Eligible Dividend Legislation:

Some Comments*

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At the end of June, the Department of Finance released draft legislation pertaining to the eligible dividend regime[i], which fleshed out the details of a rather hasty announcement by the former Liberal government in November 2005.[ii] Barely a month later[iii], the Ontario government announced that it was following the proposals, with details of the provincial dividend tax credits. Added together, the two announcements will have a substantial effect on tax planning for owner-managers of successful corporations in Ontario.

While the original federal announcement was designed mainly to “level the playing field” between public companies and income trusts, the proposals are also of interest to private corporations, particularly those with high-rate business income. 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 36.12% in Ontario). Also eligible for the regime are non-CCPCs that are resident in Canada.[iv]

Before commenting on some of the new developments stemming from the release of the draft legislation, some background is in order.

The original design of the eligible dividend proposals was to provide “integration” in respect of high-rate business income, so that the combined corporate and personal tax rate would be 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 (a degree of double taxation is referred to as “underintegration”). However, the original proposals assumed that there would be analogous provincial tax reductions, and that the reduced corporate tax rates which are to be phased-in later in the decade would apply.

The Ontario announcement features a phase-in of the enhanced provincial dividend tax credit for eligible dividends, from 6.5% this year, to 7.7% when the proposals are fully phased-in, in 2010, compared to a 5.13% credit for ineligible dividends.[v] Our calculations indicate that compared to a top-bracket Ontario taxpayer earning income personally, the degree of underintegration (i.e., extra combined corporate and personal tax payable where income is earned corporately) will drop from nearly 6% this year to less than 2% in 2010 (ignoring EHT which would reduce underintegration even further). For corporations qualifying for the M&P rate, underintegration would disappear in 2010.

Unfortunately, however, the foregoing ignores the Ontario “clawback” of the provincial small business deduction, which may undermine this result, as it increases corporate tax by 4.67% between $400,000 and the clawback income ceiling (about $1.1M). The effect of the clawback is to increase corporate rates to about 40.8% in 2006, dropping to about 37.7% in 2010, compared to top personal rates of about 46.4%. Therefore, in the income zone where the clawback applies, the approximate tax deferral available where corporate income is not distributed personally will drop from 10.3% to 5.6%, for 2006, and from 13.4% to about 8.7% in 2010, when the federal corporate rate decreases are phased-in. Where the clawback applies, underintegration is in excess of 9.2% this year, dropping to about 5.2% in 2010.[vi]

The new system will have some fairly significant results. Notably, if they have not already done so, owner-managers should reconsider the practice of bonusing-out income in excess of the small business limit (as of next year, $400,000 per associated group of corporations). In general, it can be said that, at worst, the ultimate burden when profits are taxed in the corporation and paid to the shareholder as taxable dividends may be only modestly higher than the top personal rate applicable to bonuses; in the meantime, there may be a significant element of deferral resultant from corporate tax rates which are lower than top personal rates.[vii] As discussed above, though, to the extent that the clawback applies, the deferral will be reduced and the underintegration increased;[viii] however, as profit increases over the clawback ceiling, this will be less of a factor.

In addition, the new rules will likely lead to many corporations, such as those involved in real estate rental businesses, to consider restructuring their businesses so that their income is taxed based on corporate tax rates applicable to business income, rather than as investment businesses subject to higher corporate investment tax rates coupled with the RDTOH system. The reason is that, under the new regime, there would be a significant reduction of corporate tax rates (at the moment, from about 50% to 36% in Ontario), while the loss of RDTOH may have little or no material adverse effect if eligible dividends can ultimately be paid instead.

Another interesting result of the proposals is that they also level the playing field between the taxation of eligible dividends and capital gains.[ix] The tax rate for eligible dividends will drop from about 25% this year (compared to about 31.3% for ineligible dividends) to about 22.4% in 2010. This rate will actually be lower than a personally-realized non-exempt capital gain, taxable at about 23.2% - making eligible dividends the sweetheart of Ontario investment dealers.

How the Federal Proposals Work

A good overview of the federal proposals is contained in the introduction to the explanatory notes to the proposals.[x] In a nutshell, though, CCPCs[xi] have a “GRIP” (General Rate Income Pool[xii]) which keeps track of income taxed at the high business rate (investment income and income eligible for the small business deduction are excluded). Eligible dividends can be paid to the extent of GRIP - so it’s a “good” tax account[xiii]. Finance was kind enough to give CCPCs a throw-back rule, where GRIP is calculated for taxation years of a particular corporation ending after 2000[xiv].

Public companies and other non-CCPCs have something called a “LRIP” (Low Rate Income Pool[xv]), which keeps track of income taxed at low rates, e.g., ineligible dividends received. LRIP is a “bad” tax account – because it blocks out eligible dividends until ineligible dividends paid clear out the account. Other than this blockage, non-CCPCs can pay out eligible dividends until the cows came home; so the rules allow a would-be CCPC to change its status[xvi] in return for giving up the small business deduction[xvii]. The foregoing rules apply to deemed and actual dividends[xviii].

Some Comments on the Proposals

While the proposals may not be a model of simplicity, it is fairly obvious that they were designed to avoid becoming overly complex. The proposals do not deal with such things as having a lower Part IV tax rate for eligible dividends, interaction with refundable tax, or the effect of the enhanced gross up on OAS claw-back. As a result, there are various “quirks” in the system. For example if a company pays Part IV tax on an otherwise eligible dividend, this should be higher than the tax ultimately paid by the individual recipient. And since dividend refunds stem from taxable dividends (eligible or otherwise) there appears to be nothing stopping a corporation from paying an eligible dividend, while at the same time getting a dividend refund – provided, of course, it has the appropriate tax accounts.

Change of Status

When the status of a company changes to/from a CCPC, the corporation has an opening GRIP/LRIP account. In keeping with the KISS concept, the accounts are measured on a tax balance sheet approach[xix]. Take a CCPC public, for example, and the net tax values (with a downward adjustment reflecting GRIP) become an LRIP account.

In order to facilitate the changeover and keep things simple, proposed subsection 249(4.1) calls for a deemed year-end on a change of status. As this proposal is applicable to taxation years ending after 2005, there are a lot of companies that had a deemed year-end earlier this year and didn’t even know it - until now. Besides a company that went public, this could also include where the controlling shareholder ceased to be resident, or a corporation was taken over by a public company.

In fact, there could be several deemed taxation years. For example, if there is a binding agreement of purchase and sale entered into with a non-resident or public company, this could trigger a year-end (because of paragraph 251(5)(b)), and there would be another deemed year-end on a change of control itself.

Corporate Groups

Rather than get into what could be scores of pages of complicated legislation dealing with corporate groups, the GRIP (that's the good account) and LRIP (that's the bad account) are calculated on a per-company basis. There is no consolidation or related group concept other than the result that an eligible dividend received enlarges a corporation's GRIP[xx] and an ineligible dividend received enlarges a corporation's LRIP. So take an active CCPC public and it may have an LRIP (depending on its tax balance sheet) which blocks out the payment of eligible dividends. But instead, a public company vehicle could be used to acquire the company, say, in a reverse takeover. The public company may be free to take advantage of the eligible dividend regime – as long as it doesn't get ineligible dividends from the bottom company.

Anti-Avoidance – "Artificial" Manipulation of GRIP/LRIP

Or is it? Embedded in the fine print of the legislation is an anti-avoidance provision which could be applicable to this sort of structuring. It's buried in paragraph (c) of the proposed definition of something called an "excessive eligible dividend designation"[xxi] (hereinafter referred to as "(c)"). It says that the excessive dividend will be the entire amount of the eligible dividend[xxii] if "it is reasonable to consider that the eligible dividend was paid in a transaction, or as part of a series of transactions, one of the main purposes of which was to artificially maintain or increase the corporation's general rate income pool [that's the good account], or to artificially maintain or decrease the corporation's low rate income pool [that's the bad account]."[xxiii]

The consequence of tripping over this rule is rather severe – in the form of a 30%-of dividend penalty tax on the company which[xxiv], by the way, specifically draws joint and several liability on the part of non-arm's length recipients of dividends from CCPCs[xxv].

Because of the severity of (c), its scope is rather important. Simply taking an operating company public may result in an LRIP. Not being able to pay eligible dividends is obviously a competitive disadvantage vis-à-vis public companies which are not restricted in this manner. (This is somewhat ironic, because the proposals were supposed to encourage public company offerings.) However, if a company tries to "compensate" by creative tax planning, will it run straight into this anti-avoidance rule? For example, could a soon-to-be-listed corporation dividend out earnings[xxvi] to holdcos of pre-listing shareholders to reduce its tax balance sheet[xxvii]? What if, prior to an outright sale to a public company, the selling shareholders did a safe income strip? Is that OK? If a public corporation takes over a CCPC and receives ineligible dividends from it, this blocks out eligible dividend status. What if, instead, the bottom company made a loan? Could this be considered to be artificially maintaining or decreasing the top company's LRIP?[xxviii]. If this could be problematic, given the intricacies of inter-corporate transactions, will a public company paying a dividend ever know when it is in jeopardy of a 30% tax[xxix]? Will strategies develop to "jettison" LRIP, notably to non-resident and/or exempt entities[xxx]? In the CCPC area, the obverse strategy (i.e., not streaming GRIP to these entities) will be preferable[xxxi]. How will all this play out with the dreaded (c)?

Because the eligible dividend proposals necessitate a system of tax accounts, the price of certainty in this realm is complexity. Conversely, as can be seen by the foregoing examples, a simpler system leads to uncertainty and administrative decrees. While the latter is not optimal, it is hoped that the government will take steps to clarify the application of the proposals.

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[i] *Legislative Proposals and Explanatory Notes Relating to Income Tax - Dividend Taxation*, released on June 29th.

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

[iii] August 3rd. The News Release, Backgrounder and Tax Information Bulletin on the announcement are available at www.fin.gov.on.ca.

[iv] As a result of the proposals there will now be two dividend categories for determining the tax treatment in the hands of the recipients of dividends paid by taxable Canadian corporations:

Type of dividend	Gross-up	Federal Tax Credit (grossed-up dividend)	Maximum federal marginal tax rate (outside of Quebec)
Eligible	45%	18.97%	14.55%
Ineligible	25%	13.33%	19.58%

An “eligible dividend” is a taxable dividend that is received by a person resident in Canada from a corporation resident in Canada that entitles the recipient to a more favourable tax treatment. In order to qualify as an “eligible dividend”, the dividend must be designated as such in writing by the paying corporation. At the time of payment, the paying corporation must send each recipient of a designated dividend a “written notice” indicating that it is an eligible dividend. For eligible dividends paid before Royal Assent to the proposal, corporations will have 90 days following such assent to provide such notice

[v] The rates are a percentage of the grossed-up dividend. The provincial dividend tax credit is as follows:

Year	2006	2007	2008	2009	2010
Dividend tax credit	6.5%	6.7%	7.0%	7.4%	7.7%

[vi] Special thanks to Michael Goldberg for his calculations.

[vii] In addition, if the corporation subsequently incurs tax losses, carrybacks (with the normal three year period) should be more tax effective, since corporate losses cannot shelter income bonused out to the owner manager.

[viii] The effect is particularly severe in 2006 and 2007.

[ix] 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.

[x] For convenience, we have reproduced this note:

The legislative measures described in these notes implement a new system for the taxation of "eligible dividends" paid after 2005 by corporations resident in Canada to individual shareholders resident in Canada. This new system builds upon, but does not replace, the existing "gross-up" and dividend tax credit provisions, and these notes assume that the reader is generally familiar with those provisions.

From the standpoint of the individual taxpayer, an eligible dividend benefits from a 45% gross-up (as opposed to 25% for other taxable dividends from taxable Canadian corporations) and a federal tax credit equal to 11/18 of the gross-up. A dividend is an eligible dividend if the dividend-paying corporation has given the dividend recipient written notice to that effect. The recipient can rely on that notice, and need not know anything about the tax status of the corporation.

For the dividend-paying corporation too, an eligible dividend is any dividend the corporation designates to be one. However, some corporations will have a limited capacity to pay eligible dividends. If their designations exceed that capacity, they are liable to a special tax. That tax applies

to the excess amount or, if the corporation can reasonably be considered to have attempted artificially to increase its capacity to pay eligible dividends, to the full amount of the eligible dividend

Corporations' capacity to pay eligible dividends depends mostly on their status. If a corporation is a Canadian-controlled private corporation (CCPC) or a deposit insurance corporation, it can pay eligible dividends only to the extent of its "general rate income pool" (GRIP) – a balance generally reflecting taxable income that has not benefited from the section 125 small business deduction or any of certain other special tax rates. (A corporation resident in Canada that is neither a CCPC nor a deposit insurance corporation (a "non-CCPC") can pay eligible dividends in any amount, unless it has a "low rate income pool" (LRIP).)

Some CCPCs are, because of their size or the nature of their income, ineligible for the small business deduction. Others may be willing to forego the small business deduction in exchange for being able to pay eligible dividends subject only to the LRIP limitation. A new election allows a CCPC to do this without also giving up other benefits of CCPC status. To simplify these and other cases where an existing corporation ceases to be (or becomes) a CCPC, a taxation year-end is imposed immediately before any such change in status, whether it results from the election or otherwise.

Special rules apply to the computation of a corporation's GRIP or LRIP, as the case may be, when it becomes or ceases to be a CCPC and when it has been party to an amalgamation or a winding-up. Other rules deal with the introduction of the new system, in certain cases giving existing CCPCs a starting GRIP.

[xi] And "deposit insurance corporations", as defined in proposed subsection 89(15), hereinafter ignored for simplicity.

[xii] Proposed subsection 89(1). GRIP can go negative, e.g., as a result of loss carrybacks and other "specified future tax consequences".

[xiii] Excess dividends are calculated in accordance with the proposed "excessive eligible dividend designation" definition in subsection 89(1). Basically this will apply to the extent of the excess over GRIP for CCPCs and to the extent of LRIP for other corporations. Unless paragraph (c) of that definition applies (discussed below), a 20% tax applies, with the ability to designate separate non-eligible dividends in a manner reminiscent of Part III of the Act – see proposed Part III.1. I note in passing that there is actually nothing to "designate" in the "excessive eligible dividend designation" definition. The designating stuff is in Part III.1. Per proposed subsection 185.2(1), every Canadian-resident corporation that pays a taxable dividend (other than a capital gains dividend) must file a Part III.1 return containing an estimate of Part III.1 tax payable. The explanatory notes do not specify what information is required in the return.

[xiv] See proposed subsection 89(7). The throwback rule in proposed s.89(7) is based on a notional 37% rate whereas GRIP for years ending after 2005 is based on an assumed 32% rate.

[xv] See proposed subsection 89(1). LRIP is determined at any time in a taxation year; GRIP is calculated at year-end.

[xvi] See proposed subsections 89(11)-(13).

[xvii] See proposed paragraph 125(7)(d).

[xviii] A capital dividend cannot be an eligible dividend.

[xix] See proposed subsections 89(4) and (8).

[xx] It is worth noting that dividends received from foreign affiliates deductible under section 113 also increase GRIP.

[xxi] See proposed subsection 89(1).

[xxii] With no possibility of designating a separate ineligible dividend under Part III.1.

[xxiii] It is interesting to note that this marks the re-emergence of the term "artificially" into the text of the *Income Tax Act*. On the strength of this term, the CRA has won a number of notable cases dealing with the now-repealed subsections 55(1) and 245(1), based on provisions which have since been repealed in favour of GAAR, notably subsections 55(1) and 245(1). Examples include *Novopharm Limited* v. *The Queen*, 2003 DTC 5195, FCA; *The Queen* v. *Central Supply* Company (1972) Limited, and Carousel Travel 1982 Inc., 97 DTC 5295, FCA; and *The Queen* v. *Fording Coal Limited*, 95 DTC 5672, FCA. The term artificial has generally been interpreted to apply when a transaction/deduction is contrary to the object and spirit of the Act, not in accordance with business practices, and does not have a *bona fide* business purpose.

[xxiv] See proposed section 185.1.

[xxv] See proposed subsections 185.2(3)-(5). While section 160 of the Act might also be applicable, the proposals include specific rules as to the extent of the joint and several liability and the effect of payments by the shareholder and/or corporation. For example, while section 160 would extend joint and several liability to the extent of the property transferred, subsection 185.2(3) imposes Part III.1 liability based on proportionate dividends received.

[xxvi] E.g., its safe income.

[xxvii] Interestingly, this might also transfer a pre-existing GRIP account to the holdcos. Could this strengthen the argument for the application of (c) in respect of subsequent dividends (from both the private holdcos and the Pubco) – i.e., the transaction artificially increased *both* GRIP (to the holdcos) and LRIP (to Pubco)?

[xxviii] Would it make any different if there were memos or other evidence that this course of action was taken because of LRIP considerations? What if more complicated structures were put in place because of creditor issues resulting from the bottom company having a receivable as a result of a simple loan to the top company?

[xxix] Suppose for example that, rather than advance the funds to the public company, the public company borrowed from a third party lender, with the assets of the sub as security for the loan?

[xxx] One possibility is a special class of shares that would pay ineligible dividends. However, since an LRIP account should be cleared out prior to the payment of eligible dividends, query whether such a structure can be used on a systematic basis. One-off arrangements to "dump" an LRIP balance may, of course, be more problematic with respect to (c). What about reorganizations which may have the effect of transferring LRIP to another company? I.e., if a deemed dividend is involved, this would normally appear to reduce the LRIP balance of the payor corporation. It is anticipated that practitioners will generally feel that rulings on the foregoing – i.e., that (c) will not apply - will be advisable, notwithstanding the limited comfort they often provide (e.g., in view of required representations, *caveats*, etc.).

[xxxi] The explanatory notes state: "subject to any constraints in the existing law *and the need to avoid artificial manipulations of the pools*, a corporation may choose which of its shareholders will receive eligible or other dividends." While the CRA has not had difficulty with CDA streaming, to my mind, (c) is a more specific roadblock than the issues inherent in respect to CDA.