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Revisit Your 2015 Year-End Dividend Planning Now — Before Integration Rate Changes Kick In

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You should review your year-end dividend planning now to ensure you have considered the full impact of the recently announced increase in the highest federal personal income tax rate to 33% (from 29%) effective January 1, 2016. As a result of this increase, the government made consequential changes relevant to the taxation of income flowed through your Canadian-controlled private corporations (CCPC). By revisiting your year-end dividend planning, you can properly address issues and opportunities that may have arisen following these changes.

Specifically, paying a dividend in 2015 versus 2016 to shareholders can result in absolute personal tax savings in certain situations. The savings range from 2.6% to 10.7% depending on the type of dividend (eligible or non-eligible) and province of residence. The decision as to whether it is better to pay a dividend in 2015 or 2016 to shareholders out of a corporation that has both active business income and investment income, as well as refundable dividend tax on hand (RDTOH), may vary by province.

This issue of *TaxNewsFlash-Canada* summarizes the impact of the new tax rates on year-end dividend planning that you should revisit before the end of 2015. In most cases it will be necessary to crunch some numbers and to obtain advice and assistance from your tax adviser to help evaluate all the implications before December 31, 2015.

The new federal government recently announced two major tax rate changes for individuals: a reduction in the federal tax rate for income between $45,283 and $90,563 to 20.5% (from 22%) and an increase of 4% in the tax rate for income over $200,000 to 33% (from 29%), starting January 1, 2016. These tax changes for 2016 are now included in Bill C-2 which received first reading in the House of Commons on December 9, 2015. As a result of the increase in the top federal personal tax rate to 33%, the government also made consequential changes to various factors impacting the Canadian integration mechanism to ensure that income earned through a corporation is taxed at relatively the same rates as income earned directly by an individual taxed at the top marginal tax rate (see below). Although the integration system has mostly retained the status quo the income tax deferral opportunities (costs) have changed depending on the particular province.

This *TaxNewsFlash-Canada* also reviews the mechanics of the integration system in the context of the new federal tax rates in effect for 2016, and points out some issues and opportunities that have resulted. As a note of caution further changes to tax rates and the

integration mechanism for 2016 could still be forthcoming in the 2016 spring provincial budgets.

Background — Concept of integration

The Canadian income tax system is designed so that income earned in a corporation and distributed to a shareholder as a dividend should attract the same amount of total income tax, both corporate and personal, as if the income was earned directly by an individual taxed at the top personal tax rate. Integration is achieved when the individual receives the same after-tax cash flow regardless of whether the income is flowed through a corporation.

The integration mechanism, which includes the gross-up on dividends received by individual shareholders and the non-refundable federal and provincial dividend tax credits, assumes that corporate income is taxed at a theoretical combined federal and provincial rate of tax. Since corporate income tax rates actually vary depending on the type of income earned and the province of residence, integration does not always work perfectly in every province. This imperfection results in varied amounts of tax costs or savings from using a corporation to earn income, depending on the province.

The following example illustrates how integration functions in the case of investment income (e.g., interest, rents or royalties) earned in New Brunswick in 2016. As shown below there is a tax cost (or breakdown in integration) of 2.65% (i.e., $26.50 for $1,000 of income) in New Brunswick to earning investment income through a corporation.

		Federal	New Brunswick	Total
Investment income earned through a corporation:		$1,000.00	$ 1,000.00	$1,000.00
Corporate tax rate		38.67%	12.00%	50.67%
Corporate tax on income	[C]	386.70	120.00	506.70
Dividend refund available	[R]	(306.70)		(306.70)
Income available for distribution		800.00	800.00	800.00
Personal tax rate on non-eligible dividends		26.30%	25.45%	51.75%
Personal tax on dividends	[P]	210.40	203.60	414.00
Total corporate and personal tax	**[T] = [C+P-R]**	**290.40**	**323.60**	**614.00**
Investment income earned directly by an individual:		1,000.00	1,000.00	1,000.00
Top marginal rate		33.00%	25.75%	58.75%
Personal tax on income	**[D]**	**330.00**	**257.50**	**587.50**
Integration results:				
Total savings (cost) of using a corporation	**[D - T]**	**39.60**	**(66.10)**	**(26.50)**

A tax deferral can arise where the amount of corporate tax (federal and provincial) is less than the amount of personal tax (federal and provincial) that would be payable had the individual earned the income directly. Conversely, a tax prepayment may arise where the amount of corporate tax exceeds the personal tax that would have been payable had the income not been flowed through a corporation.

Dividends paid by CCPC may be designated as eligible dividends to the extent of the balance in the corporation's general rate income pool (GRIP) at the end of its taxation year in which the dividend has been paid. Generally, GRIP is the accumulation of taxable income that did not benefit from preferential tax treatment such as the small business deduction (i.e. the low corporate tax rate) and the RDTOH afforded to investment income. Eligible dividends received from public and private companies will also retain their character and form part of the dividend recipient's GRIP balance. Eligible dividends are taxed more favorably to an individual than regular "non-eligible" dividends.

Tax rate changes for 2016 for CCPCs

The law currently provides that the tax rate on income eligible for the small business deduction will fall from 11.0% to 9% over 4 years beginning January 1, 2016. The changes to the small business tax rate are accompanied by consequential decreases to the dividend gross-up factor and dividend tax credit rate for non-eligible dividends between 2016 and 2019. The overall impact of these changes will be an increase to the federal top marginal tax rate on non-eligible dividend income for each of the 2016-2019 taxation years.

Consequential to the introduction of a new top personal income tax rate of 33% (up from 29%) Finance Canada introduced a number of amendments impacting how investment income is taxed by a CCPC (see *TaxNewsFlash-Canada* 2015-38, "Personal Tax Rate Changes Confirmed for 2016" for details of these changes).

Background — Recent proposed amendments to taxation of investment income
On December 9, 2015, Finance proposed in Bill C-2 the following consequential changes to the taxation of investment income earned by a CCPC:

- Refundable tax on CCPCs' investment income – increased to 10 2/3% (from 6 2/3%) effective for tax year-ends after 2015
  - For tax years that straddle December 31, 2015, the rate increase is prorated for the number of days in the tax year that are after 2015
- Refundable dividend tax on hand (RDTOH) – increased to 30 2/3% (from 26 2/3%) of aggregate investment income
  - For tax years that straddle December 31, 2015, the rate increase is prorated for the number of days in the tax year that are after 2015
- Dividend refund rate – increased to 38 1/3% (from 33%)
  - For tax years that straddle December 31, 2015, the dividend refund rate increase is prorated for the number of days in the tax year that are after 2015
- Part IV tax – increased to 38 1/3% (from 33 1/3%) effective for tax year-ends after 2015
  - For tax years beginning before 2016, assessable dividends are taxed at 33 1/3% if they are received before 2016 and at 38 1/3% if received after 2015

These changes generally result in integration remaining relatively steady for 2016 in comparison to 2015 as illustrated in Appendix 1. However, the integration rate changes have resulted in year-end dividend planning opportunities that should be considered.

Dividend tax planning opportunities for 2015

Pay dividends in 2015 vs. 2016 for absolute personal tax savings on distribution of active business income

Based on federal tax rate changes, the combined federal and provincial top marginal tax rates on non-eligible and eligible dividends are increasing starting in 2016 as illustrated in Row 2 of Appendix 2, "Personal Tax Paid on Dividend". Any corporation that is planning to make a dividend payment from active business income (where there is no RDTOH in the corporation) should consider making this distribution before the end of 2015 to qualify for the lower personal income tax rates.

In the case of eligible dividends, the tax savings of accelerating the payment of dividends into 2015 range from 2.62% in British Columbia to 10.69% in Alberta. For non-eligible dividends, the savings range from 2.63% in British Columbia to 9.4% in Alberta.

Shareholders requiring personal funds over the next few years may also consider accelerating dividends into 2015. The present value of the tax savings may rationalize the decision to pay in 2015.

Potential cash flow benefit of recovering RDTOH

Generally, a corporation receives a refund of its RDTOH at a rate of 33.33% of dividends paid in taxation years ended before 2016 and at a rate of 38.33% of dividends paid in taxation years ended after 2015. The refund rates will be pro-rated when a corporation's taxation period straddles December 31, 2015. When a corporation receives a refund of its RDTOH on paying either an eligible or non-eligible dividend, the result could be a positive cash flow to the combined personal/corporate entities. Appendix 2 summarizes the cash flow savings or cost of paying dividends to recover RDTOH in 2015 or 2016 for each province.

Corporations with taxation periods straddling December 31, 2015 may want to declare a dividend in 2015 to benefit from the lower personal tax rates while receiving the RDTOH refund at the higher prorated refund rate under the transitional rules. If, for example, a corporation with a June 30, 2016 taxation year-end paid a dividend to its shareholders in December 2015 it would be entitled to a dividend refund of 35.8% for its June 30, 2016 taxation year because of the transitional rule (i.e., six months in calendar 2015 at 33.33% and six months in calendar 2016 at 38.33%).

When to pay eligible dividends to recover RDTOH

In 2015, if a CCPC has both GRIP and RDTOH, there is a benefit in six provinces (British Columbia, Alberta, Saskatchewan, Manitoba, P.E.I. and Newfoundland) to paying out eligible dividends in 2015 to recover RDTOH as the personal tax rate on eligible dividends is lower than the 33.33% refund that the corporation will receive. The benefit ranges from a low of 1.07% in Manitoba to a high of 12.31% in Alberta.

In the case of a B.C. corporation, there is a 2.38% additional benefit to paying the eligible dividends in 2016 (versus 2015) to recover RDTOH.

When to pay non-eligible dividends to recover RDTOH

In 2015, there is a benefit to paying non-eligible dividends instead of eligible dividends to recover RDTOH in Alberta (2.49%) and Newfoundland (0.07%). These are the only two provinces where the combined top marginal individual tax rate on non-eligible dividends is still less than the 33.33% RDTOH refund.

In 2016, there is no cash flow benefit to paying non-eligible dividends to recover RDTOH, since the personal tax rate on non-eligible dividends is higher in all provinces than the corporate dividend refund rate of 38.33%.

Earning income through a corporation

Appendix 1 provides a comparison of the ultimate tax savings (cost) by province on the various types of investment and active business income earned by a Canadian corporation. Generally, on a fully distributed basis, the income tax benefits (costs) of earning income through a corporation have remained unchanged from prior years. Due to the higher personal tax rates, however, the income tax deferral benefit (prepayment cost) has changed. This is analyzed in greater detail below.

Tax deferral opportunities for small business earnings

In 2016, there continues to be a large tax deferral opportunity in all provinces on active business earnings that are retained in the corporation ranging from 19.3% to 44.3%. The higher end of the range for income tax deferral is for active income qualifying for the small business deduction. The widening gap between the higher personal tax rate and the corporate rate on active business income has increased the income tax deferral benefit of retaining profits in a corporation compared to the traditional payment of a bonus. The additional cash flow retained within the corporation, as a result of the lower corporate rates, may be used for reinvestment in business or investment opportunities. Payroll costs and eligibility for scientific research and experimental development incentives may also be factors in determining whether a corporation pays a bonus or retains the income to be paid out as a dividend in the future. However, when the retained income is ultimately distributed out to the

individual, the tax cost (savings) in most provinces are either tax neutral or have a marginal tax cost when earning active business income through a corporation.

Also, the non-income tax costs of incorporation should be carefully considered when a taxpayer is considering using a corporation to earn small business income as the flow-through tax savings are marginal.

Tax deferral opportunities for investment income

In 2015, there is a tax deferral opportunity in four provinces for earning investment income through a corporation including interest, rents, royalties and taxable capital gains that are retained in a corporation. In British Columbia, there is a modest 0.1% deferral, for Ontario and Quebec the deferral is 3.4%, and in New Brunswick, taxpayers can defer tax of 8.1% (see Appendix 1).

As a result of the federal tax rate changes, for 2016, there is now a tax deferral opportunity in only three provinces for investment income. In Ontario the deferral remains at 3.4%, in Quebec there is a 2.7% deferral, and in New Brunswick the deferral remains at 8.1% on investment income earned by a corporation (see Appendix 1). The tax deferral opportunities (costs) of earning eligible or ineligible dividends through a corporation vary by province.

KPMG observations
As a cautionary note, if you need to pay inter-corporate dividends through a corporate group to provide cash flow for your company to pay dividends to you personally, you should carefully review the 2015 federal budget's proposed change to the anti-avoidance rule that re-characterizes certain tax-free inter-corporate dividends as capital gains subject to tax. The recent changes significantly broaden the circumstances in which the anti-avoidance rule can apply, and many standard corporate transactions that give rise to dividends may now be caught by this rule (see *TaxNewsFlash-Canada* 2015-23, "Are Your Tax-Free Inter-Corporate Dividends in Jeopardy?").

We can help

Your KPMG adviser can help you assess the effect of the tax changes on your personal finances and point out benefits arising from the changes or help mitigate their impact before 2016. For details on these changes and their potential impact, contact your KPMG adviser.

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Appendix 1

Appendix 1 and 2 assume:

- The corporation is a CCPC with a taxation year-end of December 31
- Provincial tax rates remain consistent in 2016
- Tax rates and changes from Bill C-2 enacted
- Individuals are subject to tax at the top marginal tax rate and are assumed to be taxed in the same province as the corporation.

Integration – Cost and Benefit of Incorporation – Comparison 2016 and 2015

	B.C.		Alta.		Sask.		Man.		Ont.	
	2016	2015	2016	2015	2016	2015	2016	2015	2016	2015
Tax savings (cost) of incorporation										
Investment income	(4.2%)	(4.0%)	(4.2%)	(3.7%)	(4.1%)	(3.9%)	(6.2%)	(6.2%)	(2.4%)	(2.3%)
Capital gains	(2.0%)	(2.0%)	(2.1%)	(1.9%)	(2.0%)	(2.0%)	(3.1%)	(3.1%)	(1.2%)	(1.1%)
Dividends—Eligible	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Dividends—Non-eligible	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
ABI eligible for SBD	(0.6%)	(0.6%)	(0.3%)	(0.3%)	0.5%	0.6%	(1.0%)	(0.9%)	0.0%	0.1%
ABI in excess of SBD	(1.5%)	(1.4%)	(2.2%)	(1.3%)	(1.1%)	(1.1%)	(4.2%)	(4.2%)	(1.9%)	(1.8%)
Tax deferral (pre-payment) from incorporation										
Investment income	(2.0%)	0.1%	(2.7%)	(5.4%)	(2.7%)	(2.7%)	(0.3%)	(0.3%)	3.4%	3.4%
Capital gains	(0.9%)	0.1%	(1.3%)	(2.7%)	(1.3%)	(1.3%)	(0.1%)	(0.1%)	1.7%	1.7%
Dividends—Eligible	(7.0%)	(4.7%)	(6.6%)	(12.3%)	(8.0%)	(8.5%)	(0.6%)	(1.1%)	1.0%	0.5%
Dividends—Non-eligible	2.3%	4.7%	1.9%	(2.5%)	1.7%	1.6%	7.4%	7.4%	7.0%	6.8%
ABI eligible for SBD	34.7%	32.3%	34.5%	26.3%	35.5%	31.0%	39.9%	35.4%	38.5%	34.0%
ABI in excess of SBD	21.7%	19.8%	21.0%	14.3%	21.0%	17.0%	23.4%	19.4%	27.0%	23.0%

Integration – Cost and Benefit of Incorporation – Comparison 2016 and 2015

	Que.		N.B.		N.S.		P.E.I.		Nfld.	
	2016	2015	2016	2015	2016	2015	2016	2015	2016	2015
Tax savings (cost) of incorporation										
Investment income	(2.0%)	(1.8%)	(2.7%)	(2.8%)	(7.0%)	(7.0%)	(7.4%)	(7.3%)	(5.2%)	(5.3%)
Capital gains	(1.0%)	(0.9%)	(1.3%)	(1.4%)	(3.5%)	(3.4%)	(3.6%)	(3.6%)	(2.5%)	(2.5%)
Dividends—Eligible	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Dividends—Non-eligible	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
ABI eligible for SBD	(1.2%)	(1.3%)	0.0%	(0.1%)	(0.1%)	(0.0%)	(0.9%)	(0.9%)	0.7%	0.7%
ABI in excess of SBD	(2.7%)	(2.7%)	(0.2%)	(0.2%)	(5.7%)	(5.9%)	(3.2%)	(3.4%)	(8.0%)	(8.1%)
Tax deferral (pre-payment) from incorporation										
Investment income	2.7%	3.4%	8.1%	8.1%	(0.7%)	(0.7%)	(3.3%)	(3.3%)	(4.4%)	(5.4%)
Capital gains	1.4%	1.7%	4.1%	4.1%	(0.3%)	(0.3%)	(1.6%)	(1.6%)	(2.1%)	(2.6%)
Dividends—Eligible	1.5%	1.9%	5.5%	4.9%	3.3%	2.7%	(4.1%)	(4.6%)	0.2%	(1.8%)
Dividends—Non-eligible	5.9%	6.5%	13.4%	13.6%	8.6%	8.5%	5.5%	5.4%	1.1%	(0.1%)
ABI eligible for SBD	34.8%	31.0%	44.3%	39.8%	40.5%	36.0%	36.4%	31.9%	34.8%	29.3%
ABI in excess of SBD	26.4%	23.1%	31.8%	27.8%	23.0%	19.0%	20.4%	16.4%	19.3%	14.3%

Appendix 2

Net Cash Flow Savings (Cost) on Paying a Dividend from a Corporation with RDTOH in 2015 or 2016

	Ontario				Quebec				New Brunswick				Nova Scotia			
	Eligible Divs		Non-Eligible Divs		Eligible Divs		Non-Eligible Divs		Eligible Divs		Non-Eligible Divs		Eligible Divs		Non-Eligible Divs	
	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016
Dividend refund received by corporation	33.33%	38.33%	33.33%	38.33%	33.33%	38.33%	33.33%	38.33%	33.33%	38.33%	33.33%	38.33%	33.33%	38.33%	33.33%	38.33%
Personal tax paid on dividend	33.82%	39.34%	40.13%	45.30%	35.22%	39.83%	39.78%	44.23%	38.27%	43.79%	46.89%	51.75%	36.06%	41.58%	41.87%	46.97%
Net cash flow savings / (cost) on paying out dividend	(0.49%)	(1.01%)	(6.80%)	(6.97%)	(1.89%)	(1.50%)	(6.45%)	(5.90%)	(4.94%)	(5.46%)	(13.56%)	(13.42%)	(2.73%)	(3.25%)	(8.54%)	(8.64%)

	British Columbia				Alberta				Saskatchewan				Manitoba			
	Eligible Divs		Non-Eligible Divs		Eligible Divs		Non-Eligible Divs		Eligible Divs		Non-Eligible Divs		Eligible Divs		Non-Eligible Divs	
	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016
Dividend refund received by corporation	33.33%	38.33%	33.33%	38.33%	33.33%	38.33%	33.33%	38.33%	33.33%	38.33%	33.33%	38.33%	33.33%	38.33%	33.33%	38.33%
Personal tax paid on dividend	28.68%	31.30%	37.98%	40.61%	21.02%	31.71%	30.84%	40.24%	24.81%	30.33%	34.91%	40.06%	32.26%	37.78%	40.77%	45.69%
Net cash flow savings / (cost) on paying out dividend	4.65%	7.03%	(4.65%)	(2.28%)	12.31%	6.62%	2.49%	(1.91%)	8.52%	8.00%	(1.58%)	(1.73%)	1.07%	0.55%	(7.44%)	(7.36%)

	PEI				Newfoundland			
	Eligible Divs		Non-Eligible Divs		Eligible Divs		Non-Eligible Divs	
	2015	2016	2015	2016	2015	2016	2015	2016
Dividend refund received by corporation	33.33%	38.33%	33.33%	38.33%	33.33%	38.33%	33.33%	38.33%
Personal tax paid on dividend	28.71%	34.22%	38.74%	43.87%	31.57%	38.47%	33.26%	39.40%
Net cash flow savings / (cost) on paying out dividend	4.62%	4.11%	(5.41%)	(5.54%)	1.76%	(0.14%)	0.07%	(1.07%)