

FEDERAL PROPOSED TAX FAIRNESS PLAN OCTOBER 31, 2006

OVERVIEW

On October 31, 2006, Finance Minister Jim Flaherty announced the Tax Fairness Plan (the “Plan”) proposing the following measures:

- Legislation aimed to stop the tax leakage due to the proliferation of certain publicly-traded income trusts and partnerships (referred to as “flow through entities” or “FTEs”) in Canada.
- Reduction of the general corporate income tax rate by one-half percentage point in 2011.
- Enhancement of the age credit amount from \$4,066 to \$5,066.
- Provisions allowing pensioners to split their eligible pension income with their spouses.

This newsletter will briefly summarize these changes and will also discuss the implications of the proposed changes to the taxation of dividends received by an individual, which were announced earlier this year.

PROPOSED CHANGES TO THE TAX TREATMENT OF INCOME TRUSTS AND PARTNERSHIPS

Background

When a corporation pays a dividend to its shareholders, it usually does so using money that has already been taxed at the corporate level. The dividend is also subject to tax in the hands of the shareholder. If the shareholder is an individual resident in Canada, the income tax system relieves the potential double taxation through the dividend “gross-up” and dividend tax credit mechanism. On the other hand, until the October 31, 2006 announcement by the federal government, FTEs did not pay any income taxes on their earnings, since they were allowed to allocate their earnings to their investors, and the investors were required to pay income tax on such allocated earnings. Prior to 2006, the taxation of corporations and FTEs had two major differences:

1. The overall tax (corporate and personal) was much higher when income was earned by a corporation, as compared to the tax if the same income was earned by an FTE.

2. Tax-exempt investors, such as pension funds and registered retirement savings plans (“RRSPs”), enjoyed a further benefit from investing in FTEs since tax on the income distributions from an FTE was fully deferred within these plans until the funds were withdrawn from the pension funds/RRSPs.

The 2006 federal budget and the recent announcement by the Ontario government remedy the first issue by lowering the personal income tax rate on certain eligible dividends from corporations in such a manner that the overall tax on income earned through a corporation versus an FTE would essentially be the same. The second issue, however, was not addressed until October 31, 2006.

Proposed Changes

The federal government announced new measures so that most FTEs and their investors will be taxed in a similar manner as corporations and their shareholders. These changes will generally take effect beginning with the 2007 taxation year for FTEs that begin to be publicly-traded after October 2006, but will only apply beginning with the 2011 taxation year for those FTEs that are publicly-traded as of October 31, 2006.

The proposed new rules will apply to a defined set of FTEs, to be known as “specified investment flow-through” (“SIFT”) trusts or partnerships.

Definition of a SIFT Trust

A trust (other than a real estate investment trust¹) will be considered a SIFT trust throughout a year if, at any time in the year, it satisfies the following three conditions:

- (i) the trust is resident in Canada;
- (ii) units of, or other investments in, the trust are listed on a stock exchange or other public market²; and
- (iii) the trust holds one or more “non-portfolio properties”³.

¹ A trust is generally considered a “real estate investment trust” if at no time in the year it (i) held any non-portfolio property (see below for definition of a non-portfolio property), other than real property situated in Canada, (ii) earns 95% or more of its income in the form of dividends, rents, interest, and taxable capital gains from disposition of real properties, (iii) earns 75% or more of its income from rent, mortgages, or gains from the disposition of real properties situated in Canada, and (iv) 75% or more of the total fair market value of all properties consist of real properties situated in Canada, cash, and debt or other obligations of governments in Canada (including Crown corporations, etc.).

² It is not clear at this point what is the precise meaning of the term “other public market”. According to the proposal, the concept of a public market for this purpose is broader than just those stock exchanges that are prescribed for the purposes of the Income Tax Act, and are broader than even all stock exchanges. For example, an organized quotation system that supports over-the-counter trading is considered a public market for this purpose.

³ Non-portfolio properties will include significant investments by FTEs in a “subject entity”, Canadian resource properties, timber resource properties and real properties situated in Canada, as well as any other properties used in carrying on a business in Canada. Subject entities will generally include entities resident in Canada, and non-resident entities if their principal source of income is in Canada.

Definition of a SIFT Partnership

A partnership will be considered a SIFT partnership throughout a taxation year if, at any time in the year, it satisfies the following three conditions:

- (i) the partnership meets one or more of the following residence-like criteria: it is a “Canadian partnership” (that is, a partnership all of the members of which are resident in Canada); its central management and control is located in Canada; and it was formed under the laws of Canada or a province, or it would, if it were a corporation, be resident in Canada;
- (ii) units of, or other investments in, the partnership are listed on a stock exchange or other public market²; and
- (iii) the partnership holds one or more “non-portfolio properties”³.

Effects of Being a SIFT Trust or a SIFT Partnership

In general terms, under the proposed system, certain earnings that a SIFT trust distributes or that are allocated by a SIFT partnership will be subject to an income tax equal to the total of the general federal corporate tax rate and 13% on account of provincial tax (similar to the rate applicable to a publicly-traded corporation). In 2007, the combined federal and provincial tax rate will be 34%, and it will decline to 31.5% by 2011. Distributions (other than a return of capital) by a SIFT trust to its unit holders or allocations of income by a SIFT partnership to its members will be taxed as a taxable dividend from a taxable Canadian corporation. This deemed dividend will be treated as an “eligible dividend” and will therefore be subject to the new enhanced dividend tax credit (discussed later in this newsletter).

In the case of a SIFT trust, the special lower federal tax and the additional tax in lieu of provincial tax will apply only to non-portfolio earnings of the SIFT trust that are distributed in the year to unit holders, income retained by the SIFT trust will continue to be taxed at a rate equivalent to the highest personal tax rate. The continuation of this difference between the taxation of trusts and corporations is necessary because, unlike a corporation, undistributed income of a trust generally becomes “capital” of the trust, which can be distributed to unit holders on a tax-free basis. Accordingly, the undistributed income of a SIFT trust will continue to be taxed at the highest personal tax rate.

Corporate Income Tax Rate Reduction

The 2006 federal budget proposes reductions in the corporate general tax rate from 21% to 20.5% effective January 1, 2008, to 20% effective January 1, 2009, and to 19% effective January 1, 2010. The Plan proposes to reduce the 19% rate to 18.5% effective January 1, 2011. The foregoing rate reductions do not apply to investment income earned by a Canadian-controlled private corporation (“CCPC”). The updated combined federal and Ontario corporate tax rates are reflected in the table on page 6.

PROPOSED CHANGES FOR THE BENEFIT OF SENIORS

Age Credit

The Plan proposes to increase the age credit from \$ 4,066 to \$ 5,066, effective January 1, 2006. The age credit is available to Canadians aged 65 and over, and this proposed increase will provide \$ 153 of federal income tax relief to each qualified taxpayer.

Pension Income Splitting

The Plan also proposes to allow seniors to allocate to their spouses or common-law partners up to half of their qualified pension income effective 2007. This can result in tax savings where the spouse or common-law partner is in a lower tax bracket.

For taxpayers aged 65 and over, qualified pension income includes lifetime annuity payments under a registered pension plan ("RPP"), an RRSP, or a deferred profit-sharing plan, and payments out of or under a registered retirement income fund.

For taxpayers under 65, qualified pension income includes lifetime annuity payments under an RPP and certain other payments received as a result of the death of a spouse or common-law partner.

PROPOSED CHANGES TO TAXATION OF DIVIDENDS RECEIVED BY AN INDIVIDUAL

The 2006 federal and Ontario budget measures and subsequent further announcements propose to significantly reduce personal income taxes on eligible dividends paid after 2005 by public corporations and private corporations from after-tax earnings that were subject to the general corporate tax rate. The following table shows the tax rate applicable to eligible dividends received by an Ontario individual in the highest income tax bracket under the new regime:

	<i>Pre-change 2005</i>	<i>2006</i>	<i>2007</i>	<i>2008</i>	<i>2009</i>	<i>2010 and 2011</i>
<i>Maximum Personal Tax Rate</i>	<i>31.34%</i>	<i>25.09%</i>	<i>24.64%</i>	<i>23.96%</i>	<i>23.06%</i>	<i>22.38%</i>

The tax reduction is intended to equalize the taxation of (i) income earned through a corporation at the general corporate rate and paid to the shareholder as a dividend, and (ii) income earned directly by an individual in the highest tax bracket. The following table shows the total tax applicable to (i) general rate income earned by a corporation (and paid as a dividend in the same year) and (ii) income earned by an individual in the highest income tax bracket:

	<i>Pre-change 2005</i>	<i>2006</i>	<i>2007</i>	<i>2008</i>	<i>2009</i>	<i>2010</i>	<i>2011</i>
<i>(i) Income earned by a corporation</i>	56.14%	52.15%	51.86%	50.19%	49.22%	47.99%	47.61%
<i>(ii) Income earned by an individual</i>	46.41%	46.41%	46.41%	46.41%	46.41%	46.41%	46.41%

Since the personal dividend tax rate is decreasing during the period from 2006 to 2010, the payment of eligible dividends to an individual should be deferred, if possible, preferably to 2010 or later. For example, in the event that a corporation earns income in excess of the small business deduction limit in 2006 and defers paying a dividend until 2010, the combined corporate and personal tax rate would be 50.42%, as opposed to 52.15% if the dividend were paid in 2006.

Note that the new dividend taxation regime applies only to eligible dividends, and the taxation of non-eligible taxable dividends remains the same (the maximum dividend tax rate applicable to non-eligible dividends being 31.34%). The extent to which a CCPC can pay eligible dividends is determined by its General Rate Income Pool ("GRIP"). The GRIP of a CCPC reflects the corporation's after-tax income which was not subject to the small business tax rate, and was not derived from investment income. Canadian public corporations on the other hand can, in most circumstances, pay an unlimited amount of eligible dividends.

These changes in dividend taxation significantly impact the decision as to whether to pay bonuses to the owner-manager of a business or whether to pay corporate tax on earnings in excess of the federal small business deduction limit (\$ 300,000 for calendar 2006 tax years). Accordingly, we strongly recommend to our clients that they contact us prior to determining their salary/dividend mix for the year.

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To discuss the impact of these matters on you and your business, please contact your advisor at Goldfarb, Shulman, Patel & Co. LLP.

COMBINED FEDERAL AND ONTARIO CORPORATE TAX RATES

The following combined Federal and Ontario tax rates apply to corporations subject to Ontario tax:

		2005 and 2006	2007	2008	2009	2010	2011
Small business rate on active income up to \$300,000*	Federal Ontario	13.12%	13.12%	11.50%	11.00%	11.00%	11.00%
		<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>
		18.62%	18.62%	17.00%	16.50%	16.50%	16.50%
Small business rate on active income from \$300,000 to 400,000*	Federal Ontario	22.12%	13.12%	11.50%	11.00%	11.00%	11.00%
		<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>	<u>5.50%</u>
		27.62%	18.62%	17.00%	16.50%	16.50%	16.50%
Manufacturing & processing rate (income not eligible for the small business rate)	Federal Ontario	22.12%	22.12%	20.50%	20.00%	19.00%	18.50%
		<u>12.00%</u>	<u>12.00%</u>	<u>12.00%</u>	<u>12.00%</u>	<u>12.00%</u>	<u>12.00%</u>
		34.12%	34.12%	32.50%	32.00%	31.00%	30.50%
General rate (active income not eligible for the small business rate)	Federal Ontario	22.12%	22.12%	20.50%	20.00%	19.00%	18.50%
		<u>14.00%</u>	<u>14.00%</u>	<u>14.00%</u>	<u>14.00%</u>	<u>14.00%</u>	<u>14.00%</u>
		36.12%	36.12%	34.50%	34.00%	33.00%	32.50%
Investment income (other than dividend income from taxable Canadian corporations)**	Federal Ontario	35.79%	35.79%	34.67%	34.67%	34.67%	34.67%
		<u>14.00%</u>	<u>14.00%</u>	<u>14.00%</u>	<u>14.00%</u>	<u>14.00%</u>	<u>14.00%</u>
		49.79%	49.79%	48.67%	48.67%	48.67%	48.67%

* These rates do not take into account the effect of the clawback of the Ontario small business deduction. The clawback applies where taxable income of the corporation and those corporations associated with it, falls between \$400,000 and \$1,128,519. The Ontario clawback rate is 4.67%.

In addition, the table does not take into account that a corporation's business limit for federal tax purposes is clawed back where the corporation, together with any associated corporations, had taxable capital, as computed for federal Large Corporation Tax purposes, in excess of \$10 million in the preceding year.

The rates are presented on a calendar-year basis. Where a corporation's fiscal year straddles two calendar years, its corporate income tax rate will be pro-rated for the number of days in its fiscal year that falls into each calendar year.

** These rates apply to investment income earned by a CCPC, and include refundable dividend tax of 26.67%.