HOW THE DIVIDEND TAX CREDIT WORKS

A corporation is a taxpayer that pays income tax on its business income and other income. And of course, an individual shareholder in the corporation is a taxpayer who pays income tax on dividend income received from the corporation. Since a corporation pays a dividend out of after-tax income (that is, dividends are not a deductible expense to the corporation), there is the potential for double taxation.

In order to prevent double taxation, the Canadian income tax system provides a “gross-up” and “dividend tax credit” mechanism for individual shareholders receiving dividends from taxable Canadian corporations.

There are two types of dividends with different gross-up and dividend tax credit amounts. An “eligible dividend” is generally a dividend paid out of the corporation’s business income that was subject to the general corporate rate of tax, which is between 25% and 30%, depending on the province. A “non-eligible dividend” is generally a dividend paid out of the corporation’s income that was subject to the small business deduction, so that the corporation's tax rate on the income was about 9% to 13%, depending on the province.

For eligible dividends, the gross-up is 38% of the dividend and the federal dividend tax credit is 6/11ths of the gross-up. The provincial credit depends on the province. For non-eligible dividends, the gross-up is 15% of the dividend and the federal credit is 9/13ths of the gross-up. Again, the provincial credit depends on the province.

The gross-up of the dividend is meant to put the shareholder in roughly the same position as if the shareholder earned the corporation's pre-tax income. The shareholder then computes their tax payable on that amount, and the dividend tax credit is meant to roughly offset the corporate tax payable. The net result, if there is perfect “integration”, is no double taxation, and the shareholder pays personal tax on the corporation's underlying income at the shareholder's marginal tax rate, while getting a refund of the tax the corporation paid.

Example

A corporation earns $138 of business income and is subject to a combined federal and provincial regular corporate tax rate of 27.5%. The corporation distributes the after-tax amount of the income to its individual shareholder. The shareholder is in a 40% tax bracket.

Since the dividend is an eligible dividend, the gross-up is 38% of the dividend. The federal dividend tax credit is 6/11 of the gross-up. We will assume that the provincial dividend tax credit is 5/11 of the gross-up, meaning that the total credit is equal to the gross-up.

The corporation's initial 27.5% corporate tax on the $138 is $38 (to keep things simple, all numbers are rounded to the nearest dollar). The corporation thus has $100 left to pay as a dividend to the shareholder.

The shareholder includes in income $100 plus the 38% gross-up, for a total of $138. Note that this the same as the corporation's pre-tax income.

The shareholder then computes their initial 40% tax on $138, which is $55. The shareholder gets a combined federal and provincial dividend tax credit of $38. This leaves the shareholder with net tax payable of $17.

In this example, there is perfect integration because the shareholder’s dividend tax credit of $38 exactly offsets the corporate income tax paid of $38, and the total corporate tax ($38) and personal tax ($17) paid is $55, the same as if the shareholder had paid 40% tax on the original $138 of business income. Across the provinces, there is not always perfect integration due to minor differences between the federal and provincial tax systems and calculations. But in each province the dividend tax credit provides a result that is close to integration.

The other way to determine whether there is perfect integration is to compare the corporate result with that seen where the individual instead carries on the business personally (i.e. without a corporation). In such case, using the individual in the above example, the individual would pay 40% tax on $138 of business income, being $55, the same result as in the example.

The dividend tax credit applies only to Canadian resident individuals receiving taxable dividends from Canadian resident corporations. It does not apply to dividends you receive from foreign corporations, as it is not considered appropriate for the Canadian government to provide you with a credit for foreign corporate tax paid by the foreign corporation. However, you will get a foreign tax credit for the foreign tax that you pay personally on the dividend (often a 15% withholding tax, but the rate depends on the country and the provisions of Canada's tax treaty with that country, if there is one).

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