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Tax Insights: Private company tax changes – Taxes on non-eligible dividends to rise

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In brief

Combined federal and provincial/territorial personal tax rates on non-eligible dividends are going to rise. If you are subject to the top marginal tax rate, your rate will increase, on average, by one percentage point from 2017 to 2019. As a result:

- you will pay more tax on non-eligible dividends, and
- it will be less attractive to earn investment income in a Canadian-controlled private corporation (CCPC) that will be taxed as non-eligible dividends when distributed to an individual shareholder, compared to earning this income personally

In detail

What are non-eligible dividends?

Non-eligible dividends include dividends paid out of:

- income eligible for the federal small business income tax rate, or
- a CCPC's investment income (other than eligible dividends)

Most dividends paid by public corporations are eligible dividends. Eligible dividends must be designated as such by the payor.

Background

The government's October 16, 2017 announcement on the private company tax proposals stated that the small business income tax rate will drop from 10.5% to 10% on January 1, 2018, and to 9% on January 1, 2019.

A Notice of Ways and Means Motion (NWMM) released by the Department of Finance on October 24, 2017, implements this rate change.

Consequential to the decrease to the small business tax rate, the effective personal tax rate on non-eligible dividends will increase. To achieve this, the NWMM reduces the federal:

- gross-up for non-eligible dividends from 17% in 2017, to 16% in 2018, and to 15% after 2018
- dividend tax credit for non-eligible dividends from 10.5217% in 2017, to 10.0313% in 2018, and to 9.0301% after 2018 (in each case, of the grossed-up dividend)

Appendix 1 shows the top combined federal and provincial/territorial personal tax rates on non-eligible dividends for 2017 to 2020.

What's the concern?

The increase to the non-eligible dividend rate for distributions of small business income makes sense, to ensure that the combined corporate and personal tax paid on this income approximates the tax that would be paid by an individual who earns this income directly. This is referred to as the concept of "integration" for corporate and personal tax rates.

However, the change increases the combined corporate and personal tax rate on investment income (other than eligible dividends) earned through a CCPC. This results in greater "under integration" for that investment income because the effective federal and provincial/territorial corporate tax rate on this income exceeds the small business income tax rate.

There is already under integration on investment income (other than dividends) earned in a CCPC. For example, in Ontario, the top tax rate on interest income earned directly by an individual is 53.53%. If instead, the interest income is earned in a CCPC and distributed to the shareholder as a non-eligible dividend, the combined federal/Ontario tax liability is 55.97% in 2017.

The federal changes to the non-eligible dividend tax rate will increase this combined federal/Ontario tax liability to 56.32% in 2018 and 57.13% in 2019 – assuming the province does not make changes to its small business and non-eligible dividend rates to reflect the federal changes. (These rates are halved for capital gains.)

Appendix 2 shows the total effective tax rates on CCPC interest income distributed as a non-eligible dividend to an individual shareholder at the top combined federal and provincial/territorial tax rates for 2017 to 2020. These rates are higher than the top personal marginal rates in every province and territory, in some cases by more than 6%. (The rates in Appendix 2 are halved for capital gains.)

Of note, under integration occurs only when the investment earnings are distributed to the shareholder. Until then, the corporate tax paid on the investment earnings is generally similar to top personal marginal tax rates.

In effect, the dividend tax regime (gross up and tax credit) rules assume that total corporate tax on small business income and investment income are essentially the same. In fact, the former has been decreasing while the latter has not, while the non-eligible dividend gross up and tax credit amounts have been adjusted to reflect reductions in the small business rate.

This highlights a significant conceptual issue with the government's proposed changes related to the taxation of passive income earned on reinvested business income. The impetus for the federal government's July 18, 2017 tax proposals for passive investment income earned in a CCPC is the perceived advantage a CCPC owner enjoys (as compared to an individual) because of the ability to reinvest business earnings taxed at the lower corporate business rates.

There was already criticism of the proposals because of the current under integration of tax on the investment income. Clearly, the amount of under integration is increasing.

If the detailed legislation expected in the next federal budget fails to address the reality of under integration, the proposed changes could worsen the current rate disincentive to invest passively through private corporations, rather than achieving the stated objective of creating a "neutral" tax system that would neither encourage nor discourage the use of private corporations for such investment.

Next steps?

Talk to your PwC tax adviser about:

- these increasing rates to determine if any action should be taken before 2018 when the first increase in non-eligible dividend tax rates takes effect, and
- how this tax rate change and the passive investment income proposals could affect you

For more information

To learn more about the private company tax changes, see our *Tax Insights*:

- "Government targets tax planning using private corporations"
- "Private corporation tax changes: Where do things stand?"
- "Private company tax proposals: Government's initial response to outcry"
- "Private company tax proposals: More "sprinkling" of changes – Update #2"
- "Private company tax proposals: More "sprinkling" of changes – Update #3"

See our:

- submission to the Department of Finance
- press release
- upcoming *Year-end tax planner*

Appendix 1

Top combined federal and provincial/territorial marginal tax rates on non-eligible dividends

	2017	2018	2019	2020
Federal	26.30%	26.64%	27.57%	
Alberta	41.29%	41.64%	42.56%	
British Columbia	40.95%	43.73%	44.63%	
Manitoba	45.74%	45.92%	46.67%	
New Brunswick	46.25%	46.43%	47.18%	
Newfoundland and Labrador	43.62%	43.81%	44.59%	

Northwest Territories	35.72%	35.98%	36.82%	
Nova Scotia	46.97%	47.34%	48.28%	
Nunavut	36.35%	36.78%	37.79%	
Ontario	45.30%	45.74%	46.75%	
Prince Edward Island	43.87%	44.25%	45.22%	
Quebec	43.84%	43.94%	44.52%	
Saskatchewan	39.62%	39.75%	40.48%	40.19%
Yukon	40.18%	41.42%	42.17%	

Notes:

This Appendix reflects the changes in the NWMM as well as provincial and territorial changes that have been announced to date.

The reduction in the federal dividend gross-up rate automatically applies in all provinces and territories, except Quebec. The table assumes that Quebec will harmonize with this change.

The reduction in the federal dividend gross-up rate also causes the provincial/territorial dividend tax credit rate to fall in the eight jurisdictions (i.e. Alberta, British Columbia, Nova Scotia, Nunavut, Ontario, Prince Edward Island, Saskatchewan and the Yukon) in which the provincial/territorial dividend tax credit rate is linked to the federal dividend gross-up for non-eligible dividends. It is unclear whether these provinces will increase their dividend tax credit rates to avoid receiving a “windfall” tax increase as a result of the federal changes.

Appendix 2

Integration – Interest income

(twelve-month taxation year ended December 31)

This Appendix shows the combined effective federal and provincial/territorial income tax rate if interest income is earned in a CCPC and distributed to the individual shareholder as a non-eligible dividend. It assumes the shareholder is subject to the top marginal income tax rate.

The rates shown are halved for capital gains.

	2017	2018	2019	2020
Alberta	53.03%	53.31%	54.05%	
British Columbia	52.17%	54.98%	55.71%	
Manitoba	56.59%	56.74%	57.34%	
New Brunswick	58.08%	58.21%	58.80%	
Newfoundland and Labrador	56.58%	56.74%	57.33%	
Northwest Territories	48.25%	48.47%	49.14%	
Nova Scotia	59.70%	59.98%	60.69%	
Nunavut	49.08%	49.43%	50.23%	
Ontario	55.97%	56.32%	57.13%	
Prince Edward Island	57.34%	57.63%	58.37%	
Quebec	54.96%	54.98%	55.40%	

Saskatchewan	51.54%	51.80%	52.38%	52.15%
Yukon	53.03%	53.14%	53.74%	

Notes:

This Appendix reflects the changes in the NWMM as well as provincial and territorial changes that have been announced to date.

The rates in this Appendix assume no changes are made to provincial or territorial non-eligible dividend tax credit rates.

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