Northwest Territories

Backgrounder

R(15)280906313 Dividend Tax Credit
YELLOWKNIFE (28 September, 2006)

The Government of the Northwest Territories proposes to match anticipated federal increases to the dividend tax credit beginning with the 2006 tax year.

- Income earned at the corporate level is subject to both corporate income tax (CIT) and, after it is distributed as dividends to individuals, personal income tax (PIT). The PIT system provides relief from this "double taxation" through mechanisms referred to as the gross-up and the dividend tax credit (DTC). Depending on both the CIT rates and the PIT rates in effect, these mechanisms may compensate too much or not enough for taxes paid at the corporate level. When the system does not provide enough compensation an element of double taxation remains and thus creates incentives to avoid this taxation.

How the "Gross Up" and Dividend Tax Credit Work

Under the current income tax system, income earned by corporations is taxed at the corporate tax rate. If that income is paid out as dividends to individuals, it is taxed again, at the personal tax rate. Without any other measures, this would result in double taxation.

To address this, the tax system uses two mechanisms: the "gross up" and the dividend tax credit. Therefore, if we assume a corporation earns $100 in income, and pays out all the after-tax amount in dividends, the corporation will pay 30.5 per cent, or $30.50, in income tax and distribute $69.50 in dividends.

The individual receiving the $69.50 in dividends "grosses up" his or her income by 125 per cent, and reports $86.90 in income. This is intended to approximate the before-tax income of the corporation. Assuming a personal tax rate of 43.05 per cent, the individual is liable for $37.40 in tax on this income.

The individual is then eligible to claim a Dividend Tax Credit of 19 1/3 per cent of the grossed up amount, or $16.80, for a net tax liability of $20.60

The total tax paid by both the corporation and the individual is $51.10.

- When the gross-up and DTC are fully integrated with the CIT and PIT rates then there is no difference in taxes paid based on whether the business is operated as a corporation or some other structure.

- The current income tax regime in Canada is not fully integrated. An NWT taxpayer receiving a distribution of $100.00 from a flow-through arrangement such as an income trust would pay PIT of $43.05. The same $100.00 earned by a corporation and paid out in dividends would result in payment of $30.50 in CIT and $20.60 in PIT, for a total tax of $51.10. (see Table 1 for details).

- Where too much tax compensation is provided by the gross-up/DTC mechanisms, there is a tax advantage to incorporating compared to other ownership structures. When the gross-up/DTC mechanisms provide inadequate compensation, companies have an incentive to reorganize as trusts or other flow-through entities to save taxes. Flow-through structures can take the form of sole ownership, partnerships, or income trusts. Flow-through entities allow their owners to escape tax at the entity level to the extent that income is attributed to the unit holder in the case of income trusts, or partners in the case of limited partnerships. These distributions are taxed in the hands of the recipients.

- The May 2006 federal Budget announced measures designed to minimize the incidence of double taxation of dividends and make the total PIT and CIT on earnings distributed as dividends more comparable to the income tax paid on interest, income trust distributions or other flow-through structures.

NWT DIVIDEND TAX CREDIT PROPOSAL:

- The GNWT is proposing to fully harmonize the NWT's DTC rate with that proposed by the federal government so that the NWT DTC for eligible dividends is approximately equal to the NWT general corporate tax rate. The DTC rate would be 6.67 / 18 (approximately 37 per cent) of the 45 per cent gross-up of dividends or 11.5 per cent of the grossed-up dividends.

- Eligible dividends are designated dividends paid after 2005 by public corporations and other corporations that are resident in Canada. If a Canadian-controlled private corporation designates dividends that are paid out of income that is subject to tax at the small business rate, it is subject to federal penalty tax.

- The proposed NWT treatment of the DTC would provide tax treatment of dividends similar to the tax treatment provided to the flow-through structures.

- Table 1 shows the CIT and PIT impacts for this treatment of the dividend tax credit compared with alternatives, assuming $100 in corporate taxable income.

TABLE 1
Total Taxes Paid on $100 of Corporate Income.
Assuming all after tax income is distributed.

			Dividends paid by large corporations	
		Flow-through	Current	GNWT proposed legislation
A	Corporate Income	100.0	100.0	100.0
	CIT			
B	Federal (19 % of A)	N/a	19.0	19.0
C	NWT (11.5% of A)	N/a	11.5	11.5
D	**Total CIT (B plus C)**	**-**	**30.5**	**30.5**
E	Amount distributed to investor (A minus D)	100.0	69.5	69.5
F	Gross-up (E times currently 25%; changes to 45%)	-	17.4	31.3
G	Grossed-up amount included in personal income received by investor (E plus F)	100.0	86.9	100.8
	PIT			
H	Federal (G times 29% - highest PIT rate)	29.0	25.2	29.2
I	NWT (G times 14.05% - highest PIT rate)	14.1	12.2	14.2
J	**Total PIT (H + I)**	**43.1**	**37.4**	**43.4**
	Dividend Tax Credit			
K	Federal (currently 2/3 of gross-up (F); changes to 11/18)	-	11.6	19.1
L	NWT (30% of gross-up (F), proposed to 6.67 / 18)	-	5.2	11.6
M	**Total DTC (K plus L)**	**-**	**16.8**	**30.7**
N	Net PIT (J minus M)	43.1	20.6	12.7
	Total Tax paid			
O	Federal (B plus H minus K)	29.0	32.6	29.1
P	NWT (C plus I minus L)	14.1	18.5	14.1
Q	**Total Tax paid (O plus P)**	**43.1**	**51.1**	**43.2**