

Taxation of Dividends & Interest

The Steele Wealth Management Group
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Scenario Analysis: Assumptions

- Portfolio size of \$500,000
- The highest marginal tax rates are used:
 - Personal Tax: 46.41%
 - Corporate Tax: 48.67%
 - Eligible Dividends: 23.06%
 - Ineligible Dividends: 31.34%
 - Interest Income: 46.41%

GICs vs. Preferred Shares in a Personal Non-Registered Account

The after-tax yield of a portfolio of preferred shares is over 1.5x higher than that of the current 5-year GIC interest income yield

	Interest Income	Dividend Income
Portfolio Size	\$500,000	\$500,000
Approximate Yield as of 09/09/2009	3.25%	5.75%
Total Income	\$16,250	\$28,750
x Tax Rate	46.41%	23.06%
= Total Tax Payable	<u>\$7,541.63</u>	<u>\$6,629.75</u>
Therefore, After-Tax Income Available	\$8,708.38	\$22,120.25
After-Tax Yield	1.74%	4.42%

GICs vs. Preferred Shares in a Personal Non-Registered Account

The current yield of a diversified preferred share portfolio is approximately 5.75%. The interest yield required to generate the same after-tax yield is a whopping and unattainable 8.25%.

	Interest Income	Dividend Income
Portfolio Size	\$500,000	\$500,000
Hypothetical Rate of Return	8.25%	5.75%
Total Income	\$41,250	\$28,750
x Tax Rate	46.41%	23.06%
= Total Tax Payable	<u>\$19,144.13</u>	<u>\$6,629.75</u>
Therefore, After-Tax Income Available	\$22,105.88	\$22,120.25
After-Tax Yield	4.42%	4.42%

A 5.75% dividend yield is equivalent to 8.25% on an after-tax basis

GICs vs. Preferred Shares in a Personal Non-Registered Account

The current yield of a five-year GIC is approximately 3.25%. The dividend yield required to generate the same after-tax yield is only 2.26%.

	Interest Income	Dividend Income
Portfolio Size	\$500,000	\$500,000
Hypothetical Rate of Return	3.25%	2.26%
Total Income	\$16,250	\$11,300
x Tax Rate	46.41%	23.06%
= Total Tax Payable	<u>\$7,541.63</u>	<u>\$2,605.78</u>
Therefore, After-Tax Income Available	\$8,708.38	\$8,694.22
After-Tax Yield	1.74%	1.74%

Risks of GICs

- Insured up to \$100,000 by the CDIC at all participating insured banks
- Second least risky investment next to government bonds
- Initial rate available depends on interest rates at the time
- GICs are illiquid; many cannot be redeemed until maturity and most of those that can bear a penalty for early redemption

Risks of Perpetual Preferred Shares

- Perpetual preferred shares are issued by banks, insurance companies, utilities and their value is dependent on the business prospects of the issuer
- In the event of issuer default/bankruptcy, the value is zero
- Their risk level is in between that of low-risk equities and low-risk corporate bonds
- Their value is dependent on the prevailing interest rate
- Preferred shares are liquid

Dividend Income In a Corporation

- Dividends that are received in a corporation are taxed at a rate of 33.3% (as per Part IV tax CRA Tax Code)
- Distributions of dividends are refundable at a rate of 33.3% at the time of distribution; i.e. they are fully refundable
- Because of the above, if dividends are flowed-through the corporation to the individual in the **same year** they are received, their effective tax rate is that of the personal tax rate of 23.06%

Dividend Income In a Corporation cont'd

- If dividends are not flowed-through, the effective tax rate increases marginally, depending on the length of deferral
- It is not beneficial to defer the flow-through of dividends as the effective tax rate will gradually increase towards the 33.3% corporate dividend tax rate over time

Interest Income In a Corporation

- Interest that is received in a corporation is taxed at a rate of 48.67% (as per Part I tax CRA Tax Code)
- Distributions of interest income are not fully refundable
- Because of the above, if interest is flowed-through the corporation to the individual in the **same year** the interest was received, the effective interest rate will be 47.13%, higher than if the interest was received outside of the corporation

Interest Income In a Corporation cont'd

- If interest is not flowed-through, the effective tax rate increases marginally, depending on the length of deferral
- It is not beneficial to defer the flow-through of interest as the effective tax rate will gradually increase towards the 48.67% corporate interest income tax rate over time

Income Retained in Corporation

Assuming current interest and dividend yields and \$500,000 in capital:

	Interest	Dividends
Corporate Income	\$16,250	\$28,750
Corporate Tax	48.67%	33.33%
Corporate Tax Payable	\$7,908.88	\$9,583.33
Funds Available for Investment	\$8,341.13	\$19,166.67

On \$500,000, more than \$10,825 in extra funds will be available for investment within the corporation if you are invested in dividend-yielding securities compared to interest-bearing securities

Income Retained in Corporation

Assuming interest and dividend income have the same yield (for comparative purposes only):

	Interest	Dividends
Corporate Income	\$28,750	\$28,750
Corporate Tax	48.67%	33.33%
Corporate Tax Payable	\$13,993	\$9,583
Funds Available for Investment	\$14,757	\$19,167

Assuming high-yield bonds were used to achieve similar returns to that of preferred shares (e.g. 5.75%), over \$4,410 more will be available to those who are invested in dividend-yielding securities due to the tax advantage alone

Income Flowed-Through to Individual

Assuming current interest and dividend yields and \$500,000 in capital:

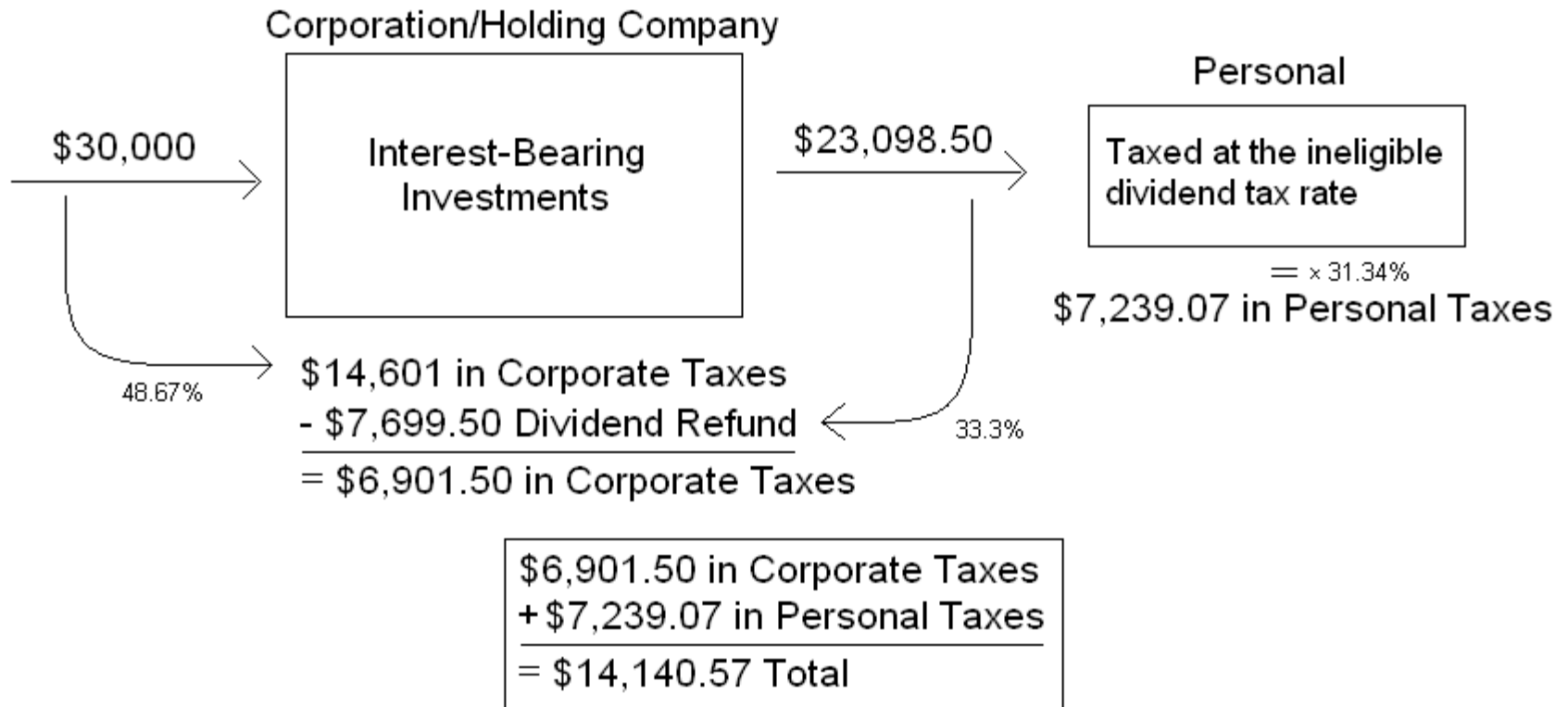
	Interest	Dividends
Corporate Income	\$16,250	\$28,750
Tax Payable	\$7,908.88	\$9,583.33
Funds Available for Distribution	\$8,341.13	\$19,166.67
Dividend Refund at Distribution	\$4,170.56	\$9,583
Total Amount Distributed	\$12,511.69	\$28,750
Dividend Tax Rate	31.34%	23.06%
Personal Tax Payable	\$3,921.16	\$6,629.75
Total After-Tax Cash to Individual	\$8,590.52	\$22,120.25
Total Taxes Paid	\$7,659.48	\$6,629.75
Effective Tax Rate	47.14%	23.06%

Income Flowed-Through to Individual

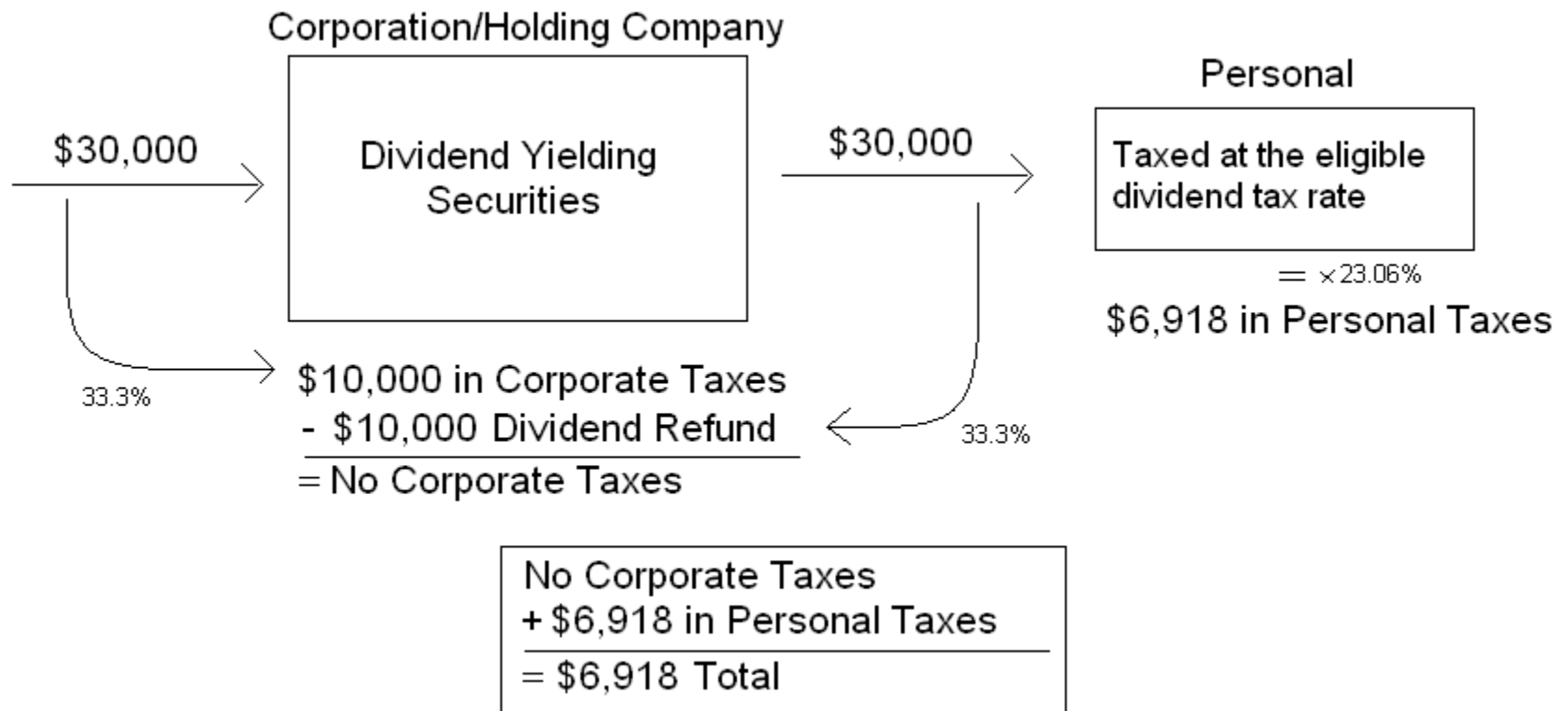
Assuming interest and dividend income have the same yield (for comparative purposes only):

	Interest	Dividends
Corporate Income	\$28,750	\$28,750
Tax Payable	\$13,993	\$9,583
Funds Available for Distribution	\$14,757	\$19,167
Dividend Refund at Distribution	\$7,378.69	\$9,583
Total Amount Distributed	\$22,136.06	\$28,750
Dividend Tax Rate	31.34%	23.06%
Personal Tax Payable	\$6,937.44	\$6,629.75
Total After-Tax Cash to Individual	\$15,198.62	\$22,120.25
Total Taxes Paid	\$13,551.38	\$6,629.75
Effective Tax Rate	47.14%	23.06%

Funds Flow: Interest



Funds Flow: Dividends



Conclusion

- There is no difference in taxation whether you hold dividend paying securities inside or outside of a corporation, so long as you flow the dividend through the corporation
- Distributions of interest income received within a corporation are only partially refunded
- The effective tax rate for interest income is higher within a corporation than outside a corporation while the tax rate for dividend income is the same

Conclusion cont'd

- Tax codes punish those corporations that are invested in bonds and GICs by charging higher taxes
- Tax codes make dividend paying securities more favourable and promote the flow-through of those dividends
- In addition to the tax advantage, most dividend paying securities (common and preferred shares) yield more than government bonds and GICs to reflect the higher degree of risk taken

Sample Preferred Share Portfolio

Name	Symbol	Type	Div Yield	Cumulative?	IEY*	Invested	Income	DBRS
Royal Bank Pfd Sr "AC"	RY.PR.C	Perpetual 4.6%	5.48%	No	7.77%	\$50000	\$2738.00	Pfd 1L
CIBC Pfd Sr 26	CM.PR.D	Perpetual 5.75%	5.75%	No	8.16%	\$50000	\$2876.00	Pfd 1L
Sun Life Financial Pfd Sr 4	SLF.PR.D	Perpetual 4.45%	5.74%	No	8.15%	\$50000	\$2871.50	Pfd 1Ln
George Weston Pfd Sr 1	WN.PR.A	Perpetual 5.8%	6.08%	Yes	8.62%	\$50000	\$3037.50	Pfd 3
Canadian Utilities Pfd Sr X	CU.PR.B	Perpetual 6%	5.87%	Yes	8.33%	\$50000	\$2934.50	Pfd 2H
Enbridge Pfd Sr A	ENB.PR.A	Perpetual 5.5%	5.49%	Yes	7.78%	\$50000	\$2742.50	Pfd 2L
TransCanada Pipe Pfd Sr U	TCA.PR.X	Perpetual 5.6%	5.62%	Yes	7.98%	\$50000	\$2810.50	Pfd 2L
Canada Life Pfd Sr B	CL.PR.B	Perpetual 6.25%	6.08%	No	8.63%	\$50000	\$3040.00	Pfd 1Ln
Great-West Life Co Pfd Sr F	GWO.PR.F	Perpetual 5.9%	5.89%	No	8.35%	\$50000	\$2944.00	Pfd 1Ln
West Coast Energy Pfd Sr 8	W.PR.J	Perpetual 5.6%	5.80%	Yes	8.24%	\$50000	\$2902.00	Pfd 2L
*IEY = interest equivalent yield, assuming highest marginal rate			5.78%		8.20%			

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