CORPORATE TAX RATES – HOW THEY (NOW) WORK*

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As many of my colleagues know, it has been my happy tradition to spend much of the summer in Maui, in my perpetual quest to become a half-decent windsurfer.**[i]** But those who know me better are also aware that, besides this, there is a variety of work I take with me. This summer, it included updating various CCH services. As several of these discuss corporate tax rates, we rapidly found that there have been fundamental changes in how corporate tax rates work.

The chart at the end of the article presents the basic federal rates. I note that the federal corporate tax system is now stable – there are no federal corporate rate changes being phased in (although the acceleration of the small business limit to $300,000 for calendar 2005 is a 2004 budget proposal).

"Business" versus "Investment" Rates

As can be seen in the chart, there is now a 7% reduction, which applies to "business income".**[ii]** This break, introduced in the 2000 budget, was fully phased-in by (calendar) 2004, and has some important effects on the corporate tax system.**[iii]**

For example, how much is tax reduced by the small business deduction? If one were to look no further than subsection 125(1), you would say that the answer is 16% - because that's what the provision says! But is it? Income qualifying for the small business deduction does *not* qualify for the 7% "business rate reduction". Thus, the benefit of the SBD is really only 9%. Of course this does not include provincial tax benefits. In fact, the provincial tax breaks are now quite significant in relation to the federal benefit. Ontario's differential (with respect to non-M&P income) is 8.5%, with B.C.'s at 9%.

Likewise, a look at section 125.1 shows that the maximum M&P deduction is 7%. However, income qualifying for this deduction does not qualify for the business rate reduction. The definition of "full rate income" in subsection 123.4(1) calls for the following reduction: if an amount is deducted under subsection 125.1(1) from the corporation's tax otherwise payable under this Part for the year, 100/7 of the amount deducted. Thus, there no longer appears to be a benefit of claiming the M&P deduction at the federal level, although the concept may still be significant in a number of provinces.**[iv]**

As shown by the chart, the federal rate, net of the 7% reduction, is 22.12 % - and is applicable to M&P income, with the small business deduction pegged at 13.12%. Provincial taxes are tacked on to this rate. So in Ontario, for example, tacking on the full provincial corporate rate brings the "business" tax rate to 36.12% with a 34.12% rate applicable to M&P. (The small business rate in Ontario is 5.5%, bringing the combined rate to 18.62%.)

However, if a corporation is a CCPC, investment income – more precisely, that subject to refundable tax under 129(4) – will not be eligible for the 7% reduction. Likewise, such investment income will be subject to the 6 2/3% refundable tax in section 123.3, so that corporate tax rates on investment income (including, of course, the taxable portion of capital gains) will be 13 2/3% higher, with Ontario rates weighing in at about 49.8%.**[v]**

Planning Points

What does this mean? First, the 13 2/3% reduction as between business and investment income is significant. Accordingly, it may be advantageous to earn such business income, even at the loss of RDTOH balances.

Also, using Ontario as an example, the 36.12% rate represents a deferral of in excess of more than 10% over the top personal rate. However, this advantage is reduced when the small business deduction clawback of 4.67% applies.**[vi]** This applies for income between $400,000 and $1,128,519, so that the marginal tax rate on business income in this zone hikes to just under 41%.**[vii]** If you ask me, this corporate tax rate is high enough to make the benefits of deferral from retention of the business earnings at the corporate level modest, as compared to the under integration that results when dividends are paid, making bonuses relatively more advantageous in this range of income. This means, for example, that, for a professional with income well in excess of the small business limit, the primary benefit of incorporation will typically be the small business deduction (i.e., since bonuses may be beneficial in the “clawback zone”). Furthermore, since such bonuses will attract Employee Health Tax,[viii] conventional incorporation methodology will make professional incorporation most beneficial where there is a high ability to retain small-business-deduction earnings at the corporate level (as opposed to being distributed, e.g., to defray day-to-day living costs).

The “business rate” (36.12% in Ontario) is high enough that there will be material under integration if dividends are paid out of a corporation. I calculate the overall tax rate in Ontario to be 56.14%, nearly 10 points higher than the 46.4% rate that applies to top-rate personal income. Similar results should apply in other provinces. However, because dividends attract higher tax than capital gains, the degree of under integration can be cut in half or so if the surplus retained in the corporation is realized as a capital gain. This can be as a result of increased value of the corporation when there is a deemed disposition on death,[ix] or if a corporate-level capital gain is triggered, with the amount being distributed utilizing the resultant capital dividend and RDTOH balances generated (since a distributed corporate-level capital gain generates a similar tax rate to a personally-incurred gain).

Happily, the small business rate in Ontario (18.12%) is low enough to result in over integration of 2.28% (vis-à-vis top Ontario personal rates) when dividends are distributed.[x]

What this all boils down to is that there are now three corporate tax rates: small business at the low end, “investment rates” at the high end and “business rates” in the middle. On both ends, the system is designed to produce integration, with deferral at the low end. However, the business rates in the middle allow for significant deferral, but with the price of significant under integration. If you ask me, that’s where tax planning becomes interesting.

Chart

The following chart shows the federal rates as of 2005:

	%
Federal tax rate	38
Abatement	(10)
Net federal rate	28
Surtax (4% of net federal rate)	1.12
Net federal rate with surtax	29.12
Rate reduction for business income (n/a where small business deduction applies, investment income – section 123.4)	7 (1)
“Business rate”	22.12
Additional tax on investment income	13 2/3 (2)

Total federal tax on investment income	35.79 (3)
Small business deduction	9 (4)
Small business rate	13.12

Notes:

1) There is no longer any federal benefit from the M&P reduction: the 7% rate reduction is reduced to the extent of the M&P credit.

2) Rate reduction does not apply; 6 2/3% refundable surtax applies.

3) 26 2/3 % is refundable, for net federal tax of about 9.12%, assuming the tax is fully refunded.

4) The small business deduction is 16%, per subsection 125(1); however, the 7% rate reduction does not apply if the small business deduction does. The $300,000 limit is reduced where taxable capital exceeds $10 million and is fully phased out when taxable capital reaches $15 million.

5) Provincial corporate tax is added to these amounts.

The above rates assume that proposals introduced by the summer of 2004 are enacted without change.

Thank you to Michael Goldberg, of Minden Gross LLP

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[i] For readers who think this is odd, I understand that Senator John Kerry is an accomplished windsurfer and also kitesurfs.

[ii] More precisely, “full-rate taxable income”, as defined in subsection 123.4(1).

[iii] For a discussion of the effects of business rates, see “Tax Rate Drops Change Business Planning,” by the author, *Tax Topic*s #1579, June 13, 2002. The article was largely premised on Ontario corporate tax rates dropping to about 30%, as was expected under the former provincial government. As noted, “business rates” apply to personal services business income as well as income subject to the corporate partnership provisions.

[iv] The concept also continues to be significant in respect of investment tax credits and CCA.

[v] As stated, only Canadian-controlled private corporations, as defined, pay this additional tax.

[vi] The M&P clawback rate is 3.57%.

[vii] Although the overall tax rate will be a maximum of 36.12%.

[viii] Income between $300,000 and $400,000 qualifies for the provincial but not the federal small business deductions, so that a rate of 27.62% applies. Once Ontario income crosses the $400,000 threshold, the provincial small business deduction of 8.5% is lost, and the 4.67% clawback applies – a swing of more than 13% - totally attributable to provincial corporate tax.

[ix] The underlying corporate surplus can then be realized using *post-mortem* procedures. For example, cash can be extracted using the so-called “pipeline” methodology. For further discussion, see various articles in the “Estate Planning in the 21st Century” series, appearing in *Tax Topics* and other CCH newsletters (Michael Atlas, David Louis and Brian Nichols editors).

[x] Combined federal-provincial small business rates of under 20% should trigger overintegration; however, the provincial tax rate on dividends may vary.