Liberal government implements measures impacting the taxation of CCPCs

December 2015

On December 7, 2015, the government tabled a Notice of Ways and Means Motion (NWMM) to implement a number of tax measures. These were noted in our recent release titled: *New Liberal government announces tax measures*. On December 9, 2015, Bill C-2, An Act to amend the Income Tax Act, received first reading in the House of Commons. These measures are considered substantively enacted for tax accounting purposes as of this date.

As noted in our initial release, consequential to the introduction of a new top personal income tax rate of 33%, the NWMM also included some unexpected changes to several tax measures affecting Canadian-controlled private corporations (CCPCs) and other private corporations. The following corporate tax amendments have been proposed:

- The refundable additional tax on investment income earned by a CCPC will increase from 6.67% to 10.67%. That means that the total initial tax rate applicable to such income will increase to 38.67% (from 34.67% in 2015).
- The percentage of investment income of a CCPC that can be included in the corporation's refundable dividend tax on hand (RDTOH) account will increase to 30.67% (from 26.67% in 2015). Consequential amendments have also been made to the refundable dividend tax refund mechanism and the gross-up factor that applies to foreign non-business income.
- The rate at which refunds are made out of a private corporation's RDTOH account when it pays taxable dividends will increase to 38.33% (from 33.33% in 2015).
- The refundable Part IV tax on certain taxable dividends received by private corporations will increase to 38.33% (from 33.33% in 2015).

These amendments generally apply to taxation years that end after 2015 (with the rate increase pro-rated for the number of days in the tax year after 2015), except that the increase in Part IV tax (the last bullet point above) applies to dividends received after 2015.

Table A summarizes the combined federal and provincial corporate tax rates by province in 2015 and 2016.

Why were these changes made?

The corporate rate changes are intended to maintain the integration of the tax system for individuals subject to the top marginal rate of tax. Integration is an important principle in our tax system. It is based on the premise that an individual earning income through a corporation should be in the same tax position as if that individual had earned the income directly. However, integration is not perfect and how closely it achieves its intended purpose varies by province.

Integration of passive investment income earned by a CCPC is achieved through a refundable tax mechanism. There are two refundable mechanisms: (1) a refundable portion of Part 1 Tax (for investment income and capital gains) and (2) refundable Part IV tax (generally, for dividend income received from another corporation that is not "connected"[1] with the recipient corporation). This refundable tax paid by the corporation is refunded to the corporation when taxable dividends are paid out to the shareholders. This tax is designed to eliminate the deferral aspect of earning investment income in a corporation.

The 4% increase in the refundable portion of Part 1 tax is intended to increase the initial rate of tax on investment income earned in a corporation so that it more closely approximates the new top personal rate of tax. Column A of Table B compares the corporate deferral/prepayment of earning and retaining interest income in a corporation to earning it personally and being subject to the top marginal personal rate of tax. As can be seen, in most cases there is an initial tax cost to earning investment income in a corporation, although there is a deferral benefit in Ontario, Quebec and New Brunswick.

Similarly, Part IV tax is intended to eliminate the deferral benefit of earning certain dividend income in a corporation (generally, dividends from a company that is not connected with the dividend recipient). The 5% increase in the Part IV tax rate is intended to more closely approximate the top personal rate of tax on dividend income. Eligible dividends are subject to a lower rate of tax than regular dividends.[2] For dividends to be taxed at the lower eligible dividend tax rate, they must be designated as dividends at the time of payment.

Table B also illustrates the corporate deferral/prepayment of earning dividends subject to Part IV tax in a corporation versus personally (assuming the top marginal rate of tax).[3] Column C (for eligible dividends) would generally apply to dividends received from Canadian public companies, whereas Column D would apply where Part IV tax is applied to the receipt of regular dividends.

Whether there is an overall benefit or cost once the income is flowed through to the shareholders in the form of dividends will depend on a number of factors, including the province of the dividend recipient and the recipient's marginal rate of tax. Table B summarizes the ultimate cost on flow through to the shareholders, assuming the shareholder is subject to the top marginal rate of tax. For interest income and capital gains, there is an overall cost to earning investment income in a corporation in all provinces.[4] Dividends subject to Part IV tax have no cost or savings on flow through; the end result is that the tax is ultimately paid at the shareholder level.

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[1] Basically, one which it controls or in which it owns more than 10% of the votes and value.
[2] Most dividends paid by public companies would be eligible dividends.
[3] See columns C and D
[4] See columns B and G

What does this mean for me and my corporation?

The corporate tax changes do not significantly alter the federal integration of future investment income earned through a CCPC and taxed at the federal top marginal personal income tax rate. However, what has changed is an increase in the tax cost associated with keeping pre-2016 retained earnings in a corporation and distributing taxable dividends after 2015 when the top marginal personal income tax rates on eligible and non-eligible dividends are much higher.

The additional tax on investment income also increases the tax burden associated with being a "specified investment business." This is a business which principally derives income from property (including interest, dividends, rents and royalties), except those with "more than five full-time employees throughout the year." Given this increase in the tax rate for investment income, this employee test will become even more important for companies earning income from property (such as real estate rentals). As an exception, a corporation that derives income from property from an associated corporation that deducted those amounts from its active business income is deemed to be receiving active business income (for example, a Holdco that rents a building, or equipment, to an operating subsidiary corporation). This rental income would then qualify as active business income and would not be subject to the increased rate of tax for investment income.

It is also important to note that no adjustments are being made to existing RDTOH balances. As such, a CCPC will be required to pay a smaller dividend in 2016 and later years to recover existing RDTOH, since the RDTOH will be refunded at a rate of 38.33% (instead of 33.33%) of taxable dividends paid.

In addition, where the corporation has a non-calendar year-end, the 38.33% refund rate will be pro-rated for the number of days in the tax year that are after 2015, regardless of when the dividend is paid. For example, a $30,000 dividend paid on November 30, 2015 for a company with a December 31, 2015 year-end will generate a dividend refund of $10,000. A $30,000 dividend paid on that same date for a company with a June 30, 2016 year-end will generate a dividend refund of $10,745. However, whether the corporation is subject to the 33 1/3% or 38 1/3% refund rate, the Part IV tax rate on the receipt of dividends will be based on when the dividend is received.

The amounts in the tables are based on the assumption that the shareholder is subject to the top marginal rate of tax. The results will differ for individuals in lower income brackets. Therefore, it is important to review your particular situation with your tax advisor. In addition, it is unknown at this time whether future changes to provincial personal or corporate income tax rates will be introduced in response to these federal rate changes, or otherwise.

If you currently earn investment income through a CCPC, please contact us before the end of 2015 to discuss the implications of these changes and to determine what immediate actions, if any, should be taken to minimize the impact of the proposed changes.

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Table A

2015 corporate tax rates

Combined federal and provincial tax rates

Province	Eligible for SBD	Not eligible for SBD		Investment Income	RDTOH
		With MPP	Without MPP		
British Columbia	13.50%	26.00%	26.00%	45.67%	26.67%
Alberta	14.00%	26.00%	26.00%	45.67%	26.67%
Saskatchewan	13.00%	25.00%	27.00%	46.67%	26.67%
Manitoba	11.00%	27.00%	27.00%	46.67%	26.67%
Ontario	15.50%	25.00%	26.50%	46.17%	26.67%
Quebec	19.00%[1]	26.90%	26.90%	46.57%	26.67%
Quebec	15.49%[2]				
New Brunswick	15.00%	27.00%	27.00%	46.67%	26.67%
Nova Scotia	14.00%	31.00%	31.00%	50.67%	26.67%
Prince Edward Island	15.50%	31.00%	31.00%	50.67%	26.67%
Newfoundland & Labrador	14.00%	20.00%	29.00%	48.67%	26.67%
Yukon	14.00%[1]	17.50%	30.00%	49.67%	26.67%
Yukon	12.50%[2]				
Northwest Territories	15.00%	26.50%	26.50%	46.17%	26.67%
Nunavut	15.00%	27.00%	27.00%	46.67%	26.67%

2016 corporate tax rates

Combined federal and provincial tax rates (based on all rate proposals up until Dec 10, 2015)

Province	Eligible for SBD	Not eligible for SBD		Investment income	RDTOH
		With MPP	Without MPP		
British Columbia	13.00%	26.00%	26.00%	49.67%	30.67%
Alberta	13.50%	27.00%	27.00%	50.67%	30.67%
Saskatchewan	12.50%	25.00%	27.00%	50.67%	30.67%
Manitoba	10.50%	27.00%	27.00%	50.67%	30.67%
Ontario	15.00%	25.00%	26.50%	50.17%	30.67%
Quebec	18.50%[1]	26.90%	26.90%	50.57%	30.67%
Quebec	14.50%[2]				
New Brunswick	14.50%	27.00%	27.00%	50.67%	30.67%
Nova Scotia	13.50%	31.00%	31.00%	54.67%	30.67%
Prince Edward Island	15.00%	31.00%	31.00%	54.67%	30.67%
Newfoundland & Labrador	13.50%	20.00%	29.00%	52.67%	30.67%
Yukon	13.50%[1]	17.50%	30.00%	53.67%	30.67%
Yukon	12.00%[2]				
Northwest Territories	14.50%	26.50%	26.50%	50.17%	30.67%
Nunavut	14.50%	27.00%	27.00%	50.67%	30.67%

Notes:
[1] Without MPP
[2] With MPP

Table B

2016 integration tables

	Interest income eligible for refundable part I tax		Dividend income			Capital gains eligible for refundable part I tax	
Canadian Investment Inco	**(Assuming no lost RDTOH)**		**Subject to part IV tax**			**(Assuming no lost RDTOH)**	
The tables are based on all rate proposals announced up to Dec 10, 2015	Deferral/ (Prepayment)	Regular Dividends: Savings/ (Cost)	Eligible Dividends: Deferral/ (Prepayment)	Regular Dividends: Deferral/ (Prepayment)	Savings/ (Cost)	Deferral/ (Prepayment)	Regular Dividends: Savings/ (Cost)
British Columbia	(1.97)	(4.19)	(7.03)	2.28	Nil	(0.98)	(2.10)
Alberta	(2.67)	(4.19)	(6.62)	1.91	Nil	(1.34)	(2.10)
Saskatchewan	(2.67)	(4.05)	(8.00)	1.73	Nil	(1.34)	(2.02)
Manitoba	(0.27)	(6.15)	(0.55)	7.36	Nil	(0.14)	(3.08)
Ontario	3.36	(2.44)	1.01	6.97	Nil	1.68	(1.22)
Quebec	2.74	(1.71)	1.50	5.51	Nil	1.37	(0.85)
New Brunswick	8.08	(2.65)	5.46	13.42	Nil	4.04	(1.33)
Nova Scotia	(0.67)	(5.70)	3.25	8.64	Nil	(0.34)	(2.85)
Prince Edward Island	(3.30)	(5.97)	(4.11)	5.54	Nil	(1.65)	(2.99)
Newfoundland & Labrador	(4.37)	(4.43)	0.14	1.07	Nil	(2.19)	(2.22)
Yukon	(5.67)	(5.94)	(13.52)	1.85	Nil	(2.84)	(2.97)
Northwest Territories	(3.12)	(1.20)	(10.00)	(2.61)	Nil	(1.56)	(0.60)
Nunavut	(6.17)	(4.58)	(5.25)	(1.98)	Nil	(3.09)	(2.29)