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Understanding dividends

BY **Stephanie Dietz** April 10, 2017

Ask the average person what a dividend is, and they might say it's something positive. For the most part, they'd be right.

Dividends are distributions of a corporation's after-tax earnings to its shareholders. They're optional to distribute, but corporations often use them to entice or pay shareholders.

Dividend taxation can be confusing, but it's part of our tax system's theory of integration: the idea that an individual should pay the same amount of tax whether income is earned personally or through a corporation.

The theory of integration doesn't usually work out precisely as intended, with individuals either realizing tax savings or paying a tax cost from corporate earnings paid out as dividends.

For the sake of fairness, dividends are subject to a special gross-up and tax credit calculation. When an individual receives a dividend, the amount received is grossed-up to a higher amount, depending on the type of dividend, to approximate the tax the corporation has paid. Personal tax is then calculated on this grossed-up amount. To compensate for this, individuals can claim a dividend tax credit, which reduces their tax otherwise payable.

Here are the different types of dividends and how they're treated.

Eligible dividends

These are dividends declared from earnings that were taxed at the general tax rate. Shareholders must be notified that a dividend is eligible at the time of payment, whether through website information for a public company, or through letters to shareholders for a private company. For the 2016 tax year, eligible dividend income is grossed-up by 38% on an individual's tax return. The top marginal tax rate on eligible dividends in Ontario is 39.34%.

Non-eligible dividends

These are dividends declared from earnings taxed at the small business tax rate. For 2016, non-eligible dividend income is grossed-up by 17% on an individual's tax return. The top marginal tax rate on non-eligible dividends in Ontario is 45.3%.

Capital gains dividend

This is a distribution by a Canadian mutual fund of its capital gains. Since the distribution is actually a capital gain, only half of the capital gain distributed will be subject to tax on an individual’s tax return.

Foreign dividend

Dividends from foreign corporations received by Canadian residents are considered to be foreign income, not dividends, for tax purposes. Foreign income is taxed at the same rates as salary or interest income, meaning no dividend tax credit is available. However, a foreign tax credit may be claimed for foreign tax withheld from the dividend payments.

Capital dividend

This is a tax-free dividend that has been paid by a Canadian controlled private corporation (CCPC) when the CCPC files an election form. The capital dividend arises from 50% of the capital gains realized by a CCPC. This amount is distributed tax-free since the CCPC has already been taxed on the capital gains.