Example 1: After-tax eligible dividend income

Eligible dividend income	$1,000
Gross-up (38%)	380
Taxable amount	$1,380
Federal tax ($1,380 x 29%)	$ 400
Less: dividend tax credit ($1,380 x 15%)	(207)
Net federal tax	$ 193
Provincial tax ($1,380 x 15%)	$ 207
Less: provincial dividend tax credit ($1,380 x 10%)	(138)
Net provincial tax	$ 69
Combined tax ($193 + $69)	$ 262
After-tax amount ($1,000 - $262)	**$ 738**

Non-eligible dividends

Non-eligible dividends are subject to a dividend gross-up that is smaller than the eligible dividends. The federal dividend tax credit for non-eligible dividends is also generally smaller. As with eligible dividends, you are also eligible for a provincial or territorial dividend tax credit. A list of gross-up factors and federal, provincial, and territorial dividend tax credit rates can be found in Appendix 1.

Comparing eligible and non-eligible dividends

Generally, the company can designate a dividend as either eligible or non-eligible. The ability to make such a designation depends mostly on a corporation's status. Since 2006, dividends paid by a Canadian public corporation (companies that trade on a stock exchange) are typically classified as eligible dividends.

On the other hand, a Canadian Controlled Private Corporation (CCPC) can pay both eligible and non-eligible dividends. The first $500,000 of active business income earned by a CCPC may be taxed at lower rates when certain conditions are met. The $500,000 is the federal small business deduction (SBD) limit (the provincial limit varies by province). When dividends are paid from income that has been subject to the SBD, the dividends are designated as non-eligible dividends. A CCPC's active business income exceeding the SBD limit is taxed at the higher general corporate tax rate. Dividends paid from this pool of income are designated as eligible dividends. A CCPC may also pay shareholders the eligible dividends it receives from other corporations.

Tax-free Dividend Income

Having little or no other income, you may be able to receive dividends from a Canadian corporation "tax-free." Under certain circumstances, the dividend tax credit and the basic personal amount (and other tax credits you may be entitled to) reduce the taxes on dividends to zero. In this case, although you receive dividends, the payment does 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, whether you have other income and the province or territory of residence. See Appendix 2 for the amount of eligible and non-eligible dividend amounts a single Canadian resident may be able to receive tax-free assuming they have no other income.

Please note this planning opportunity is only applicable for individuals. If a trust or a corporation receives dividend income, the income is subject to tax in a different manner. They do not necessarily have the same tax credits. For example, although a trust is eligible for the dividend tax credit, it cannot claim the basic personal exemption.

The effect of receiving dividend income on income-tested credits and benefits

The more dividends you receive, the higher your taxable income. It is important to keep in mind the gross-up rate on dividends will increase your taxable income. For example, $1 of actual eligible dividend is reported as $1.38 taxable income on your tax return. The grossed-up amount is used for testing your eligibility for certain credits and benefits such as the age amount or Old Age Security. You should contact a qualified tax advisor to determine the most tax-efficient amount of dividend income you should receive.

Don't forget the attribution rules

If you gift shares to a spouse or a minor child, or your minor child receives shares from a relative, the income might be subject to the attribution rules.

If these rules apply, all of the dividends will be taxable in the hands of the individual who gifted the shares. If the individual who gifted the shares has other sources of income, the dividend income may not be tax-free for them.

Split income tax (Kiddie tax)

The split income tax rules prevent families from shifting income to minor children as a way of reducing the household tax bill. Where a minor child receives dividends paid directly or indirectly (e.g. through a family trust) from private corporations, the dividends may be taxable to the child at the highest marginal tax rate. The minor child will only be able to claim the dividend tax credit on these payments. These rules do not apply to dividends that a minor receives from stocks that are traded on a public exchange. It is important to consult with your tax professional prior to implementing any income splitting strategies with minor children.

Foreign Dividends

Foreign corporations are generally not subject to Canadian corporate tax, so dividends you receive from foreign corporations are not subject to the gross-up, nor are you eligible for the dividend tax credit. Foreign dividends you receive, such as those paid by U.S. or European companies, are fully taxable to you. This tax treatment results in higher taxes payable on a foreign dividend than on a Canadian-source dividend. In addition, there may be withholding tax on the foreign dividends. In a non-registered account, you can claim a federal foreign tax credit to a maximum of 15% on your Canadian income tax return. If the withholding tax rate is more than 15%, you may not be able to avoid double tax on the income.

Capital Gains Dividends

Capital gains dividends are usually paid by regulated mutual fund corporations, investment corporations or mortgage investment corporations. They are distributions from the corporation's pool of realized capital gains. Capital gains dividends are not eligible dividends for tax purposes, and do not qualify for the dividend tax credit. They are taxed as capital gains and are subject to tax like any other capital gain. Currently, you must include half of the capital gains you realize or receive in your taxable income.

Capital Dividends

A capital dividend is a tax-free dividend that can be paid by a private Canadian corporation. When the corporation has a positive balance in the Capital Dividend Account (CDA), a capital dividend distribution can be made. In general, the following items increase a corporation's CDA:

- the non-taxable portion of capital gains net of the non-taxable portion of capital losses;
- proceeds from certain life insurance policies net of the

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adjusted cost base of the policy;

- capital dividends received by the corporation; and
- the non-taxable portion of any gains on the sale of eligible capital property, such as goodwill that is added to the account after the end of the tax year when the gain is realized.

Stock dividends

Stock dividends are typically used by public companies. They can be used to effect a stock split or increase the stated capital of the corporation. They are also sometimes used as a method to distribute shares of standalone businesses to shareholders as part of a spin-off transaction. When making a stock dividend distribution, the company does not need to go through the formal process that is generally required for cash dividend payments.

For tax purposes, stock dividends are taxable. In general, the taxable dividend amount equals the increase in paid-up capital of the corporation. In most cases, this amount is negligible and will not be reported on a T5 slip. A stock dividend distribution from a Canadian corporation is subject to the gross-up and dividend tax credit treatment. Foreign stock dividends will not be subject to the gross-up and accordingly are not eligible for the preferential dividend treatment.

If you hold shares of a foreign corporation, you may receive stock dividends as a result of a foreign spin-off. Normally, if you receive this type of dividend, the fair market value of the stock received is fully taxable to you. However, the foreign corporation may be able to structure the spin-off as an "eligible spin-off". If the company gets approval from the Canada Revenue Agency, you can then file an election with your tax return to defer the taxes payable on the foreign dividend. For more information, ask your RBC advisor for a copy of article titled "Foreign Spin-offs".

Conclusion

Understanding how you will be taxed on the various types of dividend income you may receive will help you with tax planning and investment planning. Speak to your RBC advisor to ensure that your current investments fit into your personal financial plan.

Wealth Management

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