Canadian taxing double jeopardy

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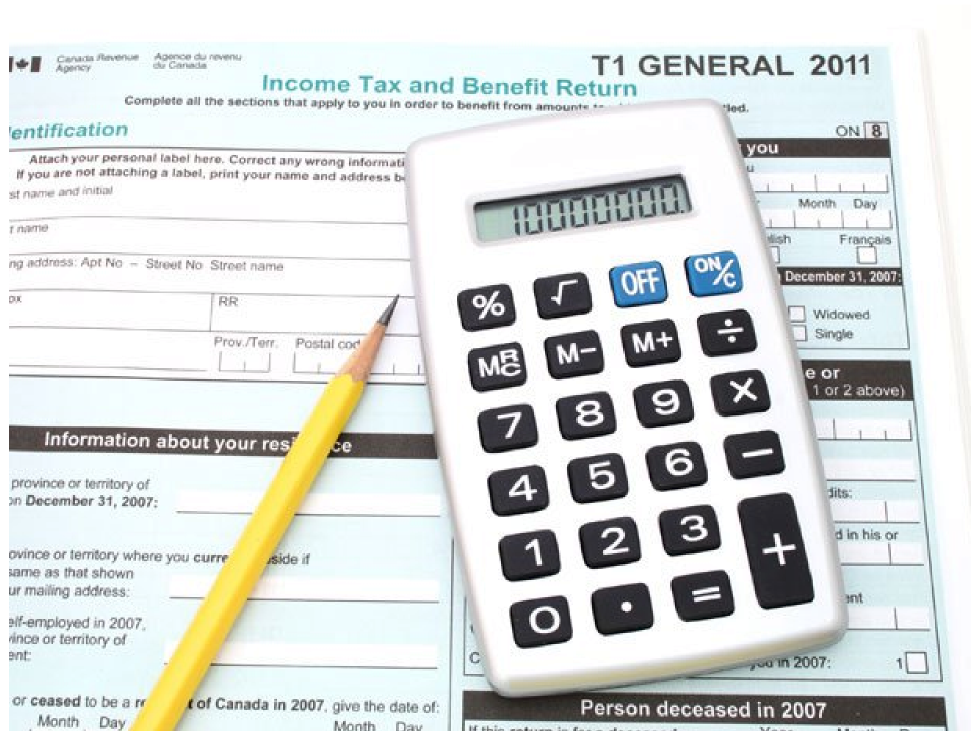

Removing the double taxation of dividend income would simply level the playing field. Fotolia

April is the month for taxes and time to reflect on the complexity of our tax system.

Start with the basics: What is income? All realized gains except those that are not income. What tax rate applies to income? Pick a number from 0% and 50% (or higher if you live in Ontario and earn more than $500,000). Should we “soak the rich”? Who are the rich and how much more revenue can we squeeze out of them?

There were 24.5 million tax returns filed in Canada in 2009 (the latest year for which statistics are available). Of these, 33% did not pay any taxes at all but received credits. About 5% had incomes above $100,000. If we define “rich” as income of $250,000 or more, there were only 0.7% of returns that qualified, most of whom had substantial investment income from dividends and capital gains.

A fundamental principle of a tax system is that it should be fair and avoid double taxing the same source of income. Canada double taxes corporate profits — first at the corporate level and then again when the company pays out its after-tax profits as dividends to shareholders. For example, when a Canadian public company earns $100, it will pay approximately $27 in tax. When it pays the remaining $73 of its after-tax income as a dividend to its shareholders, a top marginal rate individual (Ontario) will pay an additional $24 (net of dividend tax credits) in personal tax. Thus, depending upon province of residence, the total tax bill is about 52%.

In contrast, the tax system favours the issuance of debt capital by allowing companies to deduct interest on their indebtedness. By deducting its interest expense, a corporation saves 27% on its interest expense. Concurrently, a top rate individual will pay 46% (Ontario) on his or her interest income. Thus, in the simplest case, high-income taxpayers who derive dividend income are not avoiding tax. Rather, they pay a tax penalty of about 6%.

To complicate matters even more, capital gains are taxable at approximately 23% and some are not taxed at all — a zero rate. Hence, four top rate investors who earn $100 in interest, dividends and capital gains, respectively, will pay substantially different amounts in tax even though they receive identical amounts of investment income. The bondholder will pay about $46, the shareholder $52 on dividends, and the shareholder who sells his shares for a gain of $100 will pay only $23, or zero if the gain qualifies as tax exempt.

Since all law is behavioural, corporations and investors respond to the multiplicity of tax rates by manipulating their investment and spending decisions to avoid the double tax penalty and take advantage of the low rate on capital gains. Companies increasingly finance with debt to obtain the tax advantages of interest write-offs. In doing so, however, they assume greater financial risk, which, as we have seen, can be catastrophic in economic downturns.

Jim Flaherty, the federal Finance Minister, should seriously consider eliminating the double tax on dividends. Removal would be both fair and sound economic policy.

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To be sure, higher income investors would benefit more from the elimination of the double tax on dividends. That, however, is not a reason to justify retaining an unfair tax. Higher income investors will benefit more by removing the double tax because the existing system penalizes them more through double taxation. Removing the double taxation of dividend income would simply level the playing field.

Equally, removal of the double taxation of dividend income would lower the overall cost of corporate capital, remove distortions in investor decisions and increase the market capitalization of dividend-paying stocks. To be sure, the government will lose some revenue by eliminating the double tax. Concurrently, however, reinvestment of dividends will stimulate the economy and offset the revenue loss with the taxes collected on new investments.

There are various ways in which one may eliminate the double tax on corporate dividends and each of them will have a different economic cost to the government's revenue base. The simplest, and most neutral, system would be to treat dividends as deductible-expenses for equity capital in the same way as the present rules allow for the deduction of interest on debt. Investors would pay tax at the personal level at the same rate as the tax on interest income. Alternatively, the government could tax corporate dividends but exempt dividends from taxable income for resident Canadian individuals. The cost to the federal revenues would be different in each case, but there would be revenue offsets in the form of higher taxes on the reinvested income from dividends.

Removal of double taxation would also simplify the tax system and eliminate complex and artificial schemes to convert income from one source into another. Although the politics of rate reductions are always difficult, governments should consider fairness and balance in the tax system to be a principled priority.