Draft Legislation Released to Reduce Tax on Certain Dividends

Draft legislation to amend the *Income Tax Act* (Canada) was released by the Department of Finance on June 29th to implement proposals to reduce the tax rate on dividends that were first released by Paul Martin's Liberal government last year and subsequently adopted by Stephen Harper's Conservatives following their election in January. Subsequently, on August 3rd, the province of Ontario announced that it will follow the lead of the federal government and lower provincial tax on the same types of dividends over a five year period.[1] The draft legislation lowers the top combined federal/Ontario marginal tax rate on dividends received from large Canadian corporations from approximately 31.34% to 25% in 2006, eventually falling to 22.3% by 2010. Interested parties have until September 15, 2006 to submit comments on the draft legislation.

Background

The genesis of the draft legislation arises from the Department of Finance's concerns over the impact of income trust structures on government tax revenues. Income trusts are structured so as to eliminate corporate level tax and eliminate the double tax that is inherent in Canada's corporate tax system by flowing pre-tax earnings of the operating business to unitholders to be taxed at their respective marginal tax rates.

Corporations are taxed on the profit that they earn and shareholders are taxed on dividends paid from those profits. Double taxation is mitigated through the mechanism of integration. In theory, integration is designed to ensure that the total tax paid by a corporation and its shareholders approximates the tax that an individual would have paid directly by carrying out the activity without the corporate vehicle. To achieve this result, shareholders are currently required to gross-up the dividend they receive by 25% (this is intended to represent the total income tax paid by the corporation on that income). Tax is then computed on the grossed-up dividend at the individual's marginal tax rate and a tax credit of 13⅓% of the grossed-up dividend is provided to the individual (the tax credit is intended to give the shareholder credit for the total tax paid by the corporation).

Integration is only effective in mitigating double taxation if income is taxed at the corporate level at approximately 20%. Consequently, integration is currently only truly effective for shareholders of Canadian-controlled private corporations ("CCPC") that claim the reduced small business tax rate. Public and large private companies that are taxed at rates above 20% are therefore subject to an element of double taxation.

On September 8, 2005 the government launched a consultation process whereby interested Canadians were invited to discuss a number of key questions related to income trusts. The overwhelming consensus of submissions received were in favour of reducing the personal income tax on dividends rather than imposing new taxes upon income trust structures. To this end, the draft legislation establishes a tax reduction in the form of an enhanced dividend "gross-up" and tax credit to make the total tax on dividends received from large Canadian corporations more comparable to the tax paid on distributions of income trusts thereby eliminating the double taxation of dividends at the federal level.

The Draft Legislation

The basic proposal itself is quite simple. The mechanics, on the other hand, are fairly complex.

The proposed amendments will increase the amount of both the gross-up and the dividend tax credit applicable to dividends paid from corporate income which has not been taxed at reduced small business tax rates (referred to as "eligible dividends"). Eligible dividends will be grossed up by 45% (instead of 25%), and a credit of 19% (instead of 13⅓%) of the gross up will apply. The new rules assume a corporate tax rate of 32% instead of 20%. The overall effect of these adjustments is to reduce the effective federal tax burden on eligible dividends from 19.6% to 14.5%.

The Framework

The proposed amendments include one set of rules that apply to CCPCs and a second set of rules for other corporations. Both sets of rules are framed by the following cornerstones:

- Only income that has been taxed at the general rate is eligible for the new treatment as "eligible dividends." A tax account called the "General Rate Income Pool" (GRIP) has been introduced to house this income and

[1] Ontario will gradually raise its credit from 5.13% to 6.5% in 2006 and to 7.7% by 2010. Manitoba has stated that it will increase its tax credit on eligible dividends from 5% to 11%. British Columbia, Prince Edward Island, and Quebec have indicated that they will harmonize with the federal changes.

distinguish it from preferentially taxed income tracked in the "Low Rate Income Pool" (LRIP).

- Eligible dividends must be designated by the corporation paying them by filing an election with the Canada Revenue Agency. Late-filed elections to designate dividends will not be permitted.
- Corporations receiving tax-free inter-corporate dividends will also need to identify whether dividends received are designated by the payer and therefore eligible to be included in the recipient's GRIP.
- If an excessive election has been made (i.e. the dividend designated as an eligible dividend exceeds the GRIP balance) the dividend payer is required to pay an additional tax to ensure that the distributed income has, in fact, borne tax at the general rate underlying the new system. In certain cases, excessive designations can be reversed (discussed below).

Eligible Dividends for CCPCs

Income earned by a CCPC that is not subject to a reduced rate of tax (i.e. active business income in excess of the corporation's small business limit) accumulates in the corporations GRIP and gives rise to eligible dividends.[2]

The amendments also contain a transitional rule that allows a CCPC to add an additional amount to the GRIP (provided such income qualifies) in respect of taxation years ending after 2000 and before 2006.

A CCPC can pay eligible dividends only to the extent of its GRIP balance.

If an excessive election is made by the CCPC with respect to an eligible dividend, the corporation will be subject to a penalty equal to 20% of the difference between the dividend and the GRIP balance at year-end. If, however, certain conditions are met and the shareholders and the corporation jointly elect, the excess amount will be deemed to be a separate ineligible dividend and the penalty will be waived.

Eligible Dividends for Non-CCPCs

A non-CCPC can pay eligible dividends in any amount, unless it has LRIP (a non-CCPC may have a LRIP balance because it benefited from the small business deduction when it was a CCPC or because it received ineligible dividends from a CCPC). If a LRIP balance exists, it must be reduced through the payment of ineligible dividends before the non-CCPC can pay an eligible dividend.

If the non-CCPC designates a dividend as an eligible dividend despite having a LRIP balance, it is liable to a penalty equal to 20% of the LRIP. Once again, if the parties elect jointly and certain conditions are met, the LRIP balance will be considered a separate ineligible dividend and the penalty will be waived. If the corporation is a widely held public company, the ability to make such an election will be problematic. Thus, special care must be paid to ensuring that the LRIP and GRIP balances are properly accounted for.

Other Points of Interest

- The amendments allow a corporation which would otherwise qualify as a CCPC to elect to forego the small business deduction in exchange for the ability to pay unlimited eligible dividends (subject only to the LRIP limitation discussed above). This election does not preclude the corporation from other benefits associated with CCPC status.
- Corporations that enter into transactions that artificially maintain or increase the corporation's GRIP or artificially maintain or decrease the corporation's LRIP are subject to an additional penalty equal to 10% of the excessive dividend. An excessive dividend election is not provided in these situations.

Conclusion

The draft amendments will likely be adjusted somewhat once the Department of Finance has had a chance to absorb the tax community's comments and suggestions. However, major changes are not expected. If you would like more information on how these changes will affect you, please contact us at the numbers listed below.

This update is intended as a summary only and should not be regarded or relied upon as advice to any specific client or regarding any specific situation. If you would like further information regarding the issues discussed in this update or if you wish to discuss any aspect of this commentary, please feel free to contact:

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[2] Income generated by a CCPC and subject to a reduced rate of tax (i.e. due to the small business deduction) accumulates in the corporation's LRIP and gives rise to "ineligible dividends".