

GRIP: Part Two – Implications for Investors and Entrepreneurs



The new-and-improved dividend tax rules require a fresh approach to strategic tax planning for investors and entrepreneurs

By Don Nilson, CMA, FCMA

In the previous issue, we reviewed the historical background to the taxation of dividends in Canadian tax law, leading up to the introduction in 2006 of the new “GRIP” and “LRIP” (“general rate income” and “low rate income”) corporate tax accounts. The former involves **Canadian private** companies only and the latter involves **Canadian public** companies only. That article reviewed the implications for those corporations in managing their tax affairs.

In this issue, we turn to **individual investors** – both **stock market investors in public companies** and **entrepreneurs in private companies**. Both need to come to grips with the significant implications of **GRIP** and the new dividend tax law.

Commencing in 2006, there is now a **dual integration** system, one for public and one for private. **Investors in private companies** engaged in entrepreneurship enjoy the “old” system on the first \$400,000 of annual profits, now called “**ineligible**”; and the new system for profits in excess of \$400,000, now called “**eligible**”. **Investors in public companies** enjoy the new, richer “eligible” system. The two systems differ in the math of the gross-up and credit. Ineligible dividends have a gross-up of 25% while eligible ones have a gross-up of 45% (The difference reflects the different tax rates paid previously by the corporation). The dividend tax credit has

two components – federal and provincial. In BC, the combined credit is 18.43% of the grossed-up amount for ineligible dividends and 30.97% for eligible dividends.

The accompanying Chart A gives some perspective on the implications of each system. The top row shows the 2008 personal marginal tax bracket ranges in BC. The rows following show the **marginal tax rates** in BC for an incremental dollar of **different kinds of investment income** at different income levels (Note that this chart would vary significantly from province-to-province).

Implications for stock market investors

A number of observations are worthwhile. First, the tax rate on eligible dividends is now **lower** than it is on capital gains, across all marginal tax brackets. Second, in comparing the two sets of tax rates for dividends, we underscore how **over-taxed** public company dividends have been all of these years. Third, **eligible** dividends are **totally tax-free** for incomes under \$70,000, and only slightly taxed between \$70-75,000. Fourth, the top tax rate on eligible dividends is 18.4%. Fifth, the “zero” (*) tax rate on incomes under \$70,000 has a brand new additional implication - in fact, the dividend tax rate at the first three brackets is not zero, **but negative**: -15.56%, -11.59% and -1.44% respectively.

The tax credit received on dividends applies to the **total** tax bill resulting from total income. This means that, for incomes **under \$70,000**, eligible dividends are not only tax-free but actually **reduce the tax on other** income of the taxpayer. A “leakage” problem occurs when the taxpayer **does not have other sources of income** to soak up the excess dividend credits. For instance, someone in the lowest bracket earning only eligible dividends could leave as much as \$5,600 of tax credits on the table.

A foregone tax reduction of this size may **inspire tax planning initiatives** that have not been previously necessary in the world of only **ineligible** dividends. For instance, in this circumstance the tax law long has permitted a couple to transfer the dividend income (and the related tax credits) from the lower income spouse to the higher income spouse. If the transferee spouse can enjoy the tax credits and pays little or no tax on these extra dividends, the **benefit** for the couple would be the tax break on whatever dependent credits can now transfer, which can be quite sizable. But this only works if there is a couple!

Another **tax planning strategy** to address sizable leakage is to **manage taxable income** in some fashion. One version of this critically requires **pro-activity during the tax year** while the other version requires some cleverness **when preparing the tax returns** in the following Spring. **Proactive** steps would involve generating some taxable income to soak up the credits. This might, for instance, involve cashing out some RRSP funds! While this might seem heretical, in fact, it might make sense to use the proceeds to contribute to the new Tax-Free Savings Accounts which join our world in 2009. Alternately, unrealized capital gains could be harvested to generate more income.

Chart A

Taxable income	<\$35,016	\$35,017-37,885	\$37,886-70,033	\$70,034-75,769	\$75,770-80,406	\$80,407-97,636	\$97,637-123,184	>\$123,184
Interest	20.2%	23.0%	30.0%	32.5%	36.5%	38.3%	40.7%	43.7%
Capital gain	10.1%	11.5%	15.0%	16.2%	18.2%	19.1%	20.3%	21.8%
Ineligible Dividend	2.3%	5.7%	14.4%	17.6%	22.6%	24.8%	27.8%	31.6%
Eligible Dividend	0%*	0%*	0%*	2.2%	8.0%	10.6%	14.1%	18.4%

GRIP [cont'd]

Some income management strategies can be executed **at tax preparation time**. For instance:

- Defer RRSP deductions on contributed amounts
- Defer CCA on rental or self-employment income
- Accelerate the taxation of a previous capital gains reserve
- Defer some credits, like donations and medical expenses
- Transfer eligible credits to your spouse
- Elect pension splitting with a transferee spouse
- Defer permissive tax shelter deductions
- Defer loss carryforward claims

Implications for entrepreneurs

The dual integration system is good for entrepreneurs as well as investors. The old system only integrated well for corporate income taxed at a low corporate rate, which is what applies to many entrepreneurs. However, entrepreneurs making profits in excess of the Small Business Limit (recently raised to \$400,000 annually) historically found themselves trapped into a high salary/bonus distribution tax strategy in order to avoid inadequate integration. This meant drawing a salary in excess of the entrepreneurs' personal needs, and resulted in high personal tax bills. Now, with the dual system, the entrepreneur only needs to draw compensation to fund personal needs, and the excess business profits can be taxed in the company with impunity

because those profits can be withdrawn in the future as eligible dividends with proper integration.

The implications of the dual system go further. An entrepreneur with low personal income needs and whose company has **eligible** dividends available in the GRIP pool, may find it "tax smart" to **voluntarily** take **greater** compensation than needed, in the form of eligible dividends. We can see this from the chart, which tells us that voluntary eligible dividends which raise the taxable income up to \$70,000 will come tax-free.

This introduces a fundamental annual tax planning principle of use-it-or-lose-it, akin to using up personal credits each year. When the entrepreneur has a tax-free dividend window up to \$70,000 annually, it should be used, not wasted. If the entrepreneur doesn't need the extra cash, the extra funds can be retained in the business and sit in a tax (free) paid shareholder loan account in the company.

However, this strategy needs to be managed in the long term if the entrepreneur intends to sell the company and qualify for the \$750,000 capital gains deduction. If the company holds too much liquidity from its retained earnings, the share sale may not qualify for the tax-free capital gain.

Entrepreneurs who own **passive holding companies** get a new and good result, too, with eligible dividend rules. Typically, their HoldCos will only generate GRIP from the **dividends** in a

portfolio of public stockholdings, but not from interest or rental income or capital gains. However, the HoldCo might also own shares in the entrepreneur's active company, which generates business profits in excess of the Small Business Limit. An eligible dividend paid to the entrepreneur from a HoldCo will cause that income to be tax-free as it passes through the HoldCo and taxed to the entrepreneur, according to Chart A.

Lastly, for investors or entrepreneurs with exclusively, and large, eligible dividends, the interplay of federal tax, provincial tax and Alternate Minimum Tax (AMT) can leave one's head spinning. Finding an optimum and tax-free strategy is pretty well impossible. This is new, because the old **ineligible** dividend system never attracted the wrath of AMT. For instance, while the chart above indicated that an incremental amount of eligible dividends was tax-free up to \$70,000, if one's income is **solely** eligible dividends, the AMT changes that result. In fact, only \$49,000 of such dividends are tax-free; above this, the AMT kicks in. At \$70,000, the AMT tax bill would approximate \$4,100 instead of being free and, furthermore, the provincial tax credits are not fully enjoyed.



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In the next issue of Update Don will review the tax and financial planning issues of the new Tax Free Savings Accounts.



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