

# THE NEW DIVIDEND RULES

By Jamie Golombek

Will Canada's provinces (and territories) all opt to get onside with the new dividend tax-reduction program?

**Canadian** dividends are poised to surpass capital gains as the most tax-advantageous form of investment income for 2006, but that may all depend on where your clients reside. The big unknown is whether each province will agree to follow the Fed's announcement to reduce the effective tax rate on dividends, thereby restoring full integration to the corporate tax system.

The principle of integration means that, in theory, an individual should be able to realize the same amount of cash after tax, whether that income is earned personally or through a corporation.

The current "gross-up" and dividend tax credit system is based on a theoretical integration model that taxes corporate income at 20%. The current system, while not perfect, works pretty well in most provinces when it comes to private corporations that can take advantage of the small-business tax rate which approximates 20% on the first

\$300,000 (increasing to \$400,000 in 2007) of "active income" (as opposed to passive or investment income).

Under the theoretical model, an investor who is in the top bracket and earns \$100 of income personally and pays tax at the highest average tax rate in Canada of 46%, would have \$54 cash left to spend.

If the same \$100 was earned by a small business eligible for the preferential 20% corporate tax rate, the corporation would have \$80 left after tax to pay to its shareholder as a dividend.

Under the old rules (which are not changing for dividends paid out of active business income taxed at the small-business rate), the \$80 of dividends received would be "grossed-up" by 25% to \$100—the same amount of income the corporation earned pre-tax. The purpose of the gross-up, therefore, is to put the shareholder in the same position she would have been in had she earned the \$100 personally.

That being said, to compensate the shareholder for the corporate tax already paid on the \$100 by the corporation, the shareholder may claim a federal dividend tax credit (DTC) of 13.33% of the grossed-up dividend and a provincial dividend tax credit which, on average, is worth about half the federal credit or about 6.67% (each province's rate is different).

The effect of the gross-up and tax credit is that the shareholder initially pays \$46 of tax on the \$100 of grossed-up dividends received. She then gets a 20% or \$20 combined federal and provincial dividend tax credit, which puts her net tax at \$26 on an \$80 dividend received, netting her after-tax cash of \$54—the same as the after-tax proceeds if the \$100 was earned directly (see chart).

This theoretical model currently fails when it comes to dividends paid by public companies which face a much

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higher corporate tax rate than 20%. You can see that the same \$100 earned by a public company in Canada only nets the investor about \$46, versus the \$54 in the theoretical model.

Income trusts escape this double-tax problem experienced by Canadians on public company dividends—convert to a trust and, using high-yield debt and interest expense deductibility, eliminate the corporate income and thus the corporate tax burden completely.

### The New Rules

In its spring budget, the government confirmed what was previously announced by the Liberals last fall and proposed that, effective for 2006, the gross-up for “eligible dividends” would be enhanced to 45% (from 25%) and

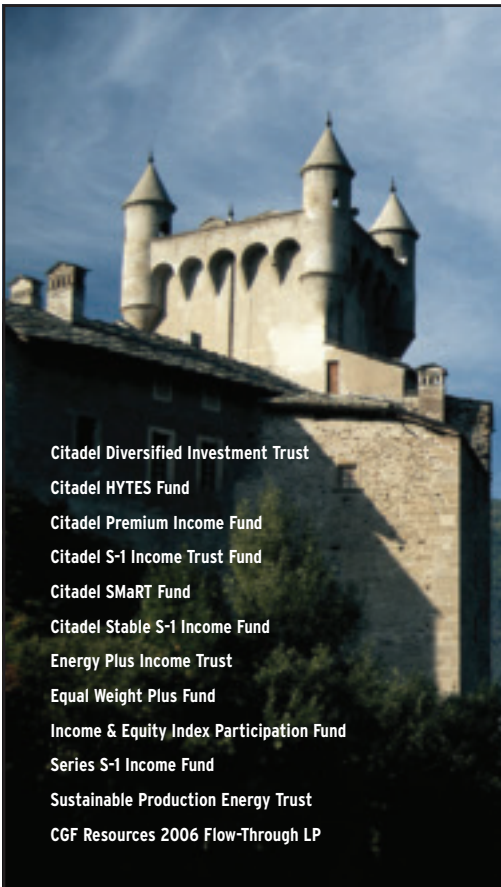
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## CORPORATE INTEGRATION MODELS

		Theoretical Model 1	Current Model: Eligible Dividends 2	New Model: Eligible Dividends 3
Income earned by corporation	A	100	100	100
Corporate tax (note 1)	B	20	32	32
Amount distributed as dividend	C	80	68	68
Gross-up		25	25	45
Amount included in income		100	85	99
Personal tax @ 46% (note 2)	D	46	39	45
Dividend tax credit (note 3)	E	(20)	(17)	(32)
Net personal tax	F	26	22	14
Net cash for investor	C-F	54	46	54
Total tax paid	B+F	46	54	46

Notes:

1. Assumes average federal-provincial corporate tax rate in 2010 is 32%
2. Assumes average top federal-provincial personal tax rate is 46%
3. Assumes provinces and territories increase their dividend tax credits to provide full integration



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the federal dividend tax credit would then be increased to approximately 19%. These rates are based on a combined average federal-provincial corporate tax rate of 32% in 2010.

“Eligible dividends” include any paid in 2006 by public corporations as well as dividends paid by Canadian-controlled private corporations whose income (other than investment income) is not subject to the low, small-business deduction on the first \$300,000 (\$400,000 in 2007) of annual active business income.

Underlying these new rates is the assumption the provinces and territories will also increase their dividend tax credits for eligible dividends to equal their general corporate income tax rates. That remains to be seen, as most provinces so far have taken a wait-and-see approach, delaying their announcements until after they review draft legislation which was only filed on June 29. So far, only half the provinces have formalized their proposals on how eligible dividends will be taxed. Interestingly, Quebec actually chose to increase its dividend tax rate.

If the provinces do follow and fully eliminate the double taxation associated with dividends, perfect integration would be achieved by 2010, as illustrated in the third column of the chart on page 20.

So, will investors prefer capital gains or dividends in 2006? As the chart above indicates, the new rate for eligible dividends will depend on the province in which you reside and whether the provinces agree to fully integrate. Given the uncertainty, the provincial tax rates for eligible dividends have been determined based on two different assumptions.

The provincial tax rates used in

## MAXIMUM PERSONAL MARGINAL INCOME TAX RATES

	Interest Income 2006	Capital Gains 2006	Canadian Dividends 2005	Dividends 2006 Ineligible	Dividends 2006 Eligible (1)	Dividends 2010 Eligible (2)
B.C.	43.70%	21.85%	31.58%	18.47%	18.47%	18.47%
Alta.	39.00%	19.50%	24.68%	24.58%	18.18%	14.55%
Sask.	44.00%	22.00%	28.33%	28.33%	18.30%	18.90%
Man.	46.40%	23.20%	35.08%	35.25%	23.83%	23.83%
Ont.	46.41%	23.20%	31.34%	31.34%	25.08%	22.37%
Que.	48.22%	24.11%	32.82%	36.36%	29.70%	29.70%
N.B.	46.84%	23.42%	37.26%	37.26%	32.09%	23.02%
N.S.	48.25%	24.13%	33.06%	33.06%	23.41%	19.26%
P.E.I.	47.37%	23.69%	31.96%	31.96%	22.13%	17.99%
Nfld.	48.64%	24.32%	37.32%	37.32%	30.77%	22.73%
N.W.T.	43.05%	21.53%	29.65%	29.65%	18.25%	18.25%
Nun.	40.50%	20.25%	28.96%	28.96%	22.23%	13.83%
Y.T.	42.40%	21.20%	28.64%	28.64%	20.13%	12.23%

### Notes:

1. Provincial DTC is computed by applying the current provincial DTC rate to the proposed 45% gross-up. Note, Quebec, Manitoba, Ontario, Alberta, B.C. and N.W.T. have introduced proposals that change the taxation of dividends—these are reflected above.
2. Provincial DTC is computed by applying the provincial corporate rate to the proposed grossed-up amount (145% of the actual dividend), except Quebec, Manitoba, Ontario, B.C., Alberta and N.W.T.

Source: Ernst & Young, LLP

the “Eligible Dividends (1)” column have been determined using the current provincial rules to determine the DTC, applied to the proposed 45% federal gross-up.

The tax rates under the “Eligible Dividends (2)” column are based on the assumption that perfect provincial integration will be achieved such that the provincial DTC will approximate the provincial tax paid by the corporation on the amount paid out as a dividend.

As stated, the chart shows the

actual numbers, where available, but it is quite likely that some provinces may introduce different DTC rates for eligible and ineligible dividends, the result of which is that the rates given for the other provinces may ultimately turn out to be different.

**AE**

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