

Canadian Tax Planners Newsletter

March April 2006

In this edition of the Canadian Tax Planners Newsletter, we shall review the following topics:

- new rules related to the taxation of dividends
- audit issues related to legal fees
- update on numerous tax issues

Increase in Federal Dividend Tax Credit

When a business distributes its income to the owners, the total tax paid by a business structured as an income trust is less than the tax the paid by a corporation and its shareholders on the same level of income. After many false starts, the former liberal government decided to increase the federal dividend tax credit for certain companies effective January 1, 2006. This approach reduces the magnitude of the income trust distribution issue, but it also creates new tax planning opportunities for shareholders. We shall review the increase in the federal dividend tax credit from the following perspectives:

- background of the income trust issue
- theory of the dividend tax credit
- revisions to the new dividend tax credit rules
- impact on owners of income trusts
- planning opportunities resulting from the new rules

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Background of the Income Trust Issue

The income tax act allows a business to be structured as a trust and avoid paying corporate taxes if all of the income is distributed to the owners. The three primary activities that utilize these rules are energy trusts, REIT's (Real Estate Income Trusts) and business trusts. It appears the government has a different policy approach to each type of trust:

Energy trusts - This structure has been used to provide capital to the oil and gas industry and appears to be consistent with the government's policy on this sector

REIT's - They are designed for the real estate industry and given the United States has a similar investment vehicle, the Department of Finance does not appear to have an issue with the sector

Business income trusts- For many businesses, the exclusive reason for being restructured as an income trust is to reduce the total tax paid on distributions to unit holders. The government sees this as an unintended tax benefit and believes that a level playing field is required so that an equivalent amount of tax is paid whether it is structured as a trust or an incorporated legal entity

Theory of the Dividend Tax Credit

Under the pre-2006 rules, if an individual receives a dividend from a Canadian company, it is grossed up by 25% and generates a tax credit equal to 13.33% of the grossed up amount. Thus, an individual receiving a \$100 dividend would include \$125 ($\100×1.25) in income and claim a credit of \$16.67 ($\$125 \times 13.33\%$). Using Ontario as an example, the net result of the gross up and tax credit mechanism is that the top marginal rate on dividends is 31%, as compared to 46% on interest and employment income.

The theory behind this calculation is to give the individual a credit for the taxes paid by the corporation. However, this assumes a corporate tax rate of 20% and although small business pays approximately this rate, large companies pay a rate closer to 35%.

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