Leith Wheeler INVESTMENT COUNSEL LTD.
Well Into the Future

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Planning Matters

LEVERAGING THE TAX ADVANTAGES OF DIVIDENDS

In 2006 one of the more significant Canadian income tax changes was introduced when the Government announced that dividends received from Canadian public companies would be taxed at a favourable rate. Essentially, what the government did was eliminate what was previously a double tax on dividends from Canadian public companies. This served to level the playing field between Canadian public companies and Canadian income trusts. As a result, a resident of British Columbia, an individual with no other personal income could earn approximately $50,000 of dividends in 2011 from Canadian public companies and pay no personal income tax, provided they have no other income. Put another way, if you have managed to put away an investment portfolio of approximately $1.0 million and can find shares of a Canadian public company paying dividends of 5%, you would be able to keep all of that income without having to part with any taxes to your favorite silent partner, Canada Revenue Agency (CRA). Of course this is built on the premise that you have no other personal income, which is often not the case.

While this may sound like a scheme that would land you in front of a CRA auditor, rest assured that this is fully endorsed by the Canada Revenue Agency. Prior to this change, the way it worked was that a Canadian public company would earn income of say, $100 and would pay tax of approximately $34, leaving $66 to be paid out as dividends. These dividends would then be taxed again in the individual investor's hands. If you were in British Columbia the top tax bracket on this dividend would have resulted in an additional $21 of tax with the result that the overall tax paid on this $100 of income would have been approximately $55. This is effectively double taxation as the top personal tax bracket in British Columbia, at the time, was slightly less than 44%. Presumably the Government recognized that a number of companies were converting to income trusts or partnerships to avoid this double taxation. Fortunately they took steps to make the system more fair. Today, if a Canadian public company earns $100 of income they pay approximately $25 of tax and the individual shareholder would pay no more than approximately $20 of tax in British Columbia, resulting in an overall tax of approximately $45.

This all sounds wonderful but how does it impact you as an individual? The mechanics of the system allow for a Canadian public company to be taxed at their rate of 25% and to pay out the remaining 75% as dividends to investors. If, as a B.C. resident individual, you have no other income then you would pay no tax on this dividend up to approximately $50,000. This results from the interaction of the dividend tax credit allowed on these dividends which offsets the Federal and Provincial taxes. If you are at the top tax bracket in B.C. (income over $128,800 in 2011) then your marginal tax rate on these dividends will be 23.91%, which is less than your tax rate on dividends from foreign companies as well as interest of 43.7%.

To illustrate, if an individual with no other income invests $1.0 million in a 5% dividend yielding Canadian public company stock, they would pay no personal income tax. However, if that same individual were to find an investment yielding an interest rate of 5%, their personal tax on that interest income would be approximately $9,000 in British Columbia. That reduces the rate of return from 5% to approximately 4.10%. In other words, you need to earn an interest yield of approximately 6.2% to equate to a 5% dividend yield. Obviously there are other considerations such as the risk that you are willing to take on with respect to your portfolio. However this significant tax advantage should not be discounted!

While the broad picture is that dividends received from Canadian public companies are very tax efficient, there are some things to watch for. If you are an individual over the age of 65 in Canada and earning Old Age Security Pension (OASP), you will need to be careful that receiving Canadian public company dividends does not put you offside and require a claw back of some or all of your OASP. This unintended result often happens as the mechanism for providing the lower tax treatment on dividends is accomplished through an often misunderstood method of grossing up these Canadian public company dividends by 41% and providing a separate tax credit on your personal tax return. However, the actual grossing up of these dividends results in higher net income for you and may result in a claw back of your OASP. Planning is required to ensure this does not occur or is minimized if possible.

If you have a holding company invested in Canadian public company stocks that pay dividends, you will receive the same treatment as these dividends retain their status and are put into a special pool within your corporation. When your company pays out dividends from the special pool to the Canadian shareholders, you receive this favourable tax treatment as well.

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