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KEEP YOUR EYES ON THE DIVIDEND TAX CREDIT THIS BUDGET SEASON

Smart investors have always understood the importance of re-investing dividends in longer-run wealth accumulation. The American economist Jeremy Siegel, a specialist in long-run rates of returns, finds that in the U.S. market "from 1871 through 2003, 97 per cent of the total after-inflation accumulation from stocks comes from reinvesting dividends. Only 3 percent comes from capital gains."[1] Closer to home and more recently, the "compounded return from reinvested dividends accounted for more than 60 per cent of the total return from the Toronto Stock Exchange Index over the past 48 years"[2]. Dividends are becoming of even greater interest to investors for 3 reasons.

First, with interest rates still relatively low, dividend yields alone rival the returns from fixed income products and that leaves completely aside the potential for capital gains on the underlying stocks. Dividends paid by public corporations typically yield 1 to 4 per cent compared to the interest rates on most maturities across the yield curve being clustered around 4 per cent. Second, flush with cash, many Canadian corporations have been increasing their dividend payments. The Toronto Stock Exchange reported 140 dividend increases in 2005. The previous high was 113 in 1995[3]. Third, federal and provincial governments have announced that they will be cutting the rate of taxation on dividend income. For anyone not deferring the taxation through a registered retirement account, this budget season should be of great interest.

In November 2005, the previous Liberal federal government proposed to cut the taxation of dividend income in order to level the playing field for dividend-paying stocks and income trusts[4]. Another perspective on the objective was to end the double taxation of dividend income from the corporate and personal income tax systems. They proposed to raise the dividend gross-up from 125 to 145 per cent and lift the federal dividend tax credit from 13.333 per cent to 19 per cent for dividends from income subject to the general corporate income tax rate[5]. Consistent with the federal dividend tax credit going to the same level as the 19 per cent general corporate income tax rate the Liberals were targeting by 2010, it was assumed that the average provincial dividend tax credit would go to 13 per cent, which matches the current average general corporate income tax rate across provinces[6].

Table 1 shows how the proposal would affect taxes paid on $100 of dividend income, assuming that a top combined federal-provincial marginal personal income tax rate of 46 per cent applies. The effective personal income tax rate on the $100 of dividend income would fall from 32.5

TABLE 1
IMPACT OF LIBERAL GOVERNMENT'S PROPOSAL TO CUT DIVIDEND TAXATION

	Previous Regime	Proposed Regime
Dividend Income (A)	$100.00	$100.00
Amount Included in Income	$125.00	$145.00
Personal Income Tax @ 46%	$57.50	$66.70
Dividend Tax Credit (DTC)		
Federal	$16.67 (13.333%)	$27.55 (19%)
Provincial	$8.33 (6.667%)	$18.85 (13%)
Total	$25.00 (20%)	$46.40 (32%)
Personal Income Tax After DTC (B)	$32.50	$20.30
Effective Personal Income Tax Rate (B/A)	32.50%	20.30%

Source: Department of Finance and TD Economics

TABLE 2 2005 PROVINCIAL AND TERRITORIAL DIVIDEND TAX CREDIT RATES	As % of Grossed-Up Dividends	As % of Actual Dividends
Federal	13.333%	16.667
Newfoundland and Labrador	5	6.25
Prince Edward Island	7.7	9.625
Nova Scotia	7.7	9.625
New Brunswick	3.7	4.625
Quebec	10.83	13.5375
Ontario	5.13	6.4125
Manitoba	5	6.25
Saskatchewan	8	10
Alberta	6.4	8
British Columbia	5.1	6.375
Yukon	5.9	7.375
Northwest Territories	6	7.5
Nunavut	4	5

Source: Canada Revenue Agency, Taxtips.ca

to 20.3 per cent. This would obviously be a tremendous boost to the after-tax rate of return to dividend income.

The Liberal's proposal is in limbo on two counts. First, the Liberals have since been replaced by a minority Conservative Government. Fortunately, the Conservatives have indicated that they will follow through on the Liberal's proposal. Hopefully this will be in their first budget, likely to be tabled next month. The second uncertainty concerns the provinces. While it is reasonable for the federal government to assume that the provinces, as partners in the personal and corporate income tax fields, will contribute to the cause of leveling the playing field for dividend-paying stocks and trusts, the provinces are under no obligation to do so. For this reason we have been following this policy field very closely as the budget season progresses.

Table 1 shows the importance of the provincial response in achieving the overall tax cut on dividend income the previous Liberal Government referred to. Indeed, if the provinces do not raise their dividend tax credit rates, provincial taxation of dividend income would go up $2.06 on the $100 of dividend income because the higher gross up factor would raise normal provincial personal income tax collections $3.40 but only raise the provincial dividend tax credit $1.34 [7]. In other words, the average provincial dividend tax credit rate has to increase from 6.667 [8] to 8.727 **merely to leave provincial taxation of dividend income unchanged** [9]. The further hike from 8.727 to 13 per cent assumed by the previous Liberal Government contributes 4.273 percentage points of the overall 12.2 percentage point decline in the effective tax rate on the $100 of income. The dividend tax credit rates of the provinces and territories are shown in Table 2.

So far in this year's budget season both British Columbia and Manitoba have indicated that they will be raising their dividend tax credits. They are, understandably, short on detail, pending legislation to be introduced by the federal government. However, in conceptual terms they seem to be striving to the same objective of the federal government, namely ending the double taxation of dividend income. As such, provided the federal government follows through on its commitment we can expect that these provinces will raise the dividend tax credit rates to a level around their respective general corporate income tax rates. That is 12 per cent in British Columbia and on the way down from 15 to 14 percent in Manitoba.

Alberta's budget will be on March 22nd, Quebec and Ontario March 23rd, New Brunswick March 28th, and Newfoundland and Labrador March 30th. So budget watchers should keep their eyes on what is proposed for the provincial dividend tax credit rates. Finally, all eyes will be on the federal government's budget, likely in April. If all governments follow through with actions along the lines of the Liberal's proposal of last November, dividends will become an even more attractive component of a wealth generation plan.

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Endnotes

1 The Future for Investors, Jeremy J. Siegel, 2005, page 126.

2 "Dividend growers easily outperform the market over the past 10 years". Wayne Chevaldayoff, SmartInvesting.ca, June 17, 2005

3 "Dividends back in favour", Carlyle Dunbar, Investment Executive, March 2006, page 48

4 The proposals were made in the context of leveling the playing field from the perspective of Canadian taxable entities. The proposals did not address some residual tax advantages to income from trusts from the perspectives of the Canadian tax-deferred sector and foreign investors. For more information on this, see for example, Jack Mintz, "Unfinished Business: Achieving Neutral Taxation of Corporations and Income Trusts" , C.D. Howe Institute, e-brief, December 21, 2005

5 In other words, the reduced taxation of dividend income would not apply in general to dividends paid by small corporations because the problem of "double taxation" of dividend income does not occur with the much lower small business corporate income tax rate.

6 As the gross up factor is 1 divided by the assumed combined federal-provincial general corporate income tax rate by 2010 (federal at 19, provincial average at 13 giving a total of 32 per cent), the respective dividend tax credit rates need to be at the federal and provincial corporate tax rates in order to eliminate double taxation.

7 We assume in this calculation that the average marginal rate for the provinces of 17 per cent would be applied to $145 of income as opposed to $125 yielding the incremental $3.40 whereas the increase in the dividend tax credit from applying to $145 rather than $125 only gives a $1.34 offset because the average credit rate is only 6.667 per cent.

8 6.667 per cent is the weighted average provincial dividend tax credit rate calculated by the federal Department of Finance for the November 2005 backgrounder to the Liberal Government's announcement of dividend taxation. The 2005 dividend tax credit rates by province and territory are shown in Table 2.

9 The legislation for the dividend tax credit in some provinces specifies the rate as a function of either the gross up factor or the federal dividend credit rate. Therefore, the provincial rate would go up automatically in some jurisdictions once the federal government passes its changes into legislation. This automatic increase would lower the provincial taxation dividends somewhat, but not nearly enough to eliminate "double taxation".