Tax Notes
Dividend Proposals – A New Ballgame for Private Companies?

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The focus of public attention in the wake of the Liberals' hasty announcement on the taxation of dividends[1] has been on public companies and income trusts. But as many readers are aware, the proposals will be applicable to private corporations with high-rate business income. The announcement indicates that eligible dividends will generally include dividends paid after 2005 by Canadian-controlled private corporations ("CCPCs"), to the extent that their income (other than investment income) is subject to tax at the general corporate income tax rate (currently 36.14% in Ontario). Also eligible are non-CCPCs that are resident in Canada and subject to the general corporate income tax rate.

As the Backgrounder to the press release illustrates, the rules pertaining to eligible dividends are designed to result in integration in respect of high-rate business income, so that the combined corporate and personal tax rate is more or less equal to the tax rate that would apply if the income had been earned by an individual in the top tax-bracket. However, besides analogous provincial tax reductions, the proposals assume that the reduced corporate tax rates which were reintroduced in the November 14th Economic and Fiscal Update - but not phasing in for a few years - apply. Without this, there would be an element of under-integration in Ontario and other provinces.[2]

Even so, the combined personal and corporate tax rate applicable to eligible dividends would now only be modestly higher than the top personal rate.

End of Owner-Manager Bonuses?

This means that, if they have not already done so, owner-managers should reconsider the practice of bonusing-out income in excess of the small business limit. We will have to wait and see how the actual proposals play out (see below for further discussion); however, it is quite possible that owner-manager bonuses could become very much a thing of the past, especially if the lower corporate tax rates come into effect [3]. Another obvious point is to delay the payment of dividends until 2006.[4]

An interesting result of the proposals is that it levels the playing field between the taxation of dividends and capital gains. In fact, with the system phased-in, eligible dividends will be materially more beneficial than capital gains. So the pecking order will be eligible dividends, capital gains, and non-eligible dividends. This could affect *post-mortem* estate planning, to name one thing. For example, under the current system, where a subsection 164(6) procedure is used, the effectiveness may be reduced because the stop-loss rules in subsection 112(3.2) may require taxable dividends (taxable at a top rate of 31.34% in Ontario) of an equal magnitude to capital dividends (for example, a 50/50 mix of capital and taxable dividends – the so-called "50% solution", will actually reduce tax in Ontario by about 1/3). This will no longer be the case where eligible dividends can be paid to the estate.

Details Details Details!

This is fairly obvious; but as one thinks through the proposals, murkier issues arise. Some phone calls to the Department of Finance last week revealed that - not surprisingly given the haste of the announcement - Ottawa has yet to iron out the details of the proposals. (It is questionable whether there will be additional details soon, especially if there is an election.)

For example, the release was silent on whether there would be a corresponding reduction to Part IV tax on eligible dividends. If not, there would be a disincentive to earn dividends in private corporations, at least until eligible dividends are paid out to individual shareholders. If, on the other hand, there were a corresponding reduction of Part IV tax, it would appear that there would be a split Part IV tax rate – 20% or thereabouts in respect of eligible dividends, 33⅓% for others.

Back to the Future?

Other issues arise. For example, since “eligible dividends” paid by private corporations do not include income eligible for the small business deduction or investment income, there will have to be some sort of tracking mechanism for “good income” and “bad income.” Older readers will remember that the way these sorts of items have been traditionally dealt with is with “surplus accounts”. If you are *really* old, like me, the mere mention of these will bring back chilling memories – long hours spent trying to understand how these complex accounts work or - worse still – actually calculating them. (Does anybody remember TPUS and 1971 CSOH?) Today, these sorts of accounts exist only in a limited form in the domestic context, such as the capital dividend and refundable tax accounts. But I assure you, gentle reader, these calculations are a piece of cake compared to what used to go on (and still does in the foreign affiliate area). How complex this will become, and whether tax preparation programs can make things simpler, will depend on the details of the proposals. However, the Department of Finance release hints of complications, indicating that special rules will take into account situations where a corporation ceases to be subject to the small business rate, as well as the retention of character for inter-corporate dividends.

Another issue which is not addressed in the Department of Finance release is whether dividends will be paid first out of “bad surplus” or “good surplus”. If the former, will there be strategies to remove the bad surplus, such as a “purification-type” spin-outs, e.g., where the bad surplus is jettisoned to a sister company? Will there be anti-avoidance rules? Will GAAR apply?

So once you start to think about it, it becomes apparent that these proposals mean that the tax planning for private corporations has the potential of becoming considerably more complex than things first appear. The extent of the complexities will depend on how tight the Department of Finance intends to make the rules.

[1] Department of Finance News Release 2005-082, November 23rd, 2005., available at www.fin.gc.ca.

[2] This, of course, depends on the precise level of provincial dividend tax credit; Ontario looks to be around 50%, assuming it is by and large responsive to the federal initiative. I don't see the point of making precise calculations until announcements are made.

[3] In Ontario, where earnings in excess of the provincial small business limit are subject to the "clawback" on the provincial small business deduction, the decision to retain earnings in the corporation may become more difficult, at least if corporation's profits are not materially higher than the clawback income ceiling ($1,128,519).

[4] If the proposal is passed and Ontario follows suit, look for a 10 or more reduction in tax. Per KPMG, without provincial changes federal tax savings of 5.1% will be available to a top-bracket taxpayer.