Step 8: The Great Dividend Tax Advantage

Description

The old saying goes there are two things certain in life – death and taxes.

Since you're reading this, we presume you're alive and breathing. But since you're alive and breathing, the taxman will also have his beady eye on you, looking to get his fair share of your investment related income and capital gains.

Regardless of the number of stocks or indices that you end up owning, it is natural to want to optimize your portfolio's *after*-tax returns. For that reason, you should have a basic understanding of how the stocks you own will be taxed. As ever, if you are unsure about anything tax related, seek advice from the tax office or your friendly accountant.

Warning – *math ahead!*

The Joy Of Dividends

We Fools love dividend payments. To long-term investors, dividends from high quality companies are the gifts that just keep on giving.

On the flip side, in non-registered accounts (does not apply to RRSP or TFSA accounts), individual taxpayers must pay tax on their dividend receipts. Trust the taxman to spoil the party!

But there is some good news. Unlike many other countries, dividends from Canadian based companies are eligible for a somewhat convoluted set of calculations that can fondly be described as the dividend gross up and tax credit system. The basic rationale behind this system is that dividends are paid by corporations after the taxman has already taken his cut. Therefore, if dividend payments were fully taxed in the hands of the investor as well, it would equate to a double taxation.

To illustrate this double tax situation, assume that Canadian based company Gnarley Tuques earned $100 in its fiscal year and was taxed at a rate of 30%. Gnarley's after tax profits would be $70. If you're keeping score at home, this means $30 went to the taxman.

Now assume the company decides to pay all of this $70 out to shareholders as a dividend. Also assume all of the company's shareholders are taxed at a rate of 40%. In theory, this means, collectively, Gnarley's shareholders would pay an additional $28 in tax on that dividend. Therefore, of Gnarley's $100 in profits, $58 would find its way into the coffers of the Canadian government. Not a very incentivizing system for the company, or the investors.

Thanks to the dividend gross up and tax credit system, this is not the way it works. The gross up is meant to convert the value of the dividend, $70 in the case of Gnarley Tuques, into an amount that approximates the company's pre-tax earnings. The current (2012) gross up rate is 38%. Applying this to the $70 dividend brings us to $96.60. As an aside, this gross up rate has been in decline in recent years. As corporate tax rates have come down, the gross up has fallen from 45% in 2008/2009 to 44% in 2010 to 41% in 2011 and now sits at 38%.

Ok, so we've grossed the dividend up to $96.60, now what? First we need to calculate how much tax the investor theoretically needs to pay on this grossed up amount. Assuming a 40% tax rate, this would amount to $38.64. Here comes the slightly tricky part. Each province has their own dividend tax credit rate which goes on top of the Federal dividend tax credit rate of 16.44%. To make our lives a little easier here, we're going to assume that the combination of the Federal and Provincial dividend tax credits amount to 25%. We apply this 25% to our grossed up dividend and arrive at a dividend tax credit of $24.15. This tax credit is then subtracted from the $38.64 that we calculated earlier. We are left with taxes being owed by Knarley's shareholders on that $70 dividend of $14.49 – basically half of the tax that would have been owed had this system not been in place.

This gross up and tax credit system adds another feather in the cap of equities as we continue to build a case for this asset class being the best vehicle to grow long term savings. Asset allocation comes up in the next section, but for now it is important to realize that fixed income instruments (bonds, GICs) pay interest, which is classified as income for tax purposes. Income is taxed at the individual's tax rate. End of story. No gross up, no credit. If your personal tax rate is 40% and you receive interest from a Government of Canada bond of $70, you're going to be sending $28 of that interest receipt right back to the GoC at tax time.

What this all boils down to is that paying less tax means that more money is left in your non-registered brokerage accounts. And guess what more money left over means? Do we really have to spell it out at this point? Just in case. Less money being paid to the tax man means that the impact of compounding is that much more powerful. That's a good thing!

Just to add – on the bright side of paying taxes, at least it means you have made some money on your investments. If you'd like to avoid this whole tax thing all together, pick stocks that decline in value!

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