The Economic Statement: Some Comments

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*(*This release is based on an article published in Tax Notes #538, November 2007, CCH Canadian Limited)*

Thank you to Michael Goldberg for some hasty calculations.

I would be remiss if I did not sneak in a few comments about the October 30th Economic Statement, which was released just before our publication deadline.

The reduction of federal corporate tax rates to 15% in 2012, applicable to general-rate business income, is a substantial tax reduction.**[1]** Although the full impact of the proposals is years off, corporate tax rates are already falling. Using Ontario as an example, the general business-income corporate tax rate, which hovered at just over 36% for a number of years, will drop to 33.5% for calendar 2008, with an additional two point provincial reduction for M&P income. The rates will continue to drop until they reach 29% in 2012. (Alas, this ignores Ontario's infamous "clawback" tax – I will come back to this in a moment.) In fact, the economic statement indicates that the Department of Finance will push for 10% provincial tax rates, which will bring the target rate to 25% in 2012.

This is a far cry from the rate on investment income, which will remain at close to 49% (in Ontario) for the foreseeable future. As a result, there will be increased pressure to convert would-be investment income to that taxable at general business rates (e.g., a would-be specified investment business with more than five full-time employees). Even without the small business deduction, tax deferral on incorporated business income will be substantial, with an eventual deferral of close to 40%**[2]** in Ontario (again, ignoring the clawback). As corporate tax rates drop, there will also be an increasing incentive to defer income, if for no other reason than to pick-up the 2.6% reduction that applies between 2007 and 2008.

As I have mentioned in previous articles, the Ontario clawback – a 4.67% hike for income between $400K and about $1.1M - is a substantial deterrent to the retention of profits at the corporate level. When it comes to corporate tax rates, the federal government has gone out of its way to reduce them, but Ontario hasn't lifted a finger for its hard-hit manufacturing sector. While Ontario's general corporate rate on business income is pretty well at the top of the heap (or the bottom, depending on how you look at it), when the clawback is tacked-on, provincial rates top out at a heartbreaking 18.67%, in the clawback income zone mentioned above. I am hopeful that Ontario's new Finance Minister will take this opportunity to drop Ontario's corporate tax rate to the targeted 10% - and above all, to trash the clawback (which is ignored, from here on).

Another consequence of the corporate rate drop is that there will be a further bias toward eligible capital rather than capital gains status. The Ontario corporate rate for the latter will be a mere 14.5% by 2012, nearly ten points lower than the rate for capital gains.

The reduction of the general corporate tax rates, coupled with the phase-in of the eligible dividend regime, will mean that there will generally be a degree of over-integration when income taxed at general business rates is distributed as eligible dividends, with the combined personal-corporate tax rate in Ontario at about 44.9% compared to the top 46.4% personal tax rate. The budget papers mention the possibility of adjustments to the enhanced dividend tax credit**[3]**. It is hoped that the Department of Finance will be sensitive to possible complexities arising from these changes.

The government did relatively little in terms of small business rates, simply accelerating the .5% reduction - formerly slated to take effect in 2009 - by one year. But it didn't have to do much: with reductions already coming into effect, the small business Ontario rate will drop from 18.62% in 2007 to 16.5% in 2008.

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[1] The following is a summary of the federal corporate tax rate reductions:

	2007	2008	2009	2010	2011	2012

Existing rate	22.12%	20.5%	20.0%	19.0%	18.5%	18.5%
Proposed rate	22.12%	19.5%	19.0%	18.0%	16.5%	15.0%

Notes:

- The 2007 rate of 22.12% includes the 1.12% corporate surtax which will be eliminated in 2008.
- The rate cuts will also apply to the new tax on distributions of income trusts and other specified investment flow-through (SIFT) entities as of 2011.

[2] I.e., the Ontario corporate business rate in 2012 will be about 62.5% of the top personal rate.

[3] As well as other tax rules that assume a specific underlying corporate income tax rate.