



Eligible Dividends Legislation Receives Royal Assent

As expected, on February 21, 2007, the proposed legislation concerning eligible dividends received Royal Assent and became law. Aside from a few technical amendments, the final legislation is virtually the same as was originally proposed. The purpose of this update is to familiarize you with the “eligible dividend” regime and explain how the new legislation may affect you, and the income taxes you pay.

Why Do You Care?

The tax rate on certain types of dividends (now called “eligible dividends”) received on or after January 1, 2006, has been reduced from 31% to 25% (22% in 2010). In general terms, eligible dividends are dividends paid out of a corporation that had active business income greater than the Federal small business limit (\$300,000 in 2006). In years past, Cunningham LLP had recommended that most corporations bonus down to the \$400,000 Ontario small business deduction limit. For these companies, active business income between \$300,000 and \$400,000, if left in the company in prior years, can benefit from the lower tax rate when paid out as an eligible dividend.

An Understanding of Eligible Dividends

In an effort to equalize the net after-tax dollars to investors of income trusts and of public corporations, the Federal government introduced legislation effectively reducing the personal income taxes paid on certain dividends. The eligible dividend legislation has a direct impact on private companies. As of January 1, 2006, all private corporations have the ability to pay out eligible dividends subject to a having a positive balance in their General Rate Income Pool (“GRIP”). Although there are specific rules in calculating a company’s GRIP, the GRIP is essentially a private corporation’s net after-tax earnings on active business income that has been subject to the Federal general corporate income tax rate.

Investment income and income earned in a corporation that has benefited from the lower corporate Federal small business rate (approximately 13%) will not be included in the calculation of the GRIP, and, as such, if subsequent paid out as a dividend, will not be permitted to be designated as an eligible dividend.

The GRIP calculation also includes a “look back” provision for corporations which had income subject to the general corporate income tax rate in 2001 through to 2005. For some of these years income that benefited from the lower manufacturing and processing (“M&P”) corporate tax rate is added to the GRIP; for other years it is excluded.

Public corporations can pay eligible dividends as long as they do not have a Low Rate Income Pool (“LRIP”). A discussion of the LRIP is beyond the scope of this update, however many taxpayers who have invested in shares of public companies can expect to receive eligible dividends in 2006 and in future years.

There are penalties for designating a dividend as an eligible dividend in excess of a private company’s GRIP. The penalty is equal to 20% of any “excessive designation”, but can reach 30% of the entire dividend if the Canada Revenue Agency believes that the corporation has artificially increased its GRIP. An election may be filed in the former situation to deem the “excessive designation” a non-eligible dividend.

The Tax Rate on Eligible Dividends

When a taxpayer receives an eligible dividend it will be grossed up by 45% (regular dividends are subject to a 25% gross-up); however, the eligible dividends will benefit from a much higher dividend tax credit.

In 2006, an individual taxpayer in the top marginal tax bracket will be subject to tax on eligible dividends at 25%. Regular, noneligible, dividends will continue to be taxed at 31%. The tax rate on eligible dividends will decrease to 22% by 2010 as a result of the enhanced Ontario dividend tax credit being phased in over 5 years.

Designating a Dividend as an Eligible Dividend

To benefit from the enhanced “gross up and dividend tax credit” system, a dividend must be designated as an eligible dividend by the payor corporation. The Canada Revenue Agency has released guidelines that explain its permitted methods for designating a dividend as an eligible dividend in 2006 and for any year after 2006.

In 2006, private corporations can designate a dividend as an eligible dividend on the relevant tax reporting slip. New boxes have been added to the 2006 T5 and T3 slips to accommodate an eligible dividend designation. Corporations can also designate a dividend as an eligible dividend in 2006 by posting such notice on its website, and in corporate reports or shareholder publications.

For dividends paid in 2007 and later, private companies must indicate that a dividend is an eligible dividend on the dividend cheque stub or in a letter provided to all shareholders. As an alternative, where all the shareholders are also directors of the company, a notation in the Corporate Minutes will suffice. Public companies can make this designation in 2007 and later by posting a notice on the corporation’s website or in a quarterly or annual report, or by issuing a press release announcing the declaration of an eligible dividend.

Bonusing Down vs. Paying a Dividend

In the past, owner-managers generally bonused down income to take advantage of the low corporate tax rate afforded to small businesses on the first \$300,000 (Federal small business deduction limit) or \$400,000 (Ontario small business deduction limit) of active income. All dividends paid out of the corporation were taxed at 31% in the hands of an individual shareholder in the top tax bracket, effectively integrating the combined corporate and personal tax rate on dividends and the combined tax rate paid on a salary or bonus (approximately 46%, not including the Employer Health Tax).

In prior years, the corporate and personal taxes resulted in a combined tax rate of 59% when income greater than \$400,000 was first taxed in the corporation, instead of being bonused out to the shareholder. When compared to a combined tax rate of 47% (including the Employer Health Tax) for a bonus, most individual owner-managers decided to bonus out corporate income down to the small business deduction limit.

The decision of whether to bonus down or not has become more complex now that there is a lower personal tax rate on eligible dividends. For corporations that continue to benefit from the lower corporate small business tax rate, the combined corporate and personal tax rate if eligible dividends are paid out is 56% in 2006 (decreasing to 52% by 2010). For corporations that do not benefit from either the Federal or Ontario low corporate small business tax rate, the combined corporate and personal tax rate if eligible dividends are paid out is 52% (48% in 2010). While there is an ultimate tax cost in most situations when income above \$300,000 or \$400,000 is not paid out of the corporation by way of a bonus, there is a deferral of the personal income taxes. Often if an individual shareholder does not need the cash and it can be reinvested within a corporation, the shareholder will become indifferent in a few short years between having paid a bonus or paying an eligible dividend at a later date.

Bonusing down decisions are further complicated by Scientific Research & Experimental Development ("SR&ED") credits, corporations which benefit from the Ontario small business deduction but not the Federal small business deduction, RRSP considerations and maintaining the corporation's status as a qualifying small business corporation for purposes of the capital gains exemption.

The new proposals are complex, and the decisions owner-managers will be required to make are not simple. We would be pleased to discuss the tax implications with you and/or your business in light of the new eligible dividend regime.

For more information please contact a member of the Cunningham LLP Tax Department.