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The Tax Informant

The Department of Finance Canada and its civil servants in complete disarray (Part 1) – Section A

MAJOR MISTAKES AND OMISSIONS, BLUNDERS CAUSED BY "PRACTICAL" INCOMPETENCE, AND LETHARGY ARE CAUSING MAJOR HARM TO TAXPAYERS AND COSTING THE FEDERAL GOVERNMENT A FORTUNE!

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A. Six years for a correction to the taxation of "non-eligible" dividends: an oversight that has cost the government at least $2.5 billion

From 2008 to 2015, the federal tax rate for small companies (SME) was cut from 13.12% (a rate implemented in 1995) to 11.0% (it is 10.5% since 2016). Normally, as per the "principle of integration", an incredibly important and nearly sacred concept in Canadian taxation, a reduction of the tax rate for SMEs should have been accompanied by a higher taxation of dividends derived from the SME's earnings generated by this reduced taxation. As a quick reminder, the concept of integration requires that the dividends received by the individuals and included in their income be grossed-up to roughly correspond to the SME's earnings before taxes and a dividend tax credit (DTC) is granted to the individual on the "grossed-up dividend", essentially corresponding to the tax paid by the SME. Therefore, an individual receives compensation for the taxes paid by the SME via the dividend credit in order to avoid double taxation. As per the principle of integration, the sum of the tax paid by the SME on his profits and by the individual on dividends is supposed to be the same amount as would have been the tax paid by the individual if he had himself earned the income.

What really happened?

It took exactly six years for the Department of Finance's civil servants to make the necessary adjustments. How much did this cost "other" taxpayers? At least $2.5 billion. Was it difficult to calculate this amount? Not really… We simply took the Department of Finance's own figures from the federal budget of March 21, 2013 in which they listed the annual additional revenue they would be collecting for every fiscal year from 2014-2015 to 2017-2018 (with an annual growth in revenue of slightly more than 6%) and we applied the same principles by retroactively calculating it from 2008-2009 to 2013-2014 (with the necessary little adjustments). And this figure is conservative because the Department of Finance has stated, in a document obtained under the Access to Information Act, that the federal tax system was "over-integrated" for non-eligible dividends by an average of 1.4%. For residents of Ontario, this federal figure came out to 1.65% in 2008 and 2009, 1.55% in 2010, and 1.46% from 2011 to 2013.

Are we sure that the civil servants working at the Department of Finance made a mistake by not adjusting the taxation of dividends?

Absolutely… they even say so themselves in their budgetary documents (Budget plan 2013, page 336, paragraphs 3 and 4):

> *"The current DTC and gross-up factor applicable to non-eligible dividends overcompensate individuals for income taxes presumed to have been paid at the corporate level on active business income. As such, an individual who receives dividend income from a corporation is in a better tax position than if the individual had earned the income directly.*

To ensure the appropriate tax treatment of dividend income, Budget 2013 proposes to adjust the gross-up factor applicable to non-eligible dividends from 25 per cent to 18 per cent and the corresponding DTC from 2/3 of the gross-up amount to 13/18. Expressed as a percentage of the grossed-up amount of a non-eligible dividend, the effective rate of the DTC in respect of such a dividend will be 11 per cent."

By way of comparison, in 2007 (when the federal tax rate for SMEs was 13.12%), compensation allocated to individuals for the federal tax paid by the corporation was 13.33% (very similar to the federal corporate tax rate of 13.12%) whereas the compensation allocated to individuals from 2008 to 2013 via the dividend credit for federal taxes paid by the corporation remained at 13.33%, despite a reduced corporate federal tax rate of 11% since 2008.

Additionally, this "tax gift" erroneously granted between 2008 and 2013 to Canadian taxpayers having earned non-eligible dividend income allowed our organization to identify in 2013 another problem, this time related to dividends allocated to Quebec residents (more than 650,000 Quebecers are affected every year), due to the 16.5% federal tax abatement that applies to the dividend tax credit (non-eligible and eligible) for federal taxes. That allows the government of Quebec (thanks to rules on transfer payments) to fill its pockets on the back of 650,000 Quebecers (see the note at the bottom of the page to read this study in French[1]).

Here is what we wrote in September 2013 on page 5 of our document published after the civil servants at the Department of Finance made the adjustments to the taxation of non-eligible dividends:

"After analyzing these scenarios and noticing the differences at the federal level regarding the dividend tax credit and taxes paid by the company, there are a few issues that we cannot overlook… Killer questions…

How is it that no one working for the tax authorities noticed this gift of a few billion dollars for non-eligible dividends, a situation that has existed since 2008?"

As further evidence, one needs only to take a look at the documents included in the April 21, 2015 federal budget which announced new progressive tax cuts for SMEs in 2016 (from 11% to 9% over four years, but in the end, only the first 0.5% cut was implemented). The budget planned for **immediate changes** to the taxation of non-eligible dividends. Civil servants at the Department of Finance thereby admitted they had been dragging their feet from 2008 to 2013. In addition, as a result of an access to information request that we recently made, the Department of Finance admitted that the dividend tax system at the federal level had been "over-integrated" for non-eligible dividends during that period. This is a very technical expression to basically say that they had been asleep at the wheel and that non-eligible dividends were not taxed enough! In the documents obtained from our access to information request, they provided a very evasive and non-committal answer as to why this was not done in 2008 instead of announcing it in the 2013 federal budget (but would only apply in 2014). We therefore took it upon ourselves to list the consequences of their negligence: this gaff cost the federal government at least $2.5 billion by allocating this amount to taxpayers who should not have received this advantage (including this author) … and it is not the only mistake that has been committed. Other devastating examples will be given in future publications, we promise.

[1] Please visit **www.cqff.com/liens/integration.pdf**