

Canadian dividends provide investors tax-efficiency

Home bias with a rational rationale

Investors are often comforted by investing in what is familiar. For Canadians, that may include investing a greater share of their portfolio in Canadian securities.

Whether or not it is intentional, this home bias can provide benefits beyond comfort, by also rewarding the investor from a tax perspective.

What – Focus on non-registered investments

In a registered account like a Registered Retirement Savings Plan (RRSP), there is no tax distinction among the types of income. No tax applies to the income earned within the plan, then all withdrawals are fully taxable.

It's different with non-registered accounts, where the method and amount of tax varies according to the type of income. In these accounts, Canadian dividends are tax-preferred, especially for those at low to middle income.

Why – Corporation adds a taxpayer level

The recipient of any income is responsible for paying tax. If all income was earned directly by individuals, or *natural persons*, then things would be straightforward.

However, there are also *artificial persons*—or corporations—which may first earn and pay tax on income before passing it on to real people. The way it is passed on by the corporation is by paying dividends to its owner/shareholders, in this case the portfolio investors.

How – Integration mitigates double-taxation

With both individuals and corporations being required to pay tax on the income they receive, there is a risk of double-taxation. This is further complicated by the way each is taxed: corporations are taxed at a flat rate, and individuals pay tax at graduated rates that get progressively higher as income rises.

To reconcile this two-stage taxation, our system has a set of rules that integrates personal and corporate taxes. It's known as the integration model and it has two main components:

1. Gross-up

A dividend received by a shareholder from a Canadian corporation is increased by an arithmetic factor designed to add back the taxes paid by the corporation. By doing so, it's as if the investor earned the income that was really earned by the corporation. This 'taxable' dividend is what is used to calculate the investor's initial tax liability – *but wait...*

2. Dividend tax credit

Another arithmetic factor is then applied to reduce the individual's tax liability by the estimated tax that the corporation has already paid. The government has only collected part of its revenue from the corporation, so in effect the investor is topping that up.

For investors in low to middle income brackets, this can result in much less tax than would apply to interest income or foreign dividends. And at very low income, the credit may exceed the tax as calculated above, allowing the excess credit to be applied against tax otherwise due on the person's other income. The combined effect of the gross-up and dividend tax credit are shown in the table on the next page.

History – Two types of Canadian dividends

For decades, one set of factors for gross-up and tax credits applied to all Canadian-source dividends. But since 2006, dividends from a corporation that has paid its taxes at the general corporate rate have been entitled to more favourable 'eligible' gross-up and tax credit rates. This better recognizes the revenue the government has already collected from Canadian public corporations, and in turn provides relief to investors on taxation of the associated dividends received in their portfolios.

By contrast, where a corporation has used the small business rate, the 'ineligible' gross-up and tax credit rates apply. These are mostly owner-operator businesses, so not the type of dividends normally earned in an investment portfolio.

Governments adjust the gross-up and dividend tax credit figures occasionally, to maintain alignment with any changes in corporate tax rates.

Illustration – Eligible dividends in a non-registered account

This following table shows the combined federal-provincial marginal rates for a dollar of income, without breaking over bracket thresholds. Figures are rounded to integers for ease of relative comparison of the income types, though actual rates may have more decimal places.

Marginal tax rates by income type – 2023						
	\$50,000 income level		\$100,000 income level		\$250,000 income level	
	Interest or Foreign	Eligible dividends	Interest or Foreign	Eligible dividends	Interest or Foreign	Eligible dividends
BC	23%	(6%)	31%	5%	54%	37%
AB	25%	3%	31%	10%	48%	34%
SK	28%	2%	33%	10%	48%	30%
MB	28%	7%	38%	21%	50%	38%
ON	24%	(1%)	34%	12%	54%	39%
QC	33%	11%	41%	23%	53%	40%
NB	29%	(0%)	37%	10%	53%	32%
NS	30%	9%	38%	20%	54%	42%
PE	29%	5%	37%	16%	51%	34%
NL	30%	11%	36%	21%	55%	46%

For ease of display, figures are rounded to integers, though actual rates may have more decimal places.

Why not – Foreign dividends

Comparatively, dividends from foreign corporations are fully taxable to Canadian investors. A foreign corporation will have paid tax to its own government. As Canada receives none of that revenue, there is no reason for it to give a credit on foreign dividends paid to Canadian residents.

For more information, please consult your financial advisor and tax professional.

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