Restore the Integration of the Corporate and Personal Income Tax

Issue

A fully integrated income tax system, as stated by the Carter Commission Report, would avoid double taxation under the corporate income tax system and the private income tax system, while ensuring that there is relative indifference between earning income through a Canadian corporation, by salary or by dividend. It would also address other distortions in Canadian taxation.

Background

The Royal Commission on Taxation, better known as the "Carter Commission", conducted its comprehensive review of the Canadian income tax system over 50 years ago in 1966, rendering its report to Canadians in 1972. The Carter Commission Report introduced, among other recommendations, the concept that income should be taxed at the same rate regardless of whether it was earned in a corporation or personally. This concept has become known as the concept of "tax integration" of the personal income tax system **(PIT)** and the corporate income tax system **(CIT).** To accomplish this objective the Canadian Income Tax Act has various tax integration mechanisms. In effect what this means is that the Canadian personal and corporate income tax systems are integrated to yield the same overall tax liability regardless of the structure used to earn the income, which, in theory, should not influence a taxpayer's decision as to whether the income should be earned personally or through a corporate structure. These tax integration mechanisms have two major components.

The first relates to active corporate income, also called active business income **(ABI).** There are two stages of taxation of corporate earned business income. For a Canadian Controlled Private Corporation **(CCPC)** that earns active business income that qualifies for the small business deduction (SBD) there is a low rate of corporate tax charged, which is currently 11% (combined federal and provincial rates) in Alberta. That same income, if earned personally, would be taxed at 48% in Alberta at top personal marginal tax rates. How is this remaining 37% of tax charged to maintain integration? The dividend tax credit mechanism achieves the first element of integration at the PIT level. When a dividend is paid to the shareholder it is "grossed-up" to a taxable dividend and the taxpayer pays tax at full personal marginal tax rates but receives a dividend tax credit more or less equal to the tax the corporation originally paid. As a result (in theory) the overall tax rate is the same and tax integration is achieved.

The second tax integration mechanism relates to passive or investment income earned in a corporation. In this case the objective is to ensure that there is no tax benefit to earning investment income in a corporation by paying a lower rate of tax. This is accomplished by taxing the investment income earned by the corporation at high rates, in past years about the same as would be paid by an individual earning the income directly. However, in this case, part of the tax is allocated to the refundable dividend tax on hand **(RDTOH)** account with this amount being refunded to the corporation at a prescribed dollar rate for every dollar of taxable dividends paid to a (human) shareholder. Theoretically, this amount is passed to the shareholder to be taxed under the PIT system thereby again achieving tax integration.

Under these mechanisms, personal income tax returns allow taxpayers to gross-up their dividend income and then apply a tax credit to adjust the amount of taxes payable. The rates of gross-up and credit were initially set to achieve the full integration of CIT and PIT for small businesses. Since its creation in 1972, the dividend tax credit as well as statutory corporate tax rates have changed. As a result, in some years there has been over-integration for small business in the sense that the dividend credit was generous enough to reduce the combined tax on dividend income below that on other income. With the provinces levying differential rates of corporate tax on small business, and with federal and provincial surtaxes, the situation has become more complex. At present there is consistent over-integration throughout the provinces, with the departures from full integration being most significant for investment income earned by a corporation.

The most recent changes to the Income Tax Act, Canada **(the Act)** have resulted in dramatic and punitive changes with the way CCPC's are taxed on active and investment income earned. The result has been the absolute decimation of the Carter Commission's objective of integration of the CIT and PIT as we have witnessed the under-integration of all forms of income distributed from a corporation grow dramatically from mere tenths of a percentage point to in excess of 11% per cent in the 2019 taxation year. As recently as 2012, the disparity between earning $1,000 of investment income in a corporation versus earning the same $1,000 personally was a mere $17.20 of additional tax paid.' Today that same disparity has grown to $116.20 — a 676% increase in the associated tax cost.

The value of a fully integrated income tax system, as stated by the Carter Commission Report, is to avoid double taxation under the CIT and PIT while ensuring that there is relative indifference between earning income through a Canadian corporation, by salary or by dividend. The full integration of the CIT and PIT has the further benefit of eliminating another non-neutrality of the existing corporate income tax in Canada, the distortion of incorporation decisions. Without full integration, the combined taxation of corporate source income exceeds the taxation of comparable unincorporated businesses.

[1]See Appendix A for a full comparison of the 2012 integration tables to the 2019 integration tables.

Taxation of Dividends in Alberta - 2012 vs. 2019 **Appendix A**

	2012 - Income					2019 and on – Earned Income				
	Earned Personally	Earned at general rate	Earned at SBD rate	Earned As Investment Income	Earned As Capital Gains	Earned Personally	Earned at general rate	Earned at SBD rate	Earned As Investment Income	Earned As Capital Gains
Corporate										
Income Earned		1,000.00	1,000.00	1,000.00	1,000.00		1,000.00	1,000.00	1,000.00	1,000.00
Federal Corporate Tax		150.00	110.00	150.00	346.70		150.00	100.00	386.70	193.35
Alberta Corporate Tax		100.00	30.00	110.00	100.00		120.00	10.00	120.00	60.00
Total Corporate Tax		250.00	140.00	260.00	446.70		270.00	110.00	506.70	253.35
After-Tax Cash (Dividend)		750.00	860.00	740.00	553.30		730 00	890.00	493.30	246.65
Dividend Refund (Federal)					266.70				306.70	153.35
Effective Tax Rate	0.00%	25.00%	14.00%	26.00%	18.00%	0.00%	27.00%	11 00%	20.00%	10.00%
Personal										
Dividend received/Income[49]	1,000.00	750.00	860.00	740.00	820.00	1,000.00	730.00	890.00	800.00	400.00
Taxable dividend	N/A	1,035.00	1,075.00	1,021.20	1,025.00	N/A	1,007.40	1,023.50	920.00	460.00
Federal tax @29%/33%	290.00	300.15	311.75	296.15	297.25	330.00	332.44	337.76	303.60	151.80
Dividend tax credit	N/A	155.45	143.33	153.38	136.67	N/A	151.31	92.42	27.42	13.71
Net federal personal tax	290.00	144.70	168.42	142.77	160.58	330.00	181.13	245.33	276.18	138.09
Alberta personal tax	100.00	103.50	107.50	114.89	102.50	150.00	151.11	153.53	138.00	69.00
Dividend tax credit	N/A	(103.50)	(37.63)	(102.12)	(35.88)	-	(100.74)	(20.06)	(18.03)	(9.02)
Net Alberta personal tax	100.00		69.88	12.77	66.63	150.00	50.37	133.46	119.97	59.98
Total personal income taxes	390.00	144.70	238.29	155.53	227.21	480.00	231.50	378.80	396.15	198.08
After-Tax Cash to S/H	610.00	605.30	621.71	584.47	592.79	520.00	498.50	511.20	403.85	701.92
Effective Rate[50]	39.00%	19.29%	27.71%	21.02%	27.71%	48.00%	31 71%	42.56%	49.52%	49.52%

49 Dividends received for the purposes of recovering RDTOH are calculated at 2.61 times the dividend refund. In most cases there is insufficient income to recover all RDTOH.

50 Personal effective rate for capital gains earned personally is 24% due to the 50% inclusion rate.

Taxation of Dividends in Alberta - 2012 vs. 2019 (Cont.) — Appendix A (Cont.)

	2012 - Income					2019 and on – Earned Income				
	Earned Personally	Earned at general rate	Earned at SBD rate	Earned As Investment Income	Earned As Capital Gains	Earned Personally	Earned at general rate	Earned at SBD rate	Earned As Investment Income	Earned As Capital Gains
Total income taxes paid										
Corporate		250.00	140.00	260.00	180.00		270.00	110.00	200.00	100.00
Personal	390.00	144.70	238.29	155 53	227.21	480.00	231.50	378.80	396.15	198.08
Total tax paid (corporate + personal)	390.00	394.70	378.29	415.53	407.21	480.00	501.50	488.80	596.15	298.08
Effective combined tax rate	39.00%	39.47%	37.83%	41.55%	40.72%	48.00%	50.15%	48.88%	59.62%	29.81%
Over/(Under) integration		-0.47%	1.17%	-3.72%	-1.72%		-2.15%	-0.88%	-11.62%	-5.81%

The Alberta Chambers of Commerce recommends the Government of Canada:

1. Department of Finance undertake a full review of the integration mechanisms that currently exist within the Act, including, but not limited to:
    - CIT rates for active small business, general and investment income;
    - the additional tax on investment income earned in a corporation;
    - the PIT dividend gross-up mechanism; and,
    - the PIT dividend tax credit;
    - the CIT RDTOH rates;
    - eligible dividend PIT rates;
    - non-eligible dividend PIT rates; and,
    - PIT rates.
2. That upon completion of this review, the Department of Finance amend the applicable rates and provisions of the Act to ensure the restoration of tax integration as recommended by the Carter Commission Report.

The Alberta Chambers of Commerce recommends the Government of Alberta:

3. Implement a refundable CIT mechanism to ensure that provincial PIT and CIT systems support the integration of all forms of income earned and taxed in the province.