Corporate Deferral Strategies, Dalton McGuinty and Joe the Plumber

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Over the last number of years there have been a multitude of changes in corporate tax rates as well as the methodology behind taxing corporate distributions. Fortunately, these changes have generally enhanced opportunities to build corporate capital through integrated corporate tax deferrals.

Falling Corporate Tax Rates and the Eligible Dividend Regime

Traditionally, the small business corporate tax rate applicable to active business income has been much lower than the top personal tax rate. This, of course, encourages the retention of earnings at the corporate level, up to the annual "small business limit" ($500,000 per associated group of corporations, starting in 2009). Some years ago, the general corporate tax rate for business income rivaled the top marginal personal tax rate; however, in recent years, the general corporate rate has dropped dramatically. The latest group of federal changes (stemming from the November 2007 Economic Statement) will see the general business tax rate eventually dropping to 15% by 2012, for a "target" federal/provincial corporate rate of 25%.**[1]** This, of course, is considerably lower than top personal tax rates. Therefore, there is a substantial incentive to retain profits at the corporate level rather than distribute them as dividends or salaries and thus incur additional tax exposure.

In spite of these dramatic changes, our experience suggests that there continue to be many situations where business profits are still blindly bonused-out to owner-managers, so as to pass up these significant deferral opportunities, perhaps because past practices are followed by rote**[2]** – go figure**[3]**.

The incentive to retain profits at the corporate level has been enhanced by the eligible dividend regime.**[4]** The intent of this regime is to reduce the element of double-taxation ("under-integration") that would otherwise occur upon the distribution of corporate profits as dividends. In other words, the eligible dividend regime is designed to provide "integration" in respect of high-rate business income (i.e., income not subject to the small business deduction), so that the combined corporate and personal tax rate would be more or less equal to the rate that would apply if the income had been earned directly by an individual in the top tax bracket.

The exact degree of under-integration depends largely upon provincial tax rates applicable to eligible dividends. But in general it can be said that the eligible dividend regime is designed such that, at worst, the ultimate burden when profits are taxed in a corporation and paid to its shareholders as taxable dividends may be only modestly higher than the top personal tax rate that would have been paid by an individual had the income been earned directly**[5]**. The 2008 federal budget increased the effective tax rate on eligible dividends as lower corporate tax rates are phased in; however, this increase was advisable only because the drop in corporate rates mentioned above would have otherwise eventually resulted in "over-integration" – that is, a combined corporate/personal tax rate on general business income distributed as dividends which would be lower than the top personal tax rate on bonuses**[6]**.

So the bottom line is that, not only does the tax system encourage the retention of profits at the corporate level (i.e., as opposed to bonusing them out), the eligible dividend regime is designed to result in little or no downside**[7]** when profits are eventually distributed as dividends.**[8]**

Ontario Alone Again – But This Time in a Good Way…

Prior to changes proposed in the Ontario budget, the tax rules in this province might have resulted in an exception to the retention strategy. That's because Ontario was alone in imposing an income-based "clawback" of its provincial small business deduction. In recent years, the clawback consisted of a surtax in excess of 4% which was applied against corporate income between $500,000 and $1.5M, at which point the entire benefit of the Ontario small business deduction would be eliminated. The additional tax was high enough to result in a material degree of under-integration with respect to corporate profits distributed as dividends. Of course, this undermined the retention of profits at the corporate level where such profits were subject to the clawback, and encouraged bonusing-down to the small business limit in order to avoid the potential double-tax effect. Michael Goldberg's article "Ontario Alone"**[9]** encouraged the Ontario government to scrap the clawback because it was "an ill-advised fiscal policy 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."

We don't know if anyone was listening, but happily, the 2009 Ontario budget proposes to eliminate the clawback, effective starting on July 1st, 2010, leveling the playing field for Ontario businesses. In fact, the Ontario budget papers appear to indicate that Ontario corporate taxes would not even be subject to the federal clawback of the small business deduction – so Ontario is alone again, but this time in a good way. (Technical Note: outside of Ontario, the small business deduction is gradually phased out based on capital thresholds. In particular, the federal small business deduction is phased out for corporations having "taxable capital"**[10]** of between $10 and $15 million, after which it will be completely eliminated.**[11]** As a result, the clawback rules are generally applicable to relatively large and successful small business corporations.**[12]**)

A Couple More Kudos to Our Red Friends

Since we have done our share of slagging the McGuinty government in the past, it seems only fair to give them credit where credit is due. In addition to scrapping the clawback, their 2009 budget made a number of surprising and business-friendly moves. In particular, the Ontario's general corporate tax rate will fall from 14% (applicable to June 30, 2010) down to 10% by July of 2013**[13]** – thus moving the federal/provincial corporate rate to the 25% "target rate" we mentioned earlier. Further reductions to the small business deduction rates from 5.5% to 4.5% will be helpful;**[14]** reductions to the corporate minimum tax ("CMT") rate from 4% to 2.7% and a corresponding increase in the CMT thresholds from $5 million in revenue to $50 million in revenue and from $10 million in assets to $100 million in assets are all positive steps.**[15]** (Note: we are leaving comments on HST to the HST mavens.)

At the Minden Gross tax department, we're no shrinking violets when it comes to pumping some numbers. Courtesy of Michael's calculations, let's run down some of the key results of the tax system, using Ontario and its 2009 budget proposals as an example:

	2009	Ontario Budget Proposals fully phased in (2014)
Deferral – top personal rate less general business rate	13.4%	21.4%
Over-integration (under-integration)**[16]**	(1.0%)	0.3%
Deferral – CCPC investment income rate less general business rate**[17]**	15.7%	19.7%
Deferral – top personal rate less small business rate	29.9%	30.9%
Top personal rate less rate on CCPC investment income distributed as:	(0.7%) 6.0%	2.4% 4.8%

Ineligible dividends[18] Eligible dividends[19]		

These numbers are spectacular. For example, when the changes are phased in, the retention of profits at the corporate level - taxed at general business rates - will mean a 46% deferral[20].

Joe – Meet Dalton (and Jim the Finance Guy)

Generally, in the last dozen or so years, federal and provincial governments of both parties have crafted a clever corporate tax system designed to encourage capital formation, particularly for small businesses.

Joe the Plumber would be very happy here – if he immigrated to Ontario, his company would pay tax at a small business corporate tax rate of a mere 15.5% (by 2014). Although he would face higher taxes if he withdrew the funds for personal and living expenses, he looks to us like he lives pretty modestly. Maybe President Obama should consider this tax system: he and Joe could be friends.

For readers who miss our *kvetching* about the McGuinty government, we offer this: it would have been nice if the abolition of the clawback had been pushed forward to this July – or better still, the beginning of January, so that Ontario business people could have reaped the benefits of tax deferral sooner – in these challenging economic times. But better late than never.

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[1] As recently as 2001 the federal corporate rate alone was more than 28% and when combined with provincial rates, such as in Ontario, the combined rate was more than 42%.

[2] As is discussed further below, bonusing down in Ontario has continued to be a common practice due to the soon-to-be-scrapped Ontario small business deduction clawback.

[3] Of course, the retention of corporate surplus results in higher "death tax" exposure. As a result, the trend toward lower corporate tax rates means that undertaking an estate freeze will become increasingly important to the owner-manager and his or her family's succession planning.

[4] This was enacted early in 2007, applicable to dividends paid after 2005.

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

As noted previously, the eligible regime also encourages taxpayers to enter into estate freezes, since it encourages the retention of income at the corporate level (and therefore growth in corporate value), without significant tax penalties when such income is distributed as dividends. The ability to generate eligible dividends also facilitates tax-effective redemption of freeze shares to the freezor/surviving spouse, as well as *post-mortem* reorganizations after the deemed disposition on death occurs.

An estate freeze may affect the requirements in respect of eligible dividends themselves. Per subsection 89(14), the Act requires that a corporation that designates an eligible dividend must notify in writing each person to whom the eligible dividend is paid, at the time of payment. The CRA's current policy is that, where all of the shareholders are directors of the corporation, a notation in the corporation's minutes is sufficient. However, where growth shares are held by a family trust, this will no longer be the case. For non-public corporations, the CRA's policy in this regard is that contemporaneous notification of an eligible dividend may be made by letters to shareholders, or dividend cheque stubs.

Eligible dividends can also result in a dividend refund, i.e., if the payor corporation has refundable-dividend-tax-on-hand balances. However, as an eligible dividend must be a taxable dividend, a capital dividend cannot be an eligible dividend.

[6] Because the phased-in eligible dividend rate is premised on the lower corporate tax rates that are also being phased in, there may be a more significant degree of under-integration during the earlier years of the phase-in period if distributions are deferred – i.e., because the applicable corporate tax rates will be higher than those assumed in the setting of the phased-in eligible dividend rate. In Ontario, for example, by 2014, the combined personal corporate rate when profits for that year are distributed as eligible dividends will only be about 47.2% (a rate which is slightly lower than personal tax on a bonus, with EHT factored in). However, 2009 corporate profits will attract a combined personal/corporate tax rate of about 52.8% if distribution is deferred until 2012 or later, when the increases to the eligible dividend tax rate are phased-in.

[7] Depending on the province.

[8] Or if not distributed, subject to capital gains tax on death, ignoring the benefits of an estate freeze.

[9] "Dividend Taxation – Ontario Alone", *Tax Notes No.* No. 532, March, 2007.

[10] As that term is defined in Part I.3 of the Act.

[11] In general, the provincial clawback rules outside of Ontario follow the rules in the federal system.

[12] 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 or, to keep up with Ontario (see below), due to be eliminated altogether.

[13] Provided that Alberta does not further reduce its corporate rates once these rate reductions are fully phased-in, the rate will be the same as corporations in Alberta pay.

It is also worth noting that the M&P rates will fall from 12% to 10% by July of 2010. Incidentally, the fact that these changes come into effect on July 1 of the particular year, while federal rate reductions are on a calendar year basis may lead to some confusion and makes for more complex calculations.

[14] Although a positive step, the Ontario small business rate is far from the most competitive. Manitoba will completely eliminate its small business rate by December 1, 2010.

[15] A host of other targeted tax measures affecting corporations have been discussed in detail in budget summary papers and will not be repeated here.

[16] This factors in the effects of EHT.

[17] Of course, this differential will encourage structures where specified investment income status does not apply, notably by the retention of more than five full-time employees. For commentary on recent administrative developments in this respect pertaining to corporate partnerships, see "SIB Rules and Employees of Partnerships: Next Time Maybe An Announcement?", Michael Goldberg, *Tax Notes* No. 546, July 2008.

[18] An interesting side effect of the phase-in of general federal and Ontario corporate rate reductions is that, in the absence of other tax rate changes, investing through holding companies will soon be slightly more tax efficient than earning such income directly. In particular, by July 2013, an Ontario investor earning investment income through a CCPC will only pay about 44.7% tax (about 44.1% if the income is distributed as an ineligible dividend) instead of about 46.4% if he or she had earned the same income directly.

[19] On the other hand, due to changes in the dividend tax credit rates applicable to federal and Ontario eligible dividends (and most other provinces as well), if funds are required from an investment holding company that also has a positive GRIP account, 2009 will be the most tax efficient year to pay out such funds as eligible dividends.

[20] I.e., 21.41% divided by 46.41%.