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Tax Alert — Canada

Private company tax reform: Personal tax increases on non-eligible dividends scheduled for 2018 and 2019

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

In the heat of active private company tax reform, both the federal and Ontario governments have proposed to reduce the corporate income tax rate on small-business earnings. While the small-business tax reductions generated significant media attention, a less conspicuous but significant tax change accompanied the corporate small-business tax reductions — personal tax rate increases on ordinary (or non-eligible) dividends. The following is an executive summary of the recent changes.

On 24 October 2017 and in connection with the federal fall economic statement, federal Finance Minister Bill Morneau released a Notice of Ways and Means Motion to Amend the Income Tax Act. A key highlight of the federal fall economic statement was the reduction of the corporate income tax rate applicable to small-business earnings. Correspondingly, on 14 November 2017 and in connection with the Ontario fall economic statement, Ontario Finance Minister Sousa introduced draft legislation to amend Ontario's *Taxation Act, 2007*. The Ontario government, like the federal government, made small-business tax reduction a key highlight of their fall economic statement. An accompanying change was the proposed increase in personal tax rates applicable to ordinary (or non-eligible) dividends.

As a result of the proposals, the federal corporate tax rate on small-business earnings will decrease from 10.5% in 2017 to 10.0% and 9.0% in 2018 and 2019, respectively. Correspondingly, Ontario's corporate tax on small-business earnings will decrease from 4.5% in

2017 to 3.5% in 2018. These tax rates will be applicable to corporations with calendar-based fiscal periods; corporations with off-calendar fiscal periods will be required to prorate the effect of the tax rate changes. Please see Appendix A for a summary of the small-business rate rates by province.

In order to maintain the "integrative" nature of the corporate and personal tax systems, it has been also proposed that the personal tax rate on ordinary (or non-eligible) dividends be increased in 2018 and 2019 for both federal and Ontario purposes. The personal tax rate increase will generally integrate and maintain tax neutrality on the distribution of future small-business earnings. In other words, the purpose of the change is so that the aggregate level of personal and corporate tax will be approximately the same whether an individual earned the same income as an individual or through a corporation. Please see Appendix B for a summary of the highest marginal personal tax rate on ordinary (or non-eligible) dividends.

However, a tax increase on ordinary dividends may also represent an across-the-board tax increase on certain tax attributes of Canadian-controlled private corporations (CCPCs). Shareholders of corporations that have accumulated retained earnings not subject to the general rate of corporate tax (for example, historic small-business or manufacturing and processing earnings) will be subject to the higher personal tax rates on future dividend distributions, despite the fact that the historic earnings were subject to tax at higher corporate rates; there will be no grandfathering of lower personal dividend tax rates on distributions of these historic accumulated retained earnings.

Additionally, investment earnings and capital gains of CCPCs are subject to high rates of refundable corporate tax and are generally distributed in the form of ordinary dividends. As a result, the personal tax increase on ordinary (or non-eligible) dividends will also increase the overall tax cost of retaining investment earnings in a CCPC that are subsequently distributed as a dividend. This result will occur even though the personal tax increases are being driven by a reduction in the small-business corporate tax rate, which is not applicable to a CCPC's investment earnings. Please see Appendix C for a summary of the "integration" cost associated with retaining investment earnings within a CCPC and subsequently distributing the earnings as an ordinary dividend.

As the tax changes are scheduled to occur in 2018 and 2019, taxpayers have some advance notice to reorganize or plan their affairs to address the changes. Accordingly, taxpayers are encouraged to discuss these changes with their business advisors.

Learn more

To learn more about how these changes may impact your private business, contact your local Private Client Services professional at ey.com.ca/private.

And for up-to-date information on the federal, provincial and territorial budgets, visit ey.com/ca/budget.

Appendix A

Combined federal and provincial small-business income tax rates[1] (as at 20 November 2017)			
	2017 %	2018 %	2019 %
British Columbia	12.62	12.00	11.00
Alberta	12.50	12.00	11.00
Saskatchewan	12.50	12.00	11.00
Manitoba	10.50	10.00	9.00
Ontario	15.00	13.50	12.50
Quebec[2]	18.50	18.00	17.00
New Brunswick	13.62	12.62	11.50
Nova Scotia	13.50	13.00	12.00
Prince Edward Island	15.00	14.50	13.50
Newfoundland and Labrador	13.50	13.00	12.00

[1] The small-business rate is generally available to a Canadian-controlled private corporation (CCPC) on active business income up to the small-business limit. The federal small-business limit is $500,000. For 2017, the small-business limit is $500,000 in all provinces except Manitoba, where it is $450,000. For 2018 and 2019, the small-business limit will be $500,000 in all provinces except Manitoba and Saskatchewan, where it will be $450,000 and $600,000, respectively.

[2] CCPCs that are in either the primary sector or engaged in manufacturing and processing activities in Quebec may be eligible for a small-business rate that is up to 4% lower than the rates shown in this table, if certain conditions are met.

Appendix B

Maximum personal marginal income tax rates on ordinary (non-eligible) dividends[1, 2, 3, 4]			
	2017 %	2018 %	2019 %
British Columbia (income in excess of $202,800)	40.95	43.73	44.64
Alberta (income from $202,801 to $303,900)	40.12	40.48	41.41
Alberta (income in excess of $303,900)	41.29	41.64	42.56
Saskatchewan (income in excess of $202,800)	39.62	39.76	40.48
Manitoba (income in excess of $202,800)	45.74	45.92	46.67
Ontario (income from $202,801 to $220,000)[5]	43.48	45.03	45.99
Ontario (income in excess of $220,000)[5]	45.30	46.84	47.78
Quebec (income in excess of $202,800)[6]	43.84	43.94	44.52
New Brunswick (income in excess of $202,800)	46.25	46.88	47.75
Nova Scotia (income in excess of $202,800)	46.97	47.33	48.27
Prince Edward Island (income in excess of $202,800)	43.87	44.26	45.23
Newfoundland and Labrador (income in excess of $202,800)	43.62	43.81	44.59

1. The rates shown are the 2017 to 2019 maximum combined federal and provincial marginal tax rates on non-eligible dividends, including surtaxes where applicable, based on known rates as at 14 November 2017.

2. It is assumed that the income tax brackets for 2018 and 2019 will remain unchanged from 2017.

3. The calculations assume the individual is taxed at the top marginal federal-provincial personal tax rate, except for the calculations for Alberta and Ontario, which also include the rate applicable using the top federal marginal tax rate and the second highest provincial marginal tax rate.

4. The rates apply to the actual amount of taxable dividends received in the year. For Ontario, the additional surtax has been applied prior to deducting the dividend tax credit. For Prince Edward Island, the additional surtax has been applied after deducting the dividend tax credit.

5. On 14 November 2017, Ontario announced a proposal to reduce the dividend tax credit (DTC) rate for non-eligible dividends from 4.29% to 3.29% for 2018 and subsequent years. However, this announced reduction does not appear to take into account the proposed changes to the federal dividend gross-up factors for 2018 and 2019 for non-eligible dividends (16% and 15%, respectively), which impact the calculation of the Ontario DTC rate under the proposed legislation introduced by Ontario on the same date. Taking into account the proposed federal changes and Ontario's proposed legislation, the Ontario DTC rate for non-eligible dividends is reduced from 4.29% to 3.12% for 2018, and to 2.95% for 2019 and subsequent years. Although Ontario may introduce further adjustments to its DTC rate, we have assumed for now that the Ontario DTC rate for non-eligible dividends for 2018 will be 3.12% and for 2019 will be 2.95%.

6. Taxable income for Quebec purposes is computed in accordance with the province's legislation, which often differs from federal legislation. It is assumed that Quebec will harmonize its dividend gross-up rate with the 2018 and 2019 federal dividend gross-up rate and that the DTC rate applicable to the grossed-up amount of the dividend will remain at 7.05%.

Appendix C

Tax cost of investment income earned through a CCPC and distributed as ordinary (non-eligible) dividends[1, 2, 3] (as at 20 November 2017)

	Interest income[4]			Capital gains[4, 5]		
	2017 %	2018 %	2019 %	2017 %	2018 %	2019 %
British Columbia	4.47	5.19	5.91	2.23	2.59	2.95
Alberta	5.03	5.31	6.05	2.51	2.65	3.02
Saskatchewan	3.79	4.30	5.13	1.90	2.15	2.57
Manitoba	6.19	6.34	6.94	3.10	3.17	3.47
Ontario	2.44	3.68	4.43	1.22	1.84	2.22
Quebec[6]	1.65	1.68	2.09	0.83	0.84	1.05
New Brunswick	4.78	5.27	5.94	2.39	2.63	2.97
Nova Scotia	5.70	5.97	6.69	2.85	2.99	3.34
Prince Edward Island	5.97	6.27	7.00	2.98	3.13	3.50
Newfoundland and Labrador	5.28	5.43	6.03	2.64	2.72	3.02

1. The table illustrates the tax cost on a fully distributed basis of earning investment income through a Canadian-controlled private corporation (CCPC) rather than directly as an individual. This table should be used for general guidance only and does not replace the need to consider specific circumstances.

2. The calculations assume the individual is taxed at the top marginal federal-provincial personal tax rate. Payroll taxes at the corporate level (such as CPP and employer health taxes) and CPP contributions and provincial health

premiums at the individual level are ignored. The calculations do not take into account indexation of 2018 or 2019 income brackets.

3. For taxation years ending after 2015, the refundable additional Part I tax on investment income earned by a CCPC is increased by 4%, from 6.67% to 10.67%. As a result, the federal rate applicable to investment income earned by a CCPC is increased to 38.67% from 34.67%. The additional refundable tax as well as a portion of the regular Part I tax paid on the investment income is refundable to the CCPC as follows: 30.67% of the investment income (increased from 26.67%) is added to the CCPC's refundable dividend tax on hand account and is refundable at a rate of 38.33% of taxable dividends paid (increased from 33.33%).

4. It is assumed that interest income and capital gains are eligible for refundable dividend tax treatment and that the corporation can pay the total amount of ordinary dividends necessary to recover the full amount of the refundable dividend tax on hand (RDTOH).

5. It is assumed that the non-taxable portion of any capital gains is flowed out to the shareholder as a capital dividend; however, there may be situations where it is more tax-effective to pay more taxable dividends (rather than a capital dividend) to recover RDTOH.

6. Taxable income for Quebec purposes is computed in accordance with the province's legislation, which often differs from federal legislation.

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