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AT YOUR WHIT'S END — ONTARIO'S TAX ON WEALTHY AND HIGH INCOME TAXPAYERS

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I've been at this long enough to have seen a time when it was more advantageous to earn dividends than capital gains and to see rates rise as well as fall. So the Ontario NDP… I mean Liberal party's recent flip-flop on tax rates really didn't come as much of a surprise, particularly since Ontario is broke and politicians like to stay in power. Having said that, I think it will be some time before the full impact on tax planning of the freeze of the basic Ontario corporate tax rate proposed in the 2012 Ontario Budget[1] at 11.5% ("Basic Rate") and the proposed "2%" surtax on taxable incomes in excess of $500,000 per year ("New Surtax")[2] will be fully appreciated. (Collectively, the freeze in the Basic Rate ("Basic Rate Freeze") and the New Surtax are referred to in this article as the "Ontario Budget Changes".) I'm not sure I'd say the Ontario Budget Changes change everything when planning for wealthy and/or high income taxpayers ("WHITs")[3] in Ontario, but it appears that the Ontario Budget Changes impact on pretty much everything and may challenge conventional wisdom in a number of ways.[4]

The New Surtax — Basics

The New Surtax is not the equivalent of a 2% rate increase on WHITs in Ontario. As shown in the attached chart, our understanding is that once fully phased in, the New Surtax means a 3.12% increase in top ordinary income tax rates from 46.41% to 49.53%. With the employer health tax (EHT), the rate becomes an unsettling 50.49%. Of course, ordinary income rates aren't the only rates affected. Capital gain rates will now increase from about 23.21% to about 24.77% (a 1.56% increase),[5] eligible dividend rates will rebound from 29.54% to 33.85% (a 4.31% increase) and ineligible dividend rates will rise from 32.57% to 36.47% (a 3.9% increase).

As you can see, the New Surtax will impact tax rates on all forms of top rate income in Ontario. That means it will not only have an impact on Ontario WHITs while they are alive but also on death, and it will increase the value of tax planning to minimize the impact of the New Surtax in both circumstances.

While Ontario WHITs are alive, this will likely involve closely examining the best mix of income to be earned, taking steps to maximize earning controllable sources of income e.g., income from bonuses (particularly for owner-managers), capital gains and dividends, and when it makes sense to do so, to defer the realization of such controllable sources of income to periods of lower expected income.

Income-splitting strategies that shift income from WHITs with more than $500,000 of income to lower income family members will be capable of providing additional benefits in excess of the previous 2012 top marginal bracket of about $132,000 until the lower income family members earn $500,000.[6] In situations where the WHIT is willing and able to split so much income, the additional tax savings per family member should be about $11,500 by 2013 (i.e., 3.12% × ($500,000 - $132,000)).[7]

On death, the New Surtax will cause wealthy Ontario WHITs with terminal year income in excess of $500,000 to involuntarily pay an additional tax of 1.56% of all taxable capital gains (an amount that interestingly is approximately equal to the current Ontario probate fee rate). On the other hand, the New Surtax has made testamentary trust planning more valuable since by 2013 the increase in the top marginal bracket to $500,000 will increase the potential incremental savings of using each separate testamentary trust by about $11,500, from about $18,000 in 2012 to about $29,500.[8] As a result, estate freezes, will planning, insurance, and other post-mortem strategies are now even more valuable to Ontario WHITs.

As an immediate matter, the New Surtax will force planners to reconsider whether it makes sense to pay dividends to Ontario WHIT shareholders that avoid the payment of the 33.33% corporate Part IV tax by causing the Part IV tax to be "refunded" in the same year that it would otherwise have been payable. Doing so has generally been common practice in Ontario for the last number of years because avoiding paying the 33.33% Part IV tax has resulted in a pure tax savings when compared to both the 29.54% top marginal eligible and 32.57% top marginal ineligible dividend rates paid by an Ontario WHIT. However, by 2013 the top marginal eligible and ineligible dividend tax rates paid by an Ontario WHIT will be 33.85% and 36.47%, respectively. As a result, by not paying dividends that would generate a Part IV tax refund a corporation that simply pays the Part IV tax will enjoy a tax deferral of about 0.52% for eligible dividends and 3.14% for ineligible dividends. So, unless funds are personally needed by an Ontario WHIT, paying out dividends (particularly ineligible dividends) that trigger the New Surtax will likely become the exception rather than the rule. Just to be clear, this doesn't mean an end to paying out dividends to Ontario WHITs that trigger Part IV tax refunds since all of the tax advantages of generating Part IV tax refunds will continue to be available to all Ontario taxpayers, including Ontario WHITs whose aggregate annual taxable income does not exceed $500,000.

Please note that, during the 2012 phase-in period, the eligible dividend rate will be 31.69%, which is still less than the Part IV refund rate, so the practice of paying out eligible dividends to generate Part IV refunds should remain unchanged. However, since the tax rate for ineligible dividends in 2012 of 34.52% will exceed the Part IV refund rate, in 2012 more thought will be required as to whether or not to pay out such dividends to an Ontario WHIT who would otherwise not need the funds for many years.[9]

Does Passive Investing by an Ontario WHIT Through a Holding Company[10] Still Make Sense?

As with most tax issues the answer to this question will continue to be "it depends", as it was prior to the Ontario Budget Changes, but on the whole, I think that there are still significant advantages available to an Ontario WHIT who earns investment income in Ontario through a holding corporation.

The main disadvantages at this time continue to be cost and complexity in both operating and unwinding investment holding companies. A further disadvantage continues to be the uncertainty that future legislative changes may negatively impact on such planning.

As to advantages, I have already mentioned the continuing potential for both savings and deferrals in connection with corporate Part IV tax refund planning involving Ontario WHITs. In addition, even with the Ontario Budget Changes there will continue to be both ongoing deferral advantages and overall tax savings associated with earning other forms of investment income through holding companies.

For example, even though the Basic Rate Freeze has increased the corporate investment rate from 44.71% to 46.17%, the 46.17% rate represents a deferral of 3.36% compared to earning the income personally at the new top Ontario marginal tax rate of 49.53%. In addition, after the phase-in period, the effective integrated tax rate on a grossed-up eligible or ineligible dividend subject to the New Surtax will be about 46.75% and 48.86%, which are both still less than the new top marginal tax rate in Ontario.

Investing through a holding corporation rather than investing personally continues to provide opportunities for Ontarians to limit their liability and to probate plan using multiple wills. In addition, investing through a holding corporation should generally allow non-US WHITs to avoid being exposed to US estate tax on US investments.[11]

Consequently, even with the Ontario Budget Changes, an Ontario WHIT may still prefer to earn investment income through a holding corporation.

What is the Impact of the Ontario Budget Changes on Corporate Tax Integration Involving Small Business and General Rate Income Earning Corporations?

Since the Basic Rate and the top Ontario marginal rate have gone up, the Ontario Budget Changes have increased the costs of both earning income in a corporation that carries on business in Ontario and distributing income out to an Ontario WHIT earning taxable income over $500,000.

Interestingly, even though the Basic Rate will not fall as much as originally anticipated, as a consequence of the New Surtax, the deferral benefit of earning both small business and general rate income in a corporation (as opposed to personally) has actually increased by about 3.12% (from 30.91% to 34.03%) and by about 1.62% (from 21.41% to 23.03%), respectively. However, the integrated cost of distributing such corporate income out to a top tax rate Ontario

WHIT compared to a situation where the WHIT had earned the income personally has increased by about 0.18% (the savings of earning such income has been reduced to 3.21% from 3.39%) and 1.1% (there is now a cost of 1.85% instead of a cost of 0.75% to earn such income), respectively.

As a result, if anything, the Ontario Budget Changes are likely to enhance the benefits of earning small business income through a corporation. In this regard, for unincorporated professionals that have been considering incorporating, the Ontario Budget Changes may provide further incentive to do so. In the case of general rate income, provided the deferral is a relatively long one, the additional net costs of earning income through such a corporation will be unlikely to deter most Ontario WHITs from earning general rate income through a corporation.

Final Thoughts

The Ontario Budget Changes are definitely not going to make Ontario WHITs happy. However, so far it appears that with a bit of planning it may be possible to help keep Ontario WHITs from reaching — you guessed it — their wits' end.

Comparative Proposed Integrated Ontario Tax Rates Chart — Pre- and Post-2012 Budget

	Existing	**Proposed**		
	2012	**2012**	**2013**	**Increase***
Surtax Basics				
Ordinary income & interest	46.41%	47.97%	49.53%	3.12%
Capital gains	23.20%	23.98%	24.76%	1.56%
Canadian dividends				
Eligible	29.54%	31.69%		4.31%
Non-eligible	32.57%	34.52%	36.47%	3.90%
RDTOH refund rate	33.33%	33.33%	33.33%	
Integrated savings (cost) v. paying out RDTOH at eligible dividend rate	3.79%	1.64%	-0.52%	
Integrated savings (cost) v. paying out RDTOH at ineligible dividend rate	0.76%	-1.19%	-3.14%	
Investment Company Comparatives				
Investment income tax rate of a CCPC	44.71%	46.17%	46.17%	1.46%
Deferral benefit (cost) v. earning investment income at personal rate	1.70%	1.80%	3.36%	
Integrated investment income tax rate of a CCPC (ineligible dividends)	45.55%	47.29%	48.86%	3.31%
Integrated savings (cost) v. earning investment income at personal rate	0.86%	0.68%	0.67%	
Integrated investment income tax rate of a CCPC (eligible dividends)	43.10%	45.01%	46.75%	3.65%
Integrated savings (cost) v. earning investment income at personal rate	3.31%	2.96%	2.78%	
Small Business and General Rate Comparatives				
Small business rate	15.50%	15.50%	15.50%	0%
Deferral benefit (cost) v. earning small business income at personal rate	30.91%	32.47%	34.03%	
Integrated small business income tax rate of a CCPC (ineligible dividends)	43.02%	44.67%	46.32%	3.30%
Integrated savings (cost) v. earning small business income at personal rate	3.39%	3.30%	3.21%	
General rate income rate	25.00%**	26.50%	26.50%	1.50%
Deferral benefit (cost) v. earning general rate income at personal rate	21.41%	21.47%	23.03%	
Integrated general rate income tax rate of a CCPC (eligible dividends)	47.16%**	49.79%	51.38%	4.22%
Integrated savings (cost) v. earning general rate income at personal rate	0.75%	-1.82%	-1.85%	

* Only fully phased-in amount is shown where applicable.

** Since the general rate income rate was scheduled to fall to 25% by 2014, I have ignored the 2012 rates as the relevant comparable.

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Notes:

[1] Bill 55, *Strong Action for Ontario Act (Budget Measures), 2012*.

[2] See press release issued by the Ontario Premier's Office on April 23, 2012.

[3] Please note that a WHIT could be someone who is just wealthy, someone just with high income, or someone who is both wealthy and has high income.

[4] The Ontario Budget Changes are intended as temporary measures that are to be eliminated when the Ontario budget is balanced, which is projected to occur in 2017-2018. Whether the budget will be balanced by that time and whether the Ontario Budget Changes will actually be eliminated if the budget is balanced remains to be seen. Without meaning to cast aspersions on our political leaders, for purposes of this article it is assumed that the changes will be indefinite.

[5] Due to this change, the value of the $750,000 lifetime capital gains exemption to a WHIT who would otherwise be subject to the New Surtax has increased from about $174,000 to nearly $186,000.

[6] Due to indexing, these amounts will change from year to year in a manner that cannot be determined in advance.

[7] During the 2012 phase-in period the tax savings will be half this amount. Due to indexing the actual savings from year-to-year will vary.

[8] *Ibid*.

[9] Of course, after 2012 the payment of an ineligible dividend will be subject to tax at a rate of 36.47%, so a long deferral would likely be required to make the delay worthwhile.

[10] This portion of the article is intended to deal with passive investment income tax rates applicable to Canadian-controlled private corporations.

[11] In accordance with Internal Revenue Service Circular 230, we advise that, unless otherwise expressly stated, any discussion of a federal tax issue in this article is not intended to be used, and cannot be used, for the purpose of avoiding US federal tax penalties.