Dividend Investing 101: Dividends As a Superior Form of Tax-Effective Income

Description

There are a range of incentives that make investing in dividend-paying stocks attractive for investors. In an earlier article I took a closer look at how dividends can enhance returns and mitigate risk. Today, I want to spend some time discussing another Dividend Investing 101 topic: the favourable tax treatment that dividend stocks receive here in Canada.

Dividends can be a more tax-efficient means of receiving income than other methods including interest income and capital gains. But in order to be eligible for this favourable tax treatment they must be dividends categorized as "eligible dividends".

An eligible dividend is essentially any dividend paid by a public corporation resident in Canada that is paid out of after-tax profits. As such, dividends paid by the majority of Canadian companies listed on the Toronto Stock Exchange are classified as eligible dividends.

Eligible dividends are treated as part of an investor's taxable income. However, in contrast to interest income generated by fixed income investments that are taxed as ordinary income, dividends are given special treatment in the eyes of the tax man. This is because they are 'grossed up' by 25% and the federal and provincial governments grant investors a tax credit equal to the grossed up amount.

Dividend tax credits are provided in an attempt to offset the phenomenon of double taxation. You see, dividends are paid to shareholders with a corporation's *after-tax* profit. That's tax exposure #1. Then, dividends are treated as part of an investor's taxable income. Tax exposure #2.

Essentially, because the dividends were already taxed at the source so to speak, the credits help to reduce the actual amount of tax payablein the hands of the individual. But just how does this work in practice? To illustrates how it works let's take a closer look at how **Toronto Dominion Bank's** (TSX:TD) annual dividend payment is taxed.

In order to do this, let's assume that the investor holds 100 shares in Toronto Dominion. With an annual dividend of $3.44 per share, this provides the investor with an annual dividend income of $344.

The total dividend paid is then grossed up by the current (2013) gross up rate of 38%, which, for tax purposes, leaves us with a total dividend payment of $474.72. Now we need to calculate the tax payable on the grossed-up amount, which is tricky because income tax rates vary from province to province.

So let’s assume the investor is a middle-income earner giving us a combined federal and provincial income tax rate of 40%. As such the tax payable on the grossed-up amount is $189.89.

The next step is to apply the dividend credit, which is composed of two parts, a Federal credit of 15.02% (2013) and a provincial credit, which varies from province to province. But for ease of calculation let’s assume the provincial credit is 10%, giving us a combined dividend credit of 25.02%.

After applying the dividend credit to the grossed up amount we arrive at a dividend tax credit of $118.77. When deducted from the gross tax payable the investor is left with net tax payable of $71.22, which is less than half of the tax originally payable.

But had the investor derived that income from a fixed interest investment like a government bond, they would have paid tax of $137.60, which is the marginal income tax rate (40%) multiplied by the income received ($344). As such by receiving the income from eligible dividends the investor has made a significant tax saving of $66.48*.

So where can you find these tax-efficient dividend payers?

In the Canadian market, there is perhaps no better place to start looking for dividends that with the banks. As fellow Fool Robert Baillieul found, Canada’s top 5 banks have been consistently paying dividends for over 143 years.

If we take a closer look at the dividends paid by Canada’s top 5 banks the positive impact of this tax effectiveness becomes clear. To do this I have taken the dividend paid by Canada’s top 5 banks and compared the after-tax dividend payment to the after tax income received from an equivalent interest payment.

Company	**Dividend per Share**	**Dividend @ 100 shares**	**After-tax Dividend Payment**	**Tax if Treated as Interest Income**	**Annual Diff o 100 shares**
Royal Bank (TSX:RY)	$2.68	$268	$187.12	$107.20	$2
TD	$3.44	$344	$272.28	$137.60	$6
Scotia Bank (TSX:BNS)	$2.48	$248	$173.15	$99.20	$2
CIBC (TSX:CM)	$3.84	$384	$268.11	$153.60	$3

Bank of Montreal(TSX:BMO)	$3.04	$304	$212.25	$121.60	$2

The annual difference as illustrated by the table may not be significant but over time it can add up to a considerable amount. In the case of Toronto Dominion the annual difference on the dividend paid on 100 shares is $33.78, which over a ten year period would be a tax saving of $330.78.

Foolish final thoughts

Stocks paying eligible dividends provide investors with an attractive means of tax effective investing. They not only pay a regular income stream but one that is more tax effective than a range of other forms of income. But tax effectiveness is not the only benefit of investing in dividend-paying stocks and in subsequent articles I plan to review these other advantages in depth.

**Editor's Note: A previous version of this post showed this to be $33.78. We apologize for any confusion this may have caused.*

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3. TSX:CM (Canadian Imperial Bank of Commerce)
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