

Dividend Taxation - Ontario Alone

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For most modestly successful Ontario small businesses, the income-based small business deduction (“SBD”) claw back found only in Ontario has always been a nuisance. As a result of the 2006 proposals to change the taxation of dividends in Canada (“Eligible Dividend Proposals”)[1] it has become a truly punitive provision that in far too many cases threatens to undermine the objectives of the Eligible Dividend Proposals altogether.

The Eligible Dividend Proposals are intended to eliminate double taxation associated with “full-rate taxable income”[2] of a corporation by enabling full-rate taxable income to be paid out as an “eligible dividend”,[3] which on a fully integrated corporate and personal basis is intended to be taxed at aggregate tax rates approximating the rate that an individual taxpayer would have paid if she had earned the income personally in the first place.[4] Since full-rate taxable income of a corporation is taxed at rates considerably lower than top integrated personal income tax rates across Canada, the Eligible Dividend Proposals also seem to encourage Canadian controlled private corporations (“CCPCs”) eligible for the SBD to retain income in excess of small business limits. But, as they say the devil is in the details.

The Governments Giveth and Taketh Away – The Impact of Claw Backs

While the Eligible Dividend Proposals apply to all corporations there is one regime for CCPCs and deposit insurance corporations and a separate regime for all other types of corporations. The rest of this article will focus solely on the former regime as it applies to CCPCs.

With the exception of Ontario, the SBD is gradually phased out in all of Canada’s provinces and territories based on capital thresholds. In particular, the federal SBD is phased out for corporations having “taxable capital”[5] of between \$10 and \$15 million, after which it will be completely eliminated.[6] As a result, the claw back rules are generally applicable to relatively large and successful small business corporations.[7]

Ontario is alone among the Canadian provinces and territories to claw back its SBD on the basis of income earned by a corporation rather than capital. In particular, the Ontario SBD claw back applies to income retained by a corporation in a particular year in excess of \$400,000 up to \$1,128,519, at which point the entire Ontario SBD will have been eliminated.

The Bad Old Days

Under the dividend taxation rules (“Old Rules”) that existed prior to the enactment of the Eligible Dividend Proposals, the Ontario claw back was generally more of a nuisance to small business corporations than an actual cost borne by most owner/managers since they would likely have opted to bonus down to the small business limit to avoid double taxation in any event. Due to the deferral advantage of paying full-rate taxable income when compared to paying taxes at top personal tax rates, in the past some owner/managers of extremely successful Ontario corporations might have made the decision to not bonus down to the small business limit, notwithstanding the increased double taxation exposure under the Old Rules and the additional tax burden caused by the Ontario claw back. However, the loss of the SBD for most Ontario owner/managers would generally have been too significant a burden and, as a result, corporations that did not bonus down would likely have been in the minority.

While under the Old Rules non-Ontario owner/managers of small business corporations would have still have needed to concern themselves with the potential for double taxation when considering whether or not to bonus down to the small business limit, once the Eligible Dividend Proposals are fully phased in the issue of double taxation will be mostly or totally eliminated so that this issue will largely disappear for them.[8] Due to the income-based nature of the Ontario claw back, the issue of double taxation will continue to be a concern for many Ontario owner/managers.

A Brand New Day?

In furtherance of the 2006 federal-Ontario tax collection agreement, Bill 174 was introduced to harmonize Ontario and federal tax legislation. The draft legislation was given first reading on December 13, 2006 and proposes to eliminate many anomalies of Ontario tax law, such as adopting the Eligible Dividend Proposals, which are based on full-rate taxable income under the ITA, reducing the Ontario normal reassessment period from 4 years to 3 years, dovetailing Ontario capital tax and federal large corporation tax definitions, among others. One anomaly that was not harmonized by the drafters of Bill 174 is that under the draft legislation Ontario will continue to have a separate income-based SBD claw back. As discussed below, the interaction of the Eligible Dividend Proposals and the Ontario claw back gives rise to unexpected results.

Other than for Ontario provincial taxation purposes, the interaction of the Eligible Dividend Proposals with the claw back is relatively straight forward. To the extent that there is a claw back and a corporation pays tax on full-rate taxable income, the corporation will generate income that can be paid out as an eligible dividend.

Since the federal SBD does not have any impact on the Ontario SBD, an Ontario corporation that has in excess of \$10 million of capital and is subject to the federal claw back but has income that does not exceed the Ontario small business limit will have an advantage over corporations in other jurisdictions. For example, the Ontario corporation would enjoy eligible dividend treatment on portions of its full-rate taxable income as well as the Ontario SBD at the same time.

Of course the flip side of this is that if an Ontario corporation is subject to the Ontario claw back only, it will pay an additional 4.67% of taxes over the top combined Ontario federal rate of 36.12%. In other words, in 2007, about 40.8% of every dollar earned and retained by an Ontario small business corporation that exceeds \$400,000 up to \$1,128,519 will be paid in taxes[9] making Ontario far and away the least competitive place to carry on an active business in Canada nearly 3% worse than PEI and Nova Scotia and nearly 9% worse than Alberta. Furthermore, since eligible dividends are only generated by earning federal full-rate taxable income and assuming that there has been no federal claw back, even though the corporation will end up effectively paying top Ontario rates on all of its income from \$1 to \$1,128,519 due to the Ontario claw back, it will not be possible for the corporation to pay the first \$400,000 of income out as eligible dividends.

As a result, in 2007, an owner/manager of an Ontario corporation that earns and retains over \$400,000 will pay integrated taxes on dividends paid out of about 55.6% for every dollar in excess of \$400,000 up to \$1,128,519. Even in 2010, when the Eligible Dividend Proposals are fully phased in, the integrated rate will only fall to about 51.6%. By contrast, if the owner/manager had bonused down to the small business limit in 2007[10] he would have paid about 47.4%, including Ontario Employer Health Taxes (EHT) on the same income amounts.[11]

While those Ontario small business corporations subject to the federal but not the Ontario claw back will enjoy a windfall benefit under the Eligible Dividend Proposals, since many successful small businesses do not require large amounts of capital, it is much more likely that most Ontario small business corporations will be caught on the negative side of the interaction of the Ontario SBD claw back and the Eligible Dividend Proposals. The result of being caught in this trap is that the owners of such corporations will likely be forced to continue the long-standing practice of bonusing down to the small business limit and paying tax on their employment income rather than retaining income to be reinvested in their corporations. Advantage - small business owners anywhere but Ontario.

Based on informal discussions with Queen's Park, I understand that the decision to maintain the claw back was intentional. Although it is mere speculation on my part, the decision to maintain the Ontario claw back appears to have been made primarily to raise short-term tax revenue as a result of "forcing" corporations to bonus down to the small business limit and subjecting owner/managers to immediate high rate taxation on their bonuses.[12] However, the result seems to be counter-productive to the objectives of the legislation, will continue to discourage capital accumulation in Ontario among many small businesses,[13] unfairly increases the tax burden on moderately successful Ontario corporations and will continue to add unnecessary complexity to the Ontario tax system even after integration.

Scrap the Claw Back

I believe that the Ontario claw back has always been an ill-advised fiscal policy[14] that constitutes a penalty causing its greatest negative impact on modestly successful Ontario small businesses and is damaging to the province's growth prospects as a whole. The Eligible Dividend Proposals merely worsen the situation. Hopefully, Queen's Park will rethink its decision to maintain this punitive regime and scrap the Ontario claw back before Bill 174 becomes law.

[1] See Bill C-28, *A Second Act to Implement Certain Provisions of the Budget Tabled in Parliament on May 2, 2006* (first reading received on December 11, 2006).

[2] As defined in subsection 123.4(1) of the *Income Tax Act* (Canada) ("ITA"). Essentially, full-rate corporate income is corporate income that is taxed federally at 22.12% for 2007. Unless otherwise noted, all statutory references are to the ITA.

[3] As defined in draft subsection 89(1).

[4] This article will not review technical aspects associated with the Eligible Dividend Proposals.

[5] As that term is defined in Part I.3 of the ITA.

[6] In general, the provincial claw back rules outside of Ontario follow the rules in the federal system.

[7] It appears that the last time the quantum of the limit was increased was in 1996. A good argument could be made that the quantum of the limit is due for another increase.

[8] Nova Scotia, Newfoundland and Labrador have not harmonized their provincial dividend taxation regimes with the Eligible Dividend Proposals.

[9] Ontario small business corporations with incomes in excess of \$1,128,519 will continue to have to make tough decisions about bonusing down to the small business limit. However, the proportionate cost of not bonusing down will become less of a factor as the amount of income in excess of \$1,128,519 increases.

[10] Currently, there are no proposals for personal income tax rates in Ontario to fall between now and 2010.

[11] While on vacation I had a chance to catch up on my reading and noticed that Colin S.D. Smith had already reviewed the financial impact of bonusing down in the face of the Ontario SBD claw back in his article "Eligible Dividends: Issues for CCPCs" in (2007) Vol. 7, No. 1, *Tax for the Owner-Manager*, 2-3. The two charts created by Mr. Smith in his article are extremely useful, especially since they provide comparative numbers for Ontario with Alberta and British Columbia for 2006 and 2010.

One thing that should be kept in mind when reviewing the charts is that although I would normally expect EHT to apply to significant bonuses paid in Ontario; the Ontario personal income tax rates used in the charts does not address the impact of EHT. If EHT was factored into the "Savings (cost)" line found at the bottom of the charts, those lines would need to be adjusted in Ontario to increase the savings or to reduce the cost, as applicable, by about 1%.

[12] A more crass view would be to consider it an out and out middle class tax grab.

[13] If instead of taxing small businesses immediately, Ontario acted like the rest of the governments in Canada and permitted capital to build up within corporate groups, eventually the capital would likely grow enough to be caught in the federal claw back rules.

[14] A certain senior partner I work closely with would have used even stronger words.