

Eligible Dividends

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Introduction

- Review of GRIP
- Review of LRIP
- Compliance Issues
- Planning Issues
- Open Forum

Eligible Dividend Rules

■ Introduction

- Problem – disparity between the level of taxation on dividend income and the taxation on income through a flow through vehicle (“Income Trusts”)
- Solution – reduce the federal income tax imposed on dividends paid to individuals
- Leveling of the playing field by enhancing the dividend gross up to 45% (from 25%) and maintaining the DTC at 11/18% of the gross up for “eligible dividends”
- 2006 Budget – Resolution 20

Eligible Dividend Rules

- June 20, 2006 Department of Finance – Draft Legislation (“Legislation”)
- Bill C-28 tabled in December 2006
- Royal Assent – February 21, 2007
- Federal government assumed that the Provinces will adopt the Legislation and provide an enhanced DTC
- August 3, 2006 Ontario government announced it would make changes to the Ontario income tax legislation to parallel the Legislation (however phased in - 2010)

“Old Rules”

	Bonus	Dividend (old rules)
Corporate Income	\$1,000	\$1,000
Salary	\$1,000	\$0
Taxable Income	\$0	\$1,000
Corporate Tax Available	\$0	\$361
Personal Tax	\$464	\$200
Total taxes paid	\$464	\$561
Total taxes paid	46.4%	56.1%

The significant 9.7 percent difference in taxes paid under the old legislation was attributable mainly to the double taxation of dividend income.

Ontario – New Rules

	<u>Ontario Proposals 2006*</u>	<u>Ontario Proposals 2008*</u>	<u>Ontario Proposals 2010*</u>
Corporate Tax	36.10%	36.10%	32.00%
Individual's tax on dividends	25.00%	23.97%	22.38%
Effective combined rate of tax	52.13%	51.41%	47.22%
Tax if individual earned directly	46.41%	46.41%	46.41%

* Active business income not subject to M & P deduction.

Legislation

- Determines a corporation's ability to pay eligible dividends
 - "GRIP"
 - "LRIP"
- Requires corporations to designate eligible dividends
- Impose penalties if an excess designation is made
- Apply when there is an amalgamation or windup

Eligible dividends

- “Eligible dividend”
 - taxable dividend
 - received by a person resident in Canada
 - paid after 2005
 - paid by corporation resident in Canada
 - designated as eligible per 89(14)

Designation

- 89(14): “by notifying in writing *at that time* each person or partnership to whom it pays all or any part of the dividend that the dividend is an eligible dividend” [emphasis added]
- Foregoing applies to dividends paid after February 21, 2007
- Dividends paid before that date: Can designate until May 22, 2007

Effect of designation

- Dividend gross up 45%
- Dividend tax credit is 11/18 of the gross up
- Top tax rate in Ontario on eligible dividend
 - in 2006, 25.00%
 - in 2010, 22.38%

Excess designation

- Corporation must pay penalty tax
- Excess dividend
 - For CCPC: Total eligible dividends in the year exceeds GRIP
 - Non-CCPC: Any eligible dividend paid when there is LRIP
- Excess designation for CCPC is pro-rated across all eligible dividends paid in a year!

Excess designation

- Entire dividend will be excess

“if it is reasonable to consider that the dividend was paid in a transaction, or as part of a series of transactions, one of the main purposes of which was to artificially maintain or increase the corporation’s [GRIP], or to artificially maintain or decrease the corporation’s [LRIP]”

LRIP

- LRIP = low rate income pool
- Income earned by a non-CCPC that has been subject to tax at less than the full corporate rate
- Point-in-time calculation, like safe income. Must compute LRIP before paying an eligible dividend

GRIP

- GRIP = general rate income pool
- Income earned by a CCPC that has been subject to tax at the full corporate rate
- End-of-the-year calculation
- $GRIP = A - B$

GRIP (for CCPCs)

- $A = C + 0.68(D - E - F) + G + H - I$
- C is GRIP at previous year-end
- D is taxable income for the year
- E is SBD claimed for the year X
(100/rate of deduction for the year)
- F is lesser of total investment income
and taxable income

GRIP (for CCPCs)

- G is the total of dividends received that were
 - eligible dividends or
 - from foreign affiliates
- H is a special adjustment amount for reorgs (discussed below)

GRIP (for CCPCs)

- I is the total of all eligible dividends paid in the previous year minus all excess designations
- B (remember B?) is 68% of all losses or other carrybacks (“specified future tax consequences”) deducted in prior years

GRIP (for CCPCs)

- A in the formula can be a positive or negative amount
- The result of A minus B can be positive or negative

GRIP from before 2006

- If Opco is a CCPC throughout a taxation year that includes January 1, 2006, then its GRIP as of the preceding year is $A - B$ where
- A is the total of
 - 63% of full rate taxable income for a year ending after 2000 and before 2004 but not including M&P income and ignoring specified future tax consequences

GRIP from before 2006

- A is the total of (cont'd)
 - 63% of full rate taxable income for a year ending after 2003 and before 2006 ignoring specified future tax consequences
 - dividend received from a connected corporation (not necessarily CCPC but not a foreign affiliate) where “it is reasonable to consider” the amount came from A of the payer
- B is the total of all dividends paid

GRIP and reorgs

- What if Opco 1 and Opco 2, both CCPCs, amalgamate to form CCPC?
See 89(5)
- GRIP will be $A - B$ where
 - A is GRIP of each predecessor and
 - B is eligible dividends paid in previous year

GRIP and reorgs

- What if Opco1 and Opco2 amalgamate to form CCPC and one of them is not CCPC? GRIP will be $A - B$ for the CCPC predecessor
- For non-CCPC:

$$A + B + C - D - E - F - G - H$$

GRIP and reorgs

- A is cost of all property
- B is amount of money on hand
- C is losses available but not deducted
- D is all debt
- E is the total PUC of all issued shares
- F is all reserves deducted in last year of predecessor

GRIP and reorgs

- G is the predecessor's CDA
- H is the predecessor's LRIP

Compliance Issues

CCPC's

- CCPC first required to compute its GRIP at end of 2006 taxation year
- “Eligible dividend” – corporation must designate it as such in writing when the dividend is paid
- New filing requirement on Canadian resident corporations that pay taxable dividends (eligible or non-eligible) in a taxation year – Part III.1 return – due corporation filing due date for the year

Compliance Issues

CCPC's

- 2006 only – CRA administrative position
 - Designate on T3/T5
- Eligible dividends paid on or after Feb 21, 2007 must be designated at the time of payment
- Eligible dividends paid before February 21, 2007 can be designated as such up to May 22, 2007

Compliance Issues CCPC's

- Post 2006 –
notification method

	<u>HOW</u>	<u>WHEN</u>	<u>WHAT</u>
Non-public company	-Letter to shareholders -Dividend cheque stub; or -If all shareholders are directors, in a notation in the Minutes	Each time a dividend is paid	The dividend is an eligible dividend

Compliance Issues

CCPC's

- Legislation is not clear whether you can combine eligible dividend with non-eligible dividend – better practice - declare separate dividends on the class of shares
- Designation must apply to all shareholders of a particular class of shares
- Notice must be given to all shareholders in receipt of the eligible dividend including non-residents

Compliance Issues CCPC's

- Eligible dividends received by a partnership – flow through to the partners
- Eligible Designations – not prescribed for the purposes of Regulation 600 – Minister has no ability to grant an extension, revoke or amend

Compliance Issues CCPC's

- Excess eligible dividend designations – Corporation levied penalties
 - Pay Part III.1 tax of 20% of the excess amount
 - Also potential anti-avoidance rule – artificially manipulate the corporation's GRIP/LRIP – additional Part III.1 tax of 10% (total 30%) applied to an excess eligible dividend

Compliance Issues

CCPC's

- Curing provision – similar to excessive CRA election
 - Elect within 90 days of Part III.1 reassessment
 - Treats separate dividend eligible and non-eligible
 - Part III.1 does not apply to “elected amount”
 - Shareholders deemed to receive ordinary dividends (for elected amount)

Compliance Issues CCPC's

- No cure for excess dividends subject to 30% rate
- Non-arm's length shareholders in receipt of an excessive eligible dividend – jointly, severally or solidarily liable with the corporation to pay a share of the Part III.1 tax that is proportionate to the share of the eligible dividend that the shareholder received.

Planning Issues

- Bonus vs. No Bonus
- Grip Strips
- Estate Freezes
- Shareholder Agreements
- Dividends from Foreign Affiliates
- Ordering of CCPC distributions
- CCPC election to be non-CCPC

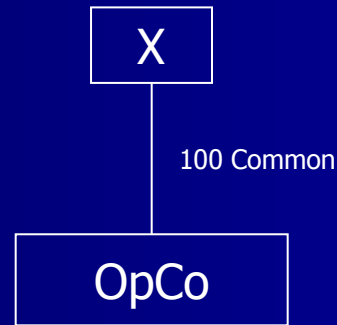
Ordering of CCPC Distributions

CCPC positive GRIP and RDTOH – consider following:

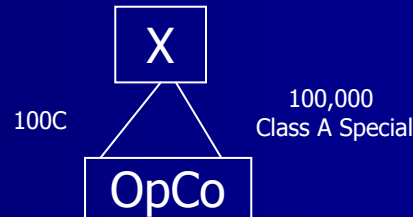
1. Eligible Dividends triggering a refund of Part I or Part IV tax (“RDTOH”);
2. Ineligible Dividends triggering a RDTOH;
3. Eligible Dividends not triggering a dividend refund;
4. Ineligible Dividends not triggering a dividend refund.

“GRIP Streaming & Parking”

(i)



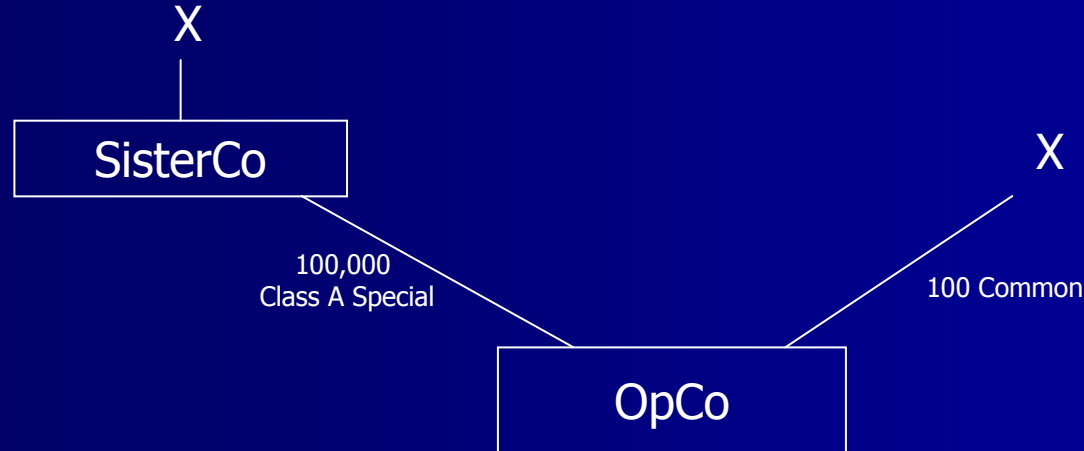
(ii)



- OpCo – 100,000 excess cash
- OpCo declares dividend satisfied by stock – (Hi-Lo shares) equal to amount of excess cash
- Amount of dividend \$100 to X (Taxable), however, fair market value of 100,000 Class A Special Shares \$100,000

“GRIP Streaming & Parking”

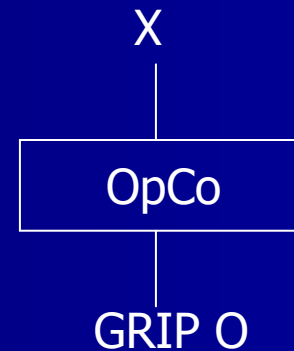
(iii)



- X creates SisterCo
- X transfers 100,000 Class A Special to Sisterco – s. 85 election
- OpCo redeems 100,000 Class A Spcial designates 84(3) dividend as “eligible dividend”

“GRIP Streaming & Parking”

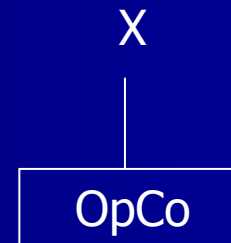
(iv)



- Preserves 100,000 GRIP in SisterCo;
- Purifies OpCo – QSBC definition (Beware 55(2))
- Creditor Proofing – OpCo
- If OpCo subsequently suffers a loss – no effect on GRIP in SisterCo (GRIP preserved and parked)

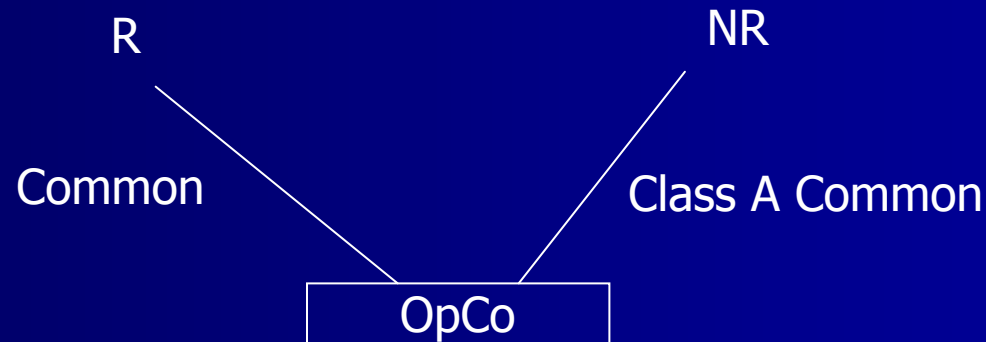
“GRIP Streaming & Parking”

(v)



- Alberta corporate tax on investment income 2007 – 45.79% vs Ontario Corp. tax 49.79% (4%)
- Alberta Combined Federal/Provincial – Top Marginal Personal Income Tax Rates – 2007 eligible dividends – 17.45% on ordinary dividends 25.21% vs Ontario eligible dividends 24.64% and ineligible dividends 31.34%
- Permanent Difference – 7.76%
- Subject to Ontario GAAR concerns

Non-Resident Shareholders



- NR – non-resident – no benefit from eligible dividends
- Isolate NR in separate class of shares
 - Preserves GRIP eligible dividends to Canadian resident shareholders that can benefit from lower rate
 - Dispenses with designation notice provisions to NR
 - Shareholders agreement need to recognize this issue

Estate Freezes

- Consider utilizing Freeze Shares that are entitled to eligible dividends first and ineligible dividends second
- Consider effect to Frozen Shareholders of delaying redemption until 2010 and beyond (Ontario resident) – eligible dividends marginal rate is 22.38%
- Consider the introduction of an Alberta Corporation and or Alberta Trust as part of the freeze structure
- Shareholder Agreements – context of succession plan – need to deal with the entitlement of eligible dividends

Bonus vs GRIP

	Bonus	Dividends	
	2006	2006	2007
<u>Corporation</u>	<hr/>	<hr/>	<hr/>
Corp. Income	100,000	100,000	100,000
Less Bonus	(100,000)		
Taxable Income	0	100,000	100,000
Less Corp. Tax	0		
		(36,120)	(36,120)
Eligible Dividend Distributed	0	63,880	63,880

Bonus vs GRIP

<u>Shareholders</u>	Bonus	Dividends	
	2006	2006	2007
Distribution Received	100,000	63,880	63,880
Less: Tax on Salary	(46,410)	0	0
Less Tax on Dividends	0	(16,027)	(15,740)
After Tax Proceeds	53,590	47,853	48,140
Total Tax Paid	46,410	52,147	51,860
	46.41%	52.15%	51.9%

- Ontario resident
- Non M & P deduction
- Excluding EHT
- By 2010 if Ontario proceeds with adjustments then the overall rate utilizing GRIP is reduced to 47.42%

Bonus vs. GRIP

- Cash needs of client dictate the decision to bonus or create GRIP
- Creating GRIP leaves more available to OpCo 63,880 vs. 53,590 (10,290) to be utilized in the business
- If Eligible Dividend not paid until 2010 then shareholder is indifferent, however, OpCo will have had more cash 10,290 to pay debt, acquire capital assets, etc.

Bonus v. GRIP

- Note the effect of creating GRIP
 - Corporate installments are higher
 - Tax is due within 60 days of year end
 - Need to plan cash flow
 - Ontario SBD claw back

Bonus vs. GRIP

- The following factors make GRIP more appealing:
 - Payroll taxes must be paid on salary/bonus payments. This reduces the after-tax proceeds of a bonus.
 - The surtax for small and medium corporations is being eliminated in 2008. This will increase the after-tax proceeds of paying out a dividend.

Bonus vs. GRIP

- A bonus cannot be paid to inactive shareholders, however, a dividend can be paid to any shareholder
- A shareholder resident in Ontario with no other income can receive up to \$41,000 of eligible dividends before paying any tax
- If a manufacturing and processing deduction is available, this means more after-tax proceeds when paying a dividend.

Bonus vs. GRIP

- The following factors make bonuses more appealing:
 - Scientific Research and Experimental Development (SRED) tax credits are higher for companies with income below the small business deduction limit. Bonuses reduce taxable income and provide a way to maximize SRED eligibility.

Bonus vs. GRIP

- Paying a salary increases RRSP contribution room (though if your base salary is already above \$106,000 a bonus will not increase the RRSP contribution limit).
- The Alternative Minimum Tax (AMT) threshold is higher for bonuses than dividends.
- Bonuses provide a potential income splitting opportunity with family members and further RRSP opportunities.

Miscellaneous

- Amalgamations and Windups
- Investment Holdcos – Disincentive to incorporate portfolio investments – Corp Tax vs. Eligible Dividends
- Sale of a Business
 - Assets vs. Shares
 - Goodwill Dispositions
- Safe Income Strips – less likely if GRIP
- Estate and Post Mortem Planning – reduces gap between eligible dividends and capital gains
- CCPC election to be non-CCPC – if pre 2001 retained earnings from GRIP