Dividends and Retirees.

Dividends from Canadian corporations receive preferential tax treatment. This is a provision in our tax system that is underutilized by retirees. Ontarians pay no tax on dividend income if total taxable income is $45,916 or less and pay 7.56% on dividend income in the next tax bracket ending at $74,316. Other provinces have different but similar thresholds and follow the same concept. This is relevant only within a non-registered account.

How Are Canadian Dividends Taxed?

Our system is a little confusing. Dividends are paid by corporations. Corporations pay dividends from after-tax profit. This is relevant to personal taxation of Canadian dividends. The idea is that one chunk of money should not be taxed twice. Think about capital gains to solidify the idea that one chunk of money should not be taxed twice. If I work and take $5,000 from employment income and invest in stock and the stock rises to $7,500, I am paying tax on the increase of $2,500, not $7,500. The original $5,000 was taxed when I earned it through work.

We have a gross up and credit system to arrive at somewhat the same end-point with dividends. For Ontario residents, eligible dividends received are grossed-up by 38% and federal and Ontario tax credits of 15% and 10% apply to reduce tax payable. The purpose of the gross-up is to arrive at corporate pre-tax profit. The purpose of the credits is to approximate corporate tax paid on the pre-tax profit.

This affects a dividend recipient. An example helps: Let's say I earn $40,000 of taxable income and receive a $200 dividend. I gross-up the dividend by 38% to arrive at $276. My taxable income increases to $40,276 due to the dividend received. My tax bill increases to $5,816 from $5,760 due to the dividend received. I now apply the tax credits. (15% x $276 + 10% x $276) = $69 of tax credit. The dividend received increased my tax bill by $56 but the tax credits reduced my tax bill by $69. I have a negative tax rate on the dividend income received. I received $200 of dividend plus a $13 reduction in my tax bill. The gross-up and the credits are reflected in the marginal rate on eligible dividends in the attached. You pay no tax on dividend income, and likely a negative tax, if taxable income is less than $45,916 in Ontario and less than 9% on taxable income below $84,404. Most retired seniors have taxable income well below $84,404.

Compare this to interest income by comparing marginal tax rates on ordinary income such as interest income versus marginal tax rates on eligible dividend income. Also note that dividend income tends to pay out at higher rates than interest income these days (late 2017). The dividend / price ratio for the Vanguard Canada All-Cap ETF is 2.31% and is 2.81% for the iShares Core S&P / TSX capped composite ETF. The 5-year GIC rate is around 2.5%. The 1-year GIC rate is around 2% these days.

The iShares S&P / TSX Canadian Preferred Share Index ETF has a current yield of 4.22%. This is a product that seniors should get to know. Preferred shares are a hybrid between Growth and Safety. Investors trade off some safety for a higher return and a substantially higher after-tax return. Retirees, or anyone with long-term savings in a non-registered account, should consider replacing at least some interest earning investments with a preferred share product. The reward substantially offsets the added risk.

Another consideration is many tax benefits seniors receive are needs tested based on taxable income. Taxable income includes the gross-up. In the above example taxable income increases $276 due to a $200 dividend received. A dividend reduces needs tested benefits more than the same amount of interest income due to the gross-up. This negative effect is usually overwhelmed by the lower tax rate. The attached compares the after-tax, after-gross up effect between $5,000 of interest income and $5,000 of eligible dividend income. It isn't exact, but close. Note the effective tax rate.

Here and here articles explaining preferred shares.