Vol. 9 No. 8 December 2006

94 Cumberland Street, Suite 200, Toronto, Ontario M5R 1A3
Telephone: (416) 961-5612 Fax: (416) 961-6158
e-mail: valuators@marmerpenner.com

Marmer Penner Inc. Newsletter

Written by Steve Z. Ranot, CA•IFA/CBV
Edited by Michael S. Penner, BBA, CA•IFA/CBV, ASA, CFE

Corporations, Income Trusts and The New Dividend Tax Rate

Prior to the release of the May 2006 federal budget, questions abounded as to how the Department of Finance would rectify the income trust situation. Income trusts were more tax efficient than public corporations and the government's tax revenues were eroding as more corporations threatened to convert to trusts. The income trusts paid no tax. Instead, they flowed their taxable income directly to the unit holders. So only one layer of tax was paid, that is, personal tax.

Corporations, on the other hand, paid a general tax rate of about 40%. When any portion of the remaining 60% was distributed as a dividend, a personal income tax of about 30% on the remaining 60%, or another 18%, was paid leading to combined income taxes of 58%. Using income trusts, the top rate was limited to the highest personal rate of about 46%. The income trusts had found a way around double taxation, and this was costing the government tax revenues.

The answer at first appeared that the Department of Finance was conceding they could not win this battle so they were going to reduce the effective dividend tax rate to eliminate some of the advantages of using income trusts. In order to do so, the federal budget announced that the dividend gross-up and dividend tax credit would be increased. By August 2006, the province of Ontario had announced that it was on board with the federal initiative. As a result, for most dividends received from public companies, a new 45% dividend gross-up now applies.

This, combined with higher federal and Ontario dividend tax credits, serves to reduce the highest marginal dividend tax rate on these types of dividends from 31.3% in 2005 to 25.1% in 2006. The rate for Ontario taxpayers will reduce even further to 24.6% in 2007 and is scheduled to drop to 22.4% in 2010.

However, most dividends from Canadian-controlled private corporations ("CCPC's") remain subject to the old 25% gross-up and its related 31.3% higher marginal income tax rate.

Confused? Dividends from the following qualify for the new 45% gross-up at a lower dividend tax rate:

a) Public corporations resident in Canada;

b) Other corporations resident in Canada that are not CCPC's and are subject to the general corporate tax rate; and

c) CCPC's resident in Canada to the extent that their income (other than investment income which is eligible for a refundable tax) is subject to tax at the general corporate tax rate.

What this means is that, in general, dividends from public companies will be taxed at a lower rate than dividends from CCPC's. We say "in general" because CCPC's that earn business income in excess of the small business deduction threshold will be eligible to pay dividends subject to the higher gross-up. It also means that each of these two common sources of dividends will be subject to a different gross-up.

What are the implications for family law specialists?

1. When determining *Guidelines* income, the source of dividends must be determined so that the appropriate gross-up can be removed as part of the income determination process;

2. Someone who earns a significant portion of their income from dividends from public corporations in Canada will see a significant increase in after-tax income. It may be more appropriate now to reply upon paragraph 19(1)(h) of the *Guidelines* and apply an income tax gross-up to this individual's income when determining income pursuant to the *Child Support Guidelines*; and

3. Individuals with no other taxable income can earn approximately $66,000 in dividend income without paying any income tax. For the self-employed payor of child support, this offers tremendous income splitting opportunities.

What are the implications to Canadian taxpayers in general? One of the unusual circumstances created by this much higher dividend tax credit is that for individuals with taxable income below about $35,000, the marginal tax rate on dividends from public companies is about –6%. Yes, you read that correctly. It is a negative tax rate. They actually lower their tax by earning greater dividend income. This opens the door to greater tax planning opportunities.

More recently, the Department of Finance announced a new layer of tax to be applied to income trusts to effectively replace the corporate income tax they were bypassing. This is expected to reduce the taxable distributions paid by income trusts. It does not create any family law implications except that those who invested heavily in income trusts will likely report lower Line 150 income in the future.