2019 Changes to Refundable Dividend Tax on Hand

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In 2018, the Federal Government introduced several tax changes affecting small businesses and small business owners. One of these changes that did not get as much coverage in the press was a change to the system for Refundable Dividend Tax on Hand ("RDTOH"), for years commencing after 2018.

For corporations with a calendar year end, this change comes into effect on January 1, 2019. RDTOH is a calculation done within the Corporate Tax Return to facilitate integration and to ensure that tax payable on investment income is the same regardless of whether that investment income is earned inside a corporation or is earned personally.

The basic concepts of RDTOH are that a corporation pays a high tax rate when it earns investment income with a portion of this high tax rate being refundable to the corporation when it pays out a dividend to shareholders. In New Brunswick, the corporate tax rate on investment income is 52.7%. Of this 52.7% tax rate, 30.7% is refundable back to the corporation as a dividend refund when it pays out a dividend. The net overall tax rate to the corporation on the investment income is therefore 22.0% (52.7% - 30.7%).

When a corporation pays out dividends to shareholders there are two types – eligible dividends and non-eligible dividends. Eligible dividends are derived from corporate income that has been taxed at the higher general active business rate (29.0% in NB). This income is tracked in the company's General Rate Income Pool ("GRIP") and only dividends out of GRIP are considered eligible dividends. Non-eligible dividends are derived from corporate income that has been taxed at the lower small business rate (12.5% in NB). Prior to the changes coming into effect on January 1, 2019, the dividend refund received by a corporation on paying out dividends to shareholders did not consider whether eligible or non-eligible dividends were being paid.

Effective January 1, 2019, new eligible and non-eligible RDTOH pools will be created. The opening balance in the eligible RDTOH pool will be the lesser of:

a) The existing RDTOH balance, and
b) 38.33% of GRIP

Any RDTOH not included in the eligible RDTOH pool will be added to the non-eligible RDTOH pool.

When a company pays an eligible dividend, it can only get a refund out of its eligible pool. When a company pays a non-eligible dividend, it can get a refund from its non-eligible pool first, and from it eligible pool after its non-eligible pool is depleted.

As a result of these upcoming changes, small business owners should consult their local DFK office to determine whether planning is necessary to optimize their eligible RDTOH and GRIP prior to January 1.

For example, it can be extremely beneficial to move GRIP from an operating company that does not have RDTOH to a holding company which does have RDTOH.

Aligning GRIP and RDTOH in the same company will allow for payment of eligible dividends and dividend refunds from eligible RDTOH going forward. In NB the difference in personal income tax rates on eligible dividends and non-eligible dividends is 13.4% based on the top marginal tax bracket. The difference can be as high as 18.5% in lower marginal tax brackets. Therefore optimizing the GRIP and RDTOH can save shareholders between 13.4% and 18.5% on dividends they receive after December 31, 2018.

For an example of this, consider a holding company that owns 100% of the shares of an operating company. The holding company has a large RDTOH balance generated in prior years from portfolio investments but no GRIP balance. The operating company has a large GRIP balance generated in prior years from having income in excess of the small business deduction limit but no RDTOH. The operating company can pay an eligible dividend up to the holding company prior to January 1 in order to move the GRIP balance up to the holding company and aligning the GRIP and RDTOH in the same company. Without this alignment a future dividend of, for example, $100,000 would cost the shareholder at least an extra $13,400 of personal tax.

Where this is a one-time planning opportunity and the time to act is running out, we strongly recommend that you contact your local DFK office to determine if such planning will help you and your business.