

Personal Income Taxation : (g) Dividends

Suppose that someone is the owner, or part owner, of an unincorporated business. Then her share of the profits of that business are taxed like ordinary income. If the firm makes profits of \$400,000 in the year, and if she owns one-quarter of the firm, then she is liable for taxes on the \$100,000 in profits that she gets. So if her marginal personal income tax rate is t_p , then what she actually gets from her ownership of part of the firm, in thousands of dollars per year, is $(1 - t_p)100$.

Suppose instead that she owns shares in a large publicly-traded corporation, which makes profits of \$10 million in the year. If she owns 1 percent of the stock of the firm, then her share of those profits is \$100,000. Since the firm is a corporation, it must pay corporate income tax on its profits. If the firm paid out all its annual after-tax profits in dividends to its shareholders, then this person would get dividend income (in thousands of dollars) of $D = (1 - \tau_c)100$ in the year, if τ_c was the corporate income tax rate. If this dividend income were taxed as ordinary income (as it is in the United States) then the person would have to pay taxes of $t_p D$ on the dividend income, leaving her with a net after-tax income (in thousands of dollars per year) from her shares of $(1 - t_p)(1 - \tau_c)100$. That is, the original \$100,000 in corporate profits (her 1% of the total firm profits of \$10 million) would be reduced to $(1 - \tau_c)$ times \$100,000, after corporate income taxes of $100,000\tau_c$ are paid. If all that's left of profits, after corporate income taxes, are paid out in dividends, she would get a dividend of $(1 - \tau_c)$ times \$100,000. If this dividend income were treated like ordinary wage income on her personal income tax, she would have to pay taxes on that dividend at the rate t_p , so the government(s) would collect $t_p(1 - \tau_c)100,000$ in personal income taxes on her dividend income of $100,000(1 - \tau_c)$. That leaves her with $(1 - t_p)(1 - \tau_c)100,000$ in net income from the dividends, after taxes.

Thus, in a sense, recipients of dividend income from corporations are subject to **double taxation** : the income of the corporation is subject to corporate income tax, and then to personal income taxation when it is paid out in dividends. If dividends are treated this way, a few positive questions come to mind : why do firms incorporate? why do they pay dividends?

The last few years may have answered those questions. The decisions by many Canadian corporations to change themselves into income trust were made precisely to reduce the taxes paid by the corporations' owners. That is, given the tax treatment of corporate income, many firms have chosen not to be corporations : an income trust is basically a firm that has all the advantages of a public corporation, but with lower tax liabilities.

Instead of addressing those questions, here the normative question of how the tax system might "correct" for this double taxation is considered. The Carter Commission (in the 1960's) in Canada thought that some sort of correction should be made. The commission's view was that it is **people** who pay taxes ultimately. What mattered in their view was the overall tax paid on a firm's income by the people who received that income. In this view, the main reason for having a corporate income tax is to serve as a **withholding tax** : a way of making sure that some tax does get collected from the owners. Having such a withholding tax makes some sense in an

open economy such as Canada’s where many shareholders in Canadian corporations are foreign residents. However domestic shareholders should pay the same tax on their share of a firm’s profits as on any other income they earn, at least in the Haig–Simons view of taxation. If this is to be the case, there must be some “correction” in the personal income tax for the double taxation of dividend income.

Here’s what the Carter commission suggested. Suppose a taxpayer receives dividend income of D . In the example above, of the person who owned 1% of a corporation, D equalled $(1 - \tau_c)100,000$. In the Carter commission’s proposal, the taxpayer should not report her dividend income D on her personal income tax form. Instead, she should report a “grossed up” amount D' as income, with

$$D' = \frac{D}{1 - \tau_c}$$

In my example, since $D = 100,000(1 - \tau_c)$, then $D' = 100,000$. That’s true in general : dividing the after–corporate–tax dividend by $1 - \tau_c$ gets back to the original pre–tax corporate profits. So the person reports D' instead of D as income on her personal income tax form, and pays tax of $t_p D'$ on it. So she is now actually reporting more than 100 percent of her dividend income ; she’d report twice her dividend income if the corporate income tax rate were 50%. But the “grossing up” of dividend income is not the whole story. Under the Carter commission’s proposed treatment, she would also get a **tax credit** of $\tau_c D'$.

The overall result of these three stages (grossing up the dividend income, paying personal income taxes on the grossed up amount, getting a tax credit equal to τ_c times the grossed–up amount) is that she pays exactly the same tax as she would have if she had been a partner in an unincorporated business. The net income she gets from receiving the dividend, taking into account her personal income taxes, is

$$D - t_p D' + \tau_c D' = (1 - \tau_c)100,000 - t_p 100,000 + \tau_c 100,000 = (1 - t_p)100,000$$

(The first term on the left side of the above equation is the actual dividend she gets ; the second term is the personal income tax paid on the grossed–up dividend ; the third term is the tax credit.) This procedure is a way of **integrating** the personal and corporate income taxes.

Now what is actually done in Canada is not exactly the same as what the Carter commission proposed. People receiving dividend income do gross up the dividends, pay personal income tax on the grossed–up amount, and get a tax credit — exactly as in the Carter proposal. But the amount the dividends are grossed up is **not** $1/(1 - \tau_c)$: it’s less. The tax credit rate on the grossed–up income is **not** τ_c : it’s less as well. So what we have in Canada is a sort of “partial” integration of corporate and personal income taxes. The effective tax rate (including corporate and personal income taxes) paid on corporate profits returned as dividends is less than $t_p + \tau_c - \tau_c t_p$ (as it would be with no integration at all), but it is not equal to t_p (as it would be under full integration).

In 2015 the gross–up rate on dividends from (most) Canadian corporations is 38%, and the federal tax credit rate is 20.73% of the original dividend (which means that the credit equals 15.02%

of the grossed-up dividend). In Ontario, there is a further credit against provincial tax : 10 % of the grossed-up amount (which equals 13.8% of the original dividend). These rules represent a change from earlier years : for example, in 2004 the gross-up rate was 25% and the tax credit rate — on the grossed-up amount — was 13.333% for the federal income tax, and 5.13% on the Ontario personal income tax.

The first table below indicates the total **personal** income tax an Ontario taxpayer would pay on dividend income received in 2015 from a large Ontario corporation. The first column indicates the **combined** federal and provincial personal income tax rates : I have chosen 4 of the 8 brackets for combined-Ontario-and-federal personal income taxes in 2015. (So people whose annual income is below \$40,922 for example, face a combined marginal rate of 20.05% : 15% federal and 5.05% provincial.)

bracket	grossed – up	taxes	credit	overall	taxes
20.05%	138	27.67	34.53	–6.86	
31.15%	138	42.99	34.53	8.46	
43.41%	138	59.91	34.53	24.38	
58.41%	138	80.61	34.53	46.08	

Notice that taxpayers in the lowest tax bracket actually get money back on their personal income tax when they receive dividend income.

Now consider the overall tax take, corporate and personal, on \$100 in corporate profits. The corporate income tax is fairly complicated, but the basic corporate income tax rate currently is 26.5% in Ontario (15% federal tax and 11.5% provincial). That means that if a firm earns \$100 in profits, it will pay \$26.50 in corporate income tax, leaving \$73.50 to pay as dividends. Adding in the personal taxes summarized in the previous table, the total taxes collected by the federal government, as a function of the shareholder’s personal tax rate, are summarized in the following table.

bracket	c.i.t.	dividend	p.i.t.	rate	p.i.t.	overall	taxes
20.05%	26.50	73.50	–6.86	–5.04	20.46		
31.15%	26.50	73.50	8.46	6.22	32.72		
43.41%	26.50	73.50	24.38	17.92	44.42		
58.41%	26.50	73.50	46.08	33.87	82.58		

For example, the “6.22” in the second-last column of the second row equals $(8.46)(73.50)$: the first table shows that a person in a 31.15% bracket pays federal personal income taxes of 0.0846 per dollar of dividend income earned, so that she would pay 6.22 on the 73.50 dividend paid on net-of-corporate-tax profits of 100 dollars.

The final column indicates how much gets paid in taxes — personal plus corporate — on \$100 of corporate income, if the firm pays out all its after-tax income (of \$73.50) in dividends.

So the current Canadian system is one of incomplete integration of corporate and personal income taxes : if the original Carter commission suggestions for the gross-up and credit rates were used, then the first and last columns in that last table would be identical.