Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Dividend income

How various types of dividend income are taxed

As an investor, you may own shares of many corporations as part of your investments. These corporations may pay you dividends. This article provides an overview of various types of dividend income and their respective tax treatment for an individual Canadian resident.

Not all dividends are the same

As a shareholder, you may receive different types of dividends from a corporation. Canadian corporations can pay eligible, non-eligible and capital dividends. A foreign corporation can pay you a foreign dividend.

The way you're taxed on the dividend depends on the type of dividend you receive. For example, eligible and non-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.

Eligible and non-eligible dividends

Eligible dividends

An eligible dividend is a taxable dividend that a Canadian corporation designates to be eligible. Eligible dividends are subject to a dividend "gross-up" on your personal tax return. This means you have to multiply the dividend by a certain percentage and include the higher amount in your taxable income. This grossed-up amount of income approximates the amount of pre-corporate tax income that would have been required to pay the dividend.

Individuals who receive eligible dividends can then claim a federal dividend tax credit. The dividend tax credit gives you credit for roughly the amount of tax that the corporation has already paid. The purpose of the gross-up and tax credit mechanism is to prevent double taxation (corporate and personal taxation) on the dividend. There's 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 an individual 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: 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

A non-eligible dividend is a taxable dividend that a Canadian corporation has not designated to be eligible. 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're 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 for non-eligible dividends can be found in Appendix 1.

Alternative minimum tax (AMT)

AMT may impact your tax liability for the year if you earn Canadian dividends. AMT aims to ensure that every Canadian individual pays a minimum amount of tax. The calculation of AMT is based on an "adjusted taxable income" which seeks to remove the advantages of certain tax-preferential items such as dividends that are eligible for the dividend tax credit. If the AMT calculated is greater than your regular tax liability, the AMT becomes your tax liability for the year. The difference between the AMT that you have to pay in a year and your regular tax liability can be carried forward for seven years to reduce your future regular income tax liability when your taxes payable exceed your AMT. For more information about AMT, ask your RBC advisor for an article on this topic.

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Tax-free dividend income

If you have little or no other income, you may be able to receive what are normally taxable 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 received taxable dividends, the payment does not trigger an income tax liability. The amount of this potentially tax-free dividend depends on whether the dividend is an eligible or non-eligible dividend, whether you have other income and your province or territory of residence. The amount of eligible and non-eligible dividends an individual Canadian resident may be able to receive tax-free, assuming they have no other income, can be found in Appendix 2.

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. Trusts and corporations are not necessarily entitled to the same tax credits as individuals. For example, although a trust is eligible for the dividend tax credit, it cannot claim the basic personal amount.

Capital dividends

Private Canadian corporations have a capital dividend account (CDA), which is a notional account. The CDA keeps tracks of the non-taxable portion of capital gains and the non-allowable portion of capital losses, as well as other amounts such as capital dividends received or paid by the corporation and certain life insurance proceeds received in excess of the policy's adjusted cost base. It is intended that the tax-free character of these amounts be transferable to shareholders. As such, when there's a positive balance in the CDA, a tax-free capital dividend can be paid to the corporation's shareholders. Once a capital dividend is distributed, the CDA is reduced by the amount of the capital dividend paid.

Capital gains dividends

Capital gains dividends are usually paid by regulated mutual fund corporations, investment corporations or mortgage investment corporations. They're 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're taxed as capital gains where half of the capital dividend is taxable as income.

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 corporations, are fully taxable to you at your marginal tax rate. 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. If you earned the dividend in a non-registered account and you were subject to withholding tax, you may be able to claim a federal foreign tax credit on your Canadian income tax return. This foreign tax credit is meant to prevent double taxation (tax paid in two countries) of the dividend. The foreign tax credit is limited to the amount of foreign taxes paid (generally this tax is paid in the form of withholding tax) or 15% of the income, whichever is less. If the foreign country withholding tax rate is more than 15%, you may be able to claim a deduction. Speak with a qualified tax advisor for more information regarding this deduction.

Stock dividends

Stock dividends are typically used by public corporations. They can be used to effect a stock split or increase the stated capital of the corporation. They're also sometimes used as a method of distributing shares of standalone businesses to shareholders as part of a spin-off transaction.

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. 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 nor will you be able to claim a dividend tax credit on the dividends.

If you hold shares of a foreign corporation, you may receive stock dividends as a result of a 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 corporation 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, please ask your RBC advisor for an article on foreign spin-offs.

For tax purposes, stock dividends are taxable. In general, the taxable dividend amount equals the increase in paid-up capital of the corporation.

Other considerations

Dividend income and income-tested credits and benefits

The more dividends you receive, the higher your taxable income. It's important to keep in mind the grossed-up amount of dividends will increase your taxable income. For example, $1 of an actual eligible dividend is reported as $1.38 of taxable income on your tax return. The grossed-up amount is also used for testing your eligibility for certain credits and benefits such as the age amount or Old Age Security.

Dividend income and 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 may be subject to the attribution rules. If these rules apply, all of the dividend income will be taxable in the hands of the individual who gifted the shares.

Dividend income and the tax on split income (TOSI) rules

There are TOSI rules which limit splitting certain types of income with family members. These TOSI rules apply to many types of income received from a private corporation, including dividends. The rules do not apply to dividends received from stocks that are traded on a public exchange. Where TOSI applies, the income is subject to tax at the highest marginal rate, regardless of the individual's actual marginal tax rate. In addition, the individual who receives split income loses the ability to claim certain personal tax credits on the split income, such as the basic personal amount.

There are some exclusions to TOSI, which differ depending on the age of the individual receiving the income. The age categories include minors under age 18, adults age 18 to 24, and adults age 25 and over. There is also an exclusion available to the spouse of a business owner who is age 65 or over. The exclusions mainly rely on whether the family member is significantly involved in the business or owns a certain portion of the votes and value of the corporation's shares. The exclusions are generally more restrictive for minors.

Due to the complexity of these rules, if you own a private corporation, it's important to consult with a qualified tax advisor prior to paying dividends from your corporation to family members.

Conclusion

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

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance 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, legal and/or insurance advisor before acting on any of the information in this article.