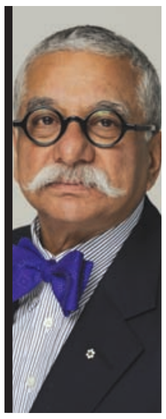
Coming to GRIPs with corporate dividends



TAX VIEWS

By Vern Krishna

An essential feature of the income tax system is that we "integrate" corporate and shareholder taxation for most Canadian corporations earning business income. However, the model for integration is complicated by the fact that Canadian corporations pay tax at different rates depending on their status, size, source of income, and place of residence.

For example, the general federal corporate rate of tax is 15 per cent. However, Canadian controlled private corporations (CCPCs) can claim a tax credit on $500,000 of "active business income" earned in Canada. The tax credit reduces the federal corporate tax payable by a CCPC to 11 per cent.

Similarly, provincial taxes also vary depending upon the type of corporation and political ideologies, and range from 2.5 per cent to 16 per cent. Hence, in order to integrate corporate and shareholder taxes we must tax shareholders according to the amount of tax that the payer corporation pays on its income.

There are two broad categories of dividends: "eligible" and "ordinary" dividends. The latter are also sometimes referred to as "non-eligible" dividends.

An eligible dividend is one that a corporation pays from income that is not eligible for the small business deduction, and an ordinary or ineligible dividend is one that a corporation pays from income that is eligible for the small business deduction.

In general terms, an eligible dividend is a dividend that a corporation pays out of its general rate income pool (GRIP) — that is, income that is not taxed at special incentive rates available for small businesses. More technically, an eligible dividend is one that satisfies four requirements:

- It is a taxable dividend;
- Paid by a corporation resident in Canada;
- To a resident of Canada; and
- Designated as such under subsection 89(14).

Individuals who receive eligible dividends are entitled to a larger gross-up and dividend tax credit in order to eliminate the inherent double taxation at the federal level on distributions that did not benefit from preferential tax rates — most notably, the small business deduction. The mathematics underlying the eligible dividend regime is to level the playing field with investments of units in income trusts. For example, where the corporation is taxed at 27.5 per cent, the gross-up is 38 per cent in order to restore the income to the corporate pre-tax income (138 per cent x $725 = $1,000).

In practice, the ultimate impact of the eligible dividend rules on tax integration depends on the level of provincial and territorial corporate tax rates, which tend to shift from year to year and depend upon the ideology of the political party elected to power. Alberta, for example, has just announced an increase in its corporate tax rate from 10 per cent to 12 per cent.

Taxable dividends must be designated as such to constitute eligible dividends. The shareholder must be notified in writing every time that a corporation pays such a dividend. The act does not contemplate partial designations.

There are two principal sources of "eligible dividends" from Canadian resident corporations:

- Dividends that a public corporation pays out of income subject to its GRIP — that is, income taxed at the general corporate rate; and
- Dividends that a Canadian-controlled private corporation (CCPC) pays out of its business income that is taxed at the full corporate tax rate – that is, income above its small business limit of $500,000 (2015).

GRIP is essentially a corporation's full rate taxable income, plus eligible dividends that it receives, minus eligible dividends that it pays out. It is a cumulative calculation that a CCPC does at the end of each year. The GRIP balance can be positive or negative at the end of the year. However, there must be a positive balance in order for the CCPC to declare an eligible dividend.

Thus, GRIP is "good." It allows a corporation to pay eligible dividends, which are taxed at a lower rate in the shareholders' hands. This is because the corporation has paid tax at the full corporate rate on its income. However, an eligible dividend can sometimes result in higher tax for an individual because the higher gross-up can bump up "net income" and, for example, affect the claw-back of the individual's old age security on income above $72,809 (2015), or medical expenses credit.

In contrast, an ordinary or "ineligible dividend" is a dividend that a CCPC pays out of income that is taxed at the special, low corporate tax rate after the small business deduction on its active business income, and dividends out of its investment income — that is, its low rate income pool (LRIP). Thus, LRIP is essentially a corporation's income that benefited from the small business deduction plus non-eligible dividends that it receives from other corporations.

Individuals who receive ordinary, non-eligible, dividends receive a lower dividend tax credit because the CCPC payer corporation paid tax at a lower federal rate of only 11 per cent on the first $500,000 of its active business income. As of 2015, non-eligible dividends are subject to a federal gross-up factor of 18 per cent and a dividend tax credit of 11 per cent. However, in the budget, the federal finance minister announced reductions in the small business tax rates from 11 per cent to nine per cent over a four-year period ending in 2019.

As a consequence of the proposed federal reductions, the personal gross-up factor and dividend tax credit for ordinary (non-eligible) dividends will increase the top federal marginal rate of tax from 21.22 per cent in 2015 to 22.97 per cent in 2019. Alberta, New Brunswick, Nova Scotia, and Yukon have announced changes as of May 15, but have not announced their DTC rates as a result of the federal changes.

Underlying all these numbers is a simple principle that is essential to fair taxation. We should avoid double taxation of corporate income because it is unfair and inefficient. However, given that the Canadian tax system relies upon tax rates set by the federal, provincial, and territorial governments, it is inevitable that we end up with less than perfect integration of corporate and shareholder taxes. This means that the ultimate tax burden on income depends upon where you live in Canada.

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