Private Corporations and Their Shareholders

– Brave New Tax World –

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In the last few years, there has been a series of tax changes that, together, amount to a substantial overhaul of the fundamentals of how Canadian-controlled private corporations and their shareholders are taxed. More specifically, changes in two areas have brought this about. The first is a series of reductions in the general corporate rate applicable to business income which is not eligible for the small business deduction. In 2008, this rate reduction is 8.5%; however, it will climb to 13% in 2012. The second is the eligible dividend rules. While these were originally proposed in an attempt to stem the tide of income trusts (heavier artillery had to be brought in), the regime also has a fundamental effect on the taxation of private companies.

The following chart highlights the changes to the federal corporate rates.

	Year	2008	2009	2010	2011	2012
1	Federal tax rate net of abatement - %	28	28	28	28	28
2	Rate reduction for business income - %	8.5	9	10	11.5	13
3	Federal business rate (1-2) - %	19.5	19	18	16.5	15
4	Additional tax on investment income - %	15.17	15.67	16.67	18.17	19.67
5	Federal Tax on Investment Income (3+4) - %	34.67	34.67	34.67	34.67	34.67
6	Small Business deduction - %	17	17	17	17	17
7	Small business rate (1-6) - %	11	11	11	11	11
8	Advantage of small business rate over general business rate (3-7) - %	8.5	8	7	5.5	4

Of course, provincial corporate taxes are added to federal taxes. Using Ontario as an example, the following are the tax rates applicable to investment income, business income, and income qualifying for the small business deduction:

Year	2008	2009	2010	2011	2012
Investment Income - %	48.67	48.67	48.67	48.67	48.67
Business Income – Full Rate - %	33.5	33	32	30.5	29
Small Business rate - %	16.5	16.5	16.5	16.6	16.5

As noted previously, income eligible for the general business rate, if earned by a CCPC, will enable the payment of eligible dividends**[i]**, which are taxed considerably more favourably than ineligible dividends (the exact rate depends on the province).

The main features of the system are as follows:

1. There is integration (more or less) for all three types of income. In other words, the combined personal/corporate rate when corporate income is distributed as dividends will approximate the personal rate that would apply had the individual earned the income directly, or if the income were bonused out to the individual. Of course, the big change is that integration will occur for general-rate income. Whether or not there is over or under-integration will depend on the province**[ii]**.

2. There is a significant difference between income taxed at the general business rate and investment income. In Ontario, for example, there is currently a 13 point difference. This discrepancy will grow to 19.67% by 2012, when corporate business tax rates will be more than 40% less than rates on investment income.

3. There is also a significant difference between the top individual tax rate and the general corporate business rate. Using Ontario as an example, the discrepancy is currently 12.9% (ignoring Employer Heath Tax); it will grow to 17.4% by 2012. In that year, there by be a nearly 40% deferral by earning and retaining business income at the corporate level.

What does all of this mean when it comes to tax planning? Here are the highlights:

1. Even if business income is taxed at the general, rather than the small business rate, there will be a significant deferral by retaining earnings at the corporate level rather than distributing it as a bonus. Moreover, there may be little to fear from under-integration (i.e., more tax than were the income earned directly or bonused out) when the income is distributed as eligible dividends. Therefore, it may be advisable to retain profits that are not needed for personal and living expenses in the relatively near future should generally be retained at the corporate level. However, this may depend on the degree of under-integration in the particular province and the period earnings can be retained at the corporate level.**[iii]** (One piece of bad news: the retention of profits at the corporate level could mean the loss of refundable investment tax credits.))

2. Because corporate tax on investment income will attract a tax rate that is significantly higher than business income, if investment income can be restructured to qualify for the general business rate, this will result in substantial tax deferral. (This will occur, for example, if the investment business has more than five full-time employees.) Furthermore, the effect of the eligible dividend rules may eliminate or greatly reduce the degree of under-integration when such profits are eventually distributed as eligible dividends.

3. The ability to obtain the small business deduction will become somewhat become less important, as the spread between the general corporate rate and the small business rate will narrow. At the federal level, the spread will decrease to a mere 4% in 2012. Of course, provincial differences will increase the spread; Ontario’s corporate rate differential will be 13.5% in that year. However, the non-availability of the small business deduction no longer means loss of deferral if income is retained at the corporate level (although the degree of deferral will of course decrease), nor will it result in a high degree of under-integration, if profits are paid out as dividends.

4. If earnings are retained at the corporate level, this will tend to result in the continual increase in the value of the shares of the corporation. If so, the deferral will largely end when the shares pass to the next generation - usually on the death of the surviving spouse – due to the “deemed sale” rules. Accordingly, estate freezes will become increasingly important as they will push-off the deferral to the next generation – in my book that’s pretty well forever.

5. When the corporate rate reductions are fully phased-in, capital gains will still be taxable in Ontario at 24.3% at the corporate level (23.2% for a capital gain at the personal level).

However, ignoring the small business deduction, the sale of goodwill and other eligible capital will attract an Ontario corporate tax rate of only 14.5% (i.e., 50% of 29%). Thus, on the sale of a business, there will be a substantial reduction of corporate tax, *vis-à-vis* capital gains, leading to a significant bias in favour of asset sales - where there is a substantial sale price, at least. While both capital gains and eligible capital potentially generate a capital dividend account in respect of the untaxed 50% of proceeds — so that this amount can be distributed to Canadian residents free of tax — a sale of eligible capital does not result in refundable tax balances in respect of the taxable portion. However, as previously mentioned, the degree of under-integration may be greatly reduced, due to the recent changes pertaining to eligible dividends.

6. For the next few years, it will be advantageous to attempt to defer the recognition of general-rate business income, as the tax rates will be decreasing over the next few years.
7. The so-called "personal services business" rules, which potentially apply to "incorporated executives", for example, should be revisited. Originally, these rules were designed to be punitive, by denying the small business deduction, and severely limiting the deductions that can be claimed by such a business. While the latter still applies, personal services business tax rates are no longer punitive, because they attract the general business corporate tax rate.

Perhaps most fundamentally, individuals and their advisors should "rethink" their attitude toward corporate deferral. From time to time, one encounters clients – and even professional advisors – who are of the mindset that corporate business profits really don't "belong to them" until they are distributed from the corporation - in the form of dividends or bonuses. While there may be no harm to this attitude if the profits stem from investment income, business income is quite another matter.**[iv]** Those who continue to desire a distribution of business profits just to "get it out" will pay a heavy tax penalty for their attitude.

Special Note to Ontario Taxpayers

For Ontario taxpayers, there is some good news and bad news. The bad news is from the Ontario clawback. As a result of Ontario's Economic Outlook and Fiscal Review in December, the additional tax due to the Ontario clawback of the small business deduction is now 4.25%, and will apply between income levels of $500,000 and $1.5M. Because of this, the advantages of deferral by virtue of tax at general business rates will decrease, and there will be a significant element of double-taxation: in 2008, the general business rate in the "clawback zone" is 37.75%, and the amount of under-integration is in excess of 6%. As profit increases over the $1.5 clawback ceiling, this will be less of a factor.

The December announcement also raised the Ontario small business limit from $400,000 to $500,000. Income in this range will not qualify for the federal small business deduction. However, because federal full rates will apply, it will allow eligible dividends to be paid**[v]**. Because of this, the results are surprisingly beneficial. In 2008, the corporate rate in this range will be 25%**[vi]** (rather than 16.5% where the federal small business deduction also applies). If the profits are distributed as eligible dividends, the overall rate will be 42.97%. Based on the forgoing, clients should retain $500,000 of income in their corporations, rather than $400,000, if possible.

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[i] Via the generation of the "GRIP" account.

[ii] For 2008, there is a slight degree of under-integration in B.C. (.5%), but in Alberta, Ontario and Quebec the under-integration is greater (2.8%, 3.1% and 3.2%, respectively). In Alberta and Ontario, tax reductions on eligible dividends are still being phased in.

The 2008 federal budget proposes to reduce benefits of eligible dividends as the decrease in corporate tax rates phases in. The eligible dividend gross-up will be decreased from its current level of 45 per cent to 44 per cent effective January 1, 2010, 41 per cent effective January 1, 2011, and 38 per cent effective January 1, 2012. The enhanced dividend tax credit rate will also change on the same schedule, moving from 11/18 of the gross-up amount to 10/17, 13/23 and 6/11. The degree of under/over-integration during the phase-in period will depend on whether the provinces make similar adjustments to the dividend tax credit calculation.

[iii] The changes to eligible dividends noted previously may result in a modest bias to realize corporate surplus in the form of a capital gain rather than a dividend, e.g., pursuant to a deemed disposition when shares pass to another generation, where the increased cost base can be used as a "pipeline" to extract corporate-level cash and other liquid assets.

[iv] Where profits are not needed for personal and living costs.

[v] i.e., GRIP will be generated.

[vi] Of course, the clawback will not apply where income does not exceed $500,000.