Eligible Dividends – A Prediction

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*(*This release is based on an article published in Tax Notes #544, May 2008, CCH Canadian Limited)*

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As I have mentioned on a couple of previous occasions, if you hope to be a good tax advisor, it isn't sufficient that you are familiar with countless pages of tax fine print. Nor to leap tall buildings in a single bound. A really good tax practitioner should be able to predict the future – the income tax environment that your clients will face years from now, when the CRA has reviewed current tax returns, issued reassessments and – *oy vey* – what will happen if your client lands up in tax court?

In that spirit, I would like to be the first to make a prediction; as is apparent from the title of this article, it relates to eligible dividends. But you have to keep reading – I will reveal my prediction only at the end of the article. Before I do so, here are some clues.

The birth of the eligible dividend system was not exactly auspicious. In its waning days in the fall of 2005, the former Liberal government ushered in the rules, supposedly to level the playing field between income trusts and public companies. The rules were designed to eliminate the double-tax (under-integration) that occurred when public companies pay dividends to individuals. Of course, they missed the point: it's the exempt entities - stupid - that were pocketing income trust distributions with little or no tax being paid on either end. A year later, lest public companies disappear completely, the Conservative government was forced to move against this with the SIFT regime.

While eligible dividends continued, they really started to unravel last fall, when the government announced that corporate rates would be dramatically reduced, on a phase-in basis to 2012. At the time, it was indicated that adjustments to the eligible dividends gross-up and tax credits were being considered, in order to compensate for these lower tax rates.**[1]**

In the 2008 federal budget, the government did just that, announcing a phased-in reduction to the gross-up and credit for eligible dividends.**[2]** In 2012, the gross-up would be 38% (as opposed to 25% on ineligible dividends), with the dividend tax credit being $6/11^{th}$ of that amount. The idea behind these reductions is that, as we get closer to 2012, the system of integration would be maintained, rather than the dropping corporate tax rates causing "over-integration" – i.e., where income pumped through a corporation would be taxed more favourably than had it been earned directly.

The various budget night releases slavishly picked-up the formulas, but I don't remember much in the way of analysis beyond this. Some days later, when I started to do my revisions to some CCH services to which I contribute, I made some calculations – and just about fell off my chair. By 2012, when the proposals are fully phased-in, the difference in federal rates applicable to eligible and ineligible dividends will be just 0.29%!

So we have all of these complications – calculation of GRIP, LRIP accounts, change of status rules, deemed year-ends and so on - for a lousy 0.29%. That's not quite the end of the story, though. At time of writing, there are fairly significant differences in terms of provincial tax – but more on this later.

From Here to Eternity

First, a problem: The integration may work nicely in 2012. But right now it's 2008 – and the corporate rates are significantly higher than the 2012 rates. This means that, for 2008, income earned at the general business rate and retained at the corporate level may tend to give rise to significant under-integration (depending on the particular province) if the earnings are distributed later – i.e., to take advantage of deferral in the meantime due to low corporate rates. In Ontario, for example, corporate income earned in 2008 and distributed as eligible dividends in 2012 or later will face under-integration of about 4.88% - and it looks like fairly similar rates apply in a number of provinces. My feeling is that this is enough to make many owner-managers reconsider whether income should be bonused-out rather than retained at the corporate level to take advantage of the deferral (thus facing a 46.4% personal rate in Ontario, rather than a 33.5% corporate rate). Of course, if owner-managers decide to bonus out corporate income, this defeats the purpose of lowering corporate rates.

In plain words, in order to preserve the niceties of the system when it is fully phased-in, owner-managers will face material tax penalties if they wish to try to take advantage of the corporate tax deferral that is available in the next few years. Oh, did I mention that many economists are predicting slowdown, if not an outright recession? So this isn't exactly the best time for this sort of effect.

But where under-integration really gets out of hand is if the Ontario small business deduction "clawback" applies. This will be the case where corporate taxable income is between $500,000 and $1.5 million – an income range in which a great many small businesses find themselves.**[3]** In this case, the under-integration will be about 8%, so that the total tax rate where 2008 profits are distributed as eligible dividends in 2012 or later will be about 54.4%, as opposed to the 46.4% personal rate where bonuses are paid**[4]**. Very few, if any, owner-managers with corporate income in the clawback zone would opt to leave these profits in their corporations - where the tax rate including the clawback weighs in at a fairly hefty 37.75%. In my view, the clawback seriously undermines the federal initiative to lower corporate tax rates. Not only is this dumb tax policy, but just after the federal corporate-tax-reduction initiative was announced, the Ontario government actually had the *cohones* to issue a press release claiming that Ontario has a competitive tax system.**[5]**

A while ago, I mentioned that the provincial taxation of eligible dividends may provide a material advantage *vis-à-vis* ineligible dividends. However, with the feds virtually eliminating the advantage of eligible dividends, it remains to be seen whether, over the next few years, the provinces will maintain these advantages. I find it rather ironic that, when the eligible dividend regime was first announced, the federal government implored the provinces to bring in similar changes. As we stand, most provinces have done so, only to find that the Federal government has turned in its tracks – talk about being deaked-out!

But even if provinces do not reduce the eligible dividend incentives over the next few years, one may question whether the complexities of the system are worth the few points of tax reduction that occur in most provinces. For example, the difference between eligible and ineligible dividends in 2012 will be 4.6% in Ontario**[6]**, and 3.54%**[7]** in Quebec.**[8]**

I have pointed out the quirks of the system in previous articles**[9]** – they are numerous. It seems that, every few weeks, another bunch of technical interpretations are released, explaining the esoterica of this system.

Eligible Dividends: 2006 – 2012

As a tax old-timer, I can tell you that "surplus systems" which are designed to provide advantages for corporate distributions tend to be short-lived.[x] So if you haven't already guessed, here's my prediction: the eligible dividend regime will be repealed after 2012. "Eligible dividends", "GRIP", "LRIP", and the like will go the way of such arcane corporate surplus terminology as "TPUS" and "CSOH".

When tax old timers (including myself, I guess) get together, they have a habit of dropping this terminology, and watching younger tax practitioners' eyes glaze over. Perhaps the ultimate legacy of the eligible dividend system is that it will eventually give younger tax practitioners the opportunity to so the same thing one day. My advice to them: there's nothing more boring than tax history.

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[1] Economic Statement, October 31, 2007, Annex - Tax Measures: Supplementary Information and Notices of Ways and Means Motion, p. 97.

[2]The following table shows the phase-in of gross-up and dividend tax credits for eligible dividends (per the 2008 federal budget) as well as federal corporate tax rates, as originally proposed in the October 30, 2007 federal Economic Statement.

Year	Gross-up	Dividend Tax Credit	Federal Corporate Tax Rate
2007	45%	11/18	22.12%
2008	45%	11/18	19.5%
2009	45%	11/18	19.0%
2010	44%	10/17	18.0%
2011	41%	13/23	16.5%
2012	38%	6/11	15.0%

[3] The clawback thresholds include taxable income of associated corporations, including investment-type income. For example, if there is a purification structure in place in respect of the capital gains exemption, cash jettisoned from an Opco to an associated Holdco may generate investment income that might push the associated group's taxable income into the clawback zone. (Thanks to Michael Goldberg for pointing this out.)

[4] Ignoring Employer Health Tax.

[5] "Mcguinty *[sic]* Government Enhances Ontario's Tax Competitiveness Businesses Ringing In The New Year With Tax Breaks", December 28, 2007.

[6] The tax rate in Ontario for eligible dividends is:

2008	2009	2010	2011	2012
23.96%	23.06%	23.65%	25.33%	26.74%

The tax rate for ineligible dividends is 31.34%.

[7] The tax rate in Quebec for eligible dividends is:

2008	2009	2010	2011	2012
29.69%	29.69%	30.68%	31.85%	32.81%

The tax rate for ineligible dividends is 36.35%.

[8] If Ontario followed Finance Minister Flaherty's "suggestion" to lower provincial corporate taxes, the provincial eligible dividend system may no longer be necessary. If Ontario corporate rates were dropped to 10%, the combined personal corporate rate with ineligible dividends would be 48.6%, whereas eligible dividends would result in a combined tax rate of 45.1% - overintegration of about 1.3%.

[9] See, for example, "Eligible Dividends — The Good, the Bad, and the Ugly", *Tax Notes* #523, August 2006.

[x] With the exception of the capital dividend account.