STEPUP

Sales Tax Estate Planning Underwriting & Product Newsletter

Taxes on dividends going up

The fall 2017 Economic Statement, released on Oct. 24, 2017, included changes to the small business tax rate. Those federal tax rates will be reduced to **10.03% effective January 1, 2018**, and to **9.03% effective January 1, 2019**. The release by the Department of Finance stated that concurrent with these changes will be adjustments to the dividend gross-up and tax credit mechanism. Specifically, there will be downward adjustments for non-eligible dividends paid in 2018, with a further decrease for dividends paid in 2019 and future years. This is a different and perhaps additional way of making the declaration of dividends paid to shareholders of private corporations on earnings from active business and passive investments in their companies less and less attractive.

Let's quickly review how dividends are taxed.

Dividends are distributions of after tax profits to shareholders of corporations. That means that corporations have already paid income tax on these profits before paying them out to shareholders. The theory of integration is supposed to ensure that the ultimate amount of income tax paid on profits should be the same whether the individual receiving them got them directly or through his or her corporation as dividends.

Here is how this has been handled under the *Income Tax Act* (Canada). The dividend that the individual receives is first grossed up to reflect the total amount of pre-tax income that the company issuing the dividend is presumed to have earned. The individual receiving the dividend then receives a dividend tax credit which is supposed to recognize the income tax that the corporation presumably paid. I keep saying "presumably" because the actual income earned or income tax paid by the corporation is not used.

Canadian dividends are further distinguished as being either eligible dividends or non-eligible dividends.

Eligible dividends are paid out of income that the corporation has paid out of business income that is taxed at the general or high corporate tax rate. These are grossed up by 38% (Federal, 2017) and reported on the receiving individual shareholder's personal income tax return as part of total income. The individual then may claim a 15% tax credit (Federal 15%, 2017). (S)he may also claim provincial dividend tax credits on this income.

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Peter works with independent advisors and other professionals raising awareness on issues and concerns faced by affluent individuals, professionals and business owners. He supports efforts in researching and developing optimal solutions for clients aimed at improving their financial well-being and supporting their personal wishes and lifestyles. He annually provides 100's of workshops, seminars and technical support throughout the country on tax, retirement income and estate planning issues, concepts and strategies to both advisors and consumers. As a Registered Financial Gerontologist, a good deal of his time is spent on building awareness and educating people of all professions who work with or specialize in the needs, expectations and issues of elders. Comprehensive lifestyle planning is an important element of these processes.

The Sales, Tax, Estate Planning, Underwriting & Product (STEPUP) team provides internal and broker support, including seminars, education, advanced concept illustrations & Client case technical consultations.

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Non-eligible dividends are received from Canadian Controlled Private Corporations that pay income tax at the small business rate. They are grossed up and reported on the receiving individual shareholder's personal income tax return as part of total income. The individual then may claim a federal tax credit. (S)he may also claim a provincial dividend tax credit on this income. The Notice of Ways and Means Motion published on Oct. 24, 2017 proposes to make the following changes as shown in the table below.

Federal adjustments Impacting Non-eligible dividends			
	Current 2017	2018	2019
Gross up	17%	16%	15%
Dividend tax credit	10.5%	10.03%	9.03%

The adjustments in the gross up and tax credit scheme for dividends paid by Canadian Controlled Private Corporations on income qualifying for the small business tax rate will increase the amount of income tax paid on this type of income. This may offset any perceived advantage gained from the announced reductions in the small business tax rate. These income tax changes may be in addition to changes in eligibility for refunds of the extra income tax levied against corporate passive investment income.

Corporate investment income is taxed at the general or high rates instead of the small business tax rate. This is aimed to discourage shareholders from using their corporations as tax shelters for investment income. Part of that extra income tax may be refunded when the corporation declares a dividend to the shareholder. Otherwise, the total amount of income tax paid could approach 70% or more, much higher than if the individual had received all the profits from the company and invested them personally. Again, the income tax proposals put forth by the Department of Finance drive the total income taxes owed to these much higher levels, first by denying any refunds on extra taxes first collected against the corporation and second by adjusting the gross up and tax credit scheme.

No additional information was contained in the 2017 Fall Economic Statement relating to the:

- passive investment rules (expected as part of Federal Budget 2018)
- income sprinkling proposals (draft legislation expected later this year, 2017) or
- tax relief for intergenerational transfers of shares in private corporations (which is part of an ongoing consultation process that is slated to take up to one year).

The battles between the Federal Government and private industry continue about what is fair and reasonable in terms of income taxes.

Stay tuned for further news and updates to income tax proposals impacting small businesses operating as Canadian Controlled Private Corporations and the shareholders and families connected to them.

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