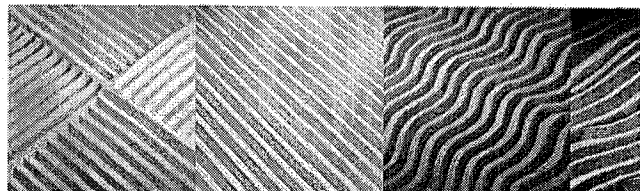


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Estate Planning Under the New Dividend Regime

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Table of Contents

INTRODUCTION	1
THE NEW REGIME.....	1
ELIGIBLE DIVIDENDS	3
GRIP.....	3
LRIP	3
DESIGNATING ELIGIBLE DIVIDENDS	4
EXCESS DESIGNATIONS	4
Rectifying excess designations	4
CORPORATE STRUCTURE AND CCPC STATUS CHANGES	5
Amalgamations and wind-ups	5
Addition to GRIP or LRIP: non-CCPC to CCPC / CCPC to non-CCPC	5
IMPLICATIONS FOR CCPCS UNDER THE NEW REGIME	6
ORDERING OF DISTRIBUTIONS	6
CARRYING BACK LOSSES	6
PRE-2006 RETAINED EARNINGS	6
DIVIDENDS FROM FOREIGN AFFILIATES.....	7
INVESTMENT PREFERENCE	7
SPECIFIED INVESTMENT BUSINESSES ("SIB")	7
TAX PLANNING	7
Electing to change status: CCPC to Non-CCPC.....	7
IMPLICATIONS FOR NON-CCPCS UNDER THE NEW REGIME	8
PRE-2006 RETAINED EARNINGS	8
CAPITAL GAINS OF PUBLIC COMPANIES.....	8
ACQUISITION OF CCPCS BY NON-CCPC	8
IMPLICATIONS FOR TRUSTS AND ESTATES UNDER THE NEW REGIME	8
ESTATE FREEZE.....	8
POST-MORTEM ESTATE PLANNING	9
TESTAMENTARY TRUSTS.....	11
IMPLICATIONS FOR SHAREHOLDER-MANAGERS UNDER THE NEW REGIME	11
ADVANTAGES OF DIVIDEND DISTRIBUTIONS	11
CORPORATE ADVANTAGES	11
Ontario employer health tax ("EHT").....	11
Large corporations tax ("LCT").....	12
Loss carry back	12
Ontario corporate minimum tax ("CMT").....	12
RDTOH	12
Canada pension plan ("CPP") premiums	12
Employment insurance ("EI") premiums.....	13
Charitable donations.....	13
Investment tax credits ("ITCs").....	13
INDIVIDUAL ADVANTAGES.....	13
Income splitting.....	13
Cumulative new investment losses ("CNIL").....	14
ECGE dividend test.....	15
Old age security ("OAS") clawback.....	15
Safe income on hand	15
Personal tax instalments	15
Creditor proofing	15

PROVINCIAL HARMONIZATION	16
ONTARIO DIVIDEND TAX CREDIT.....	16
SATISFYING REQUIREMENTS	16
COMPLIANCE REQUIREMENTS.....	16
<i>CCPCs</i>	16
<i>Non-CCPCs</i>	16
FILING REQUIREMENTS	16
CONCLUSION	16
APPENDICES	17
SCHEDULE I: GRIP	17
SCHEDULE II: LRIP	18

Estate Planning Under the New Dividend Regime

Martin J. Rochweg¹

Introduction

On June 29, 2006, the Federal Department of Finance ("Finance") released draft amendments to the *Income Tax Act* (Canada) ("ITA") in an effort to better integrate the taxation of large corporation dividends effective January 1, 2006. Income of Canadian corporations is first taxed at the corporate level and again at the shareholder level when dividends from after-tax profits are received. Double taxation on dividends has made "flow-through" investments vehicles, like income trusts, comparatively more attractive. By promoting improved integration of aggregate net taxes on dividends, the new dividend regime "levels the playing field" between dividends and proceeds otherwise earned directly as income.

The New Regime

The new regime responds to the recent and impressive increase in the utilization of income trusts. Unlike corporate income, income earned by a trust is not automatically subject to tax. With no underlying corporate tax to pay, income trusts have relatively more cash flow to distribute to unit-holders who then pay personal income tax on proceeds received, thereby realizing a greater after-tax return on their investment than on corporate dividends under current taxation.

Building upon the existing dividend "gross up" and dividend tax credit ("DTC") system, the new regime decreases the top federal income tax rate on "eligible dividends," a new type of dividend. Currently, dividends from Canadian-resident corporations receive a 25% gross up and a DTC of 2/3 of the gross-up to adjust for the corporation's pre-tax income and taxes already paid. The new regime increases the "gross up" and the DTC on eligible dividends paid after 2005 to 45% and 11/18 respectively. Ontario plans to fully implement parallel measures by 2010.

Table I: Current and proposed regime for eligible and non-eligible dividends

	Current and proposed regime for non-eligible dividends	New regime for eligible dividends
Gross-Up	25.00%	45.00%
Federal DTC % of taxable dividend	13.33%	18.87%
Combined federal and Ontario	31.34%	25.09% → 22.38%*

¹ The author wishes to thank James A. Fraser (Student-at-Law) for his invaluable help in preparing this paper.

	Current and proposed regime for non-eligible dividends	New regime for eligible dividends
top tax rate on dividends		

* Range reflects Ontario's plan to phase in increase in the provincial DTC over a five-year period from 2006 to 2010.

If after 2009 the corporate income tax rate is 31% and the top personal income tax is 46.4%, the effective combined federal and provincial tax rate on income distributed to an Ontario resident shareholder as eligible dividends will be 46.5%, which approximates the current top personal marginal tax rate in Ontario of 46.4%.

Table II: Move towards integration – current and proposed taxation of dividends issued to Ontario residents

		Current		New regime
Corporate Tax				
Income		\$100		\$100
Corporate Income Tax (A)*	–	<u>\$31</u>	–	<u>\$31</u>
Distributed Dividend		\$69		\$69
Personal Tax				
Dividend Received		\$69		\$69
Gross-up Amount	+	<u>\$17</u>	+	<u>\$31</u>
Taxable Dividend		\$86		\$100
Personal Tax^		\$40		\$46
Federal and Ontario DTC	–	<u>\$18</u>	–	<u>\$31</u>
Net Personal Income Tax (B)		\$22		\$15
Total Tax Paid (A + B)		<u><u>\$53</u></u>		<u><u>\$46</u></u>

* Combined federal and Ontario corporate income tax rate, as set out by the Ministry of Finance (Ontario) on August 3, 2006, is expected to be 31% for 2010.

^ Assumed at the top combined federal and Ontario personal tax rate of 46.4%.

Eligible dividends

An “eligible dividend” is:²

A taxable dividend that is received by a person resident in Canada, paid after 2005 by a corporation resident in Canada and designated as provided under subsection [89(14)], to be an eligible dividend. (Emphasis added)

A corporation’s ability to pay eligible dividends depends on the balance in two newly introduced pools for corporate income based on applied and applicable income tax rates. For a Canadian-controlled private corporation (“CCPC”), eligible dividends are payable up to the corporation’s “General Rate Income Pool” (“GRIP”).³ “Low Rate Income Pool” (“LRIP”)⁴ restricts a resident non-CCPC’s otherwise pervasive ability to pay eligible dividends.

GRIP

CCPCs can only pay eligible dividends to the extent a positive GRIP balance exists at a corporation’s taxation year end. Generally, GRIP refers to income taxed at the general federal corporation income tax rate, or after-tax income that has not benefited from preferential taxation of active business income through the small business deduction or a refund of refundable dividend tax on hand (“RDTOH”). CCPCs will need to determine their GRIP balance at the end of each tax year to ensure compliance with the new regime. Eligible dividends cannot be paid from investment income, other than eligible dividends received from other corporations. CCPCs need not pay non-eligible dividends before electing to pay eligible dividends. *Schedule I* provides a detailed account of the GRIP calculation.

LRIP

Non-CCPCs can pay eligible dividends only if the corporation’s current LRIP is zero. LRIP reflects income preferentially taxed (e.g. through a prior small business deduction). Receiving non-eligible dividends from CCPCs or income earned in previous years as a CCPC may generate a positive LRIP balance. If a positive LRIP balance exists, the corporation must pay non-eligible dividends to deplete the balance before eligible dividends can be paid. Whenever a non-CCPC pays a dividend, the corporation’s LRIP should be calculated. *Schedule II* provides a detailed account of the LRIP calculation.

² Proposed subsection 89(1).

³ GRIP refers to income taxed at the general federal corporation income tax rate.

⁴ LRIP describes taxable income subject to preferential taxation.

Designating eligible dividends

Corporations must designate eligible dividends as such prior to or at the time of distribution and provide written notice of the designation to any one who receives all or any part of eligible dividends; if not, the dividends will not benefit under the new regime. Finance has informally indicated that copying a directors' resolution or delivering a simple letter to eligible dividend recipients should satisfy the notice requirement. Generally, designation cannot be made retroactively or otherwise altered – designation is not prescribed for purposes of Regulation 600. However, dividends paid before the draft legislation receives Royal Assent may be designated up to 90 days after the new regime comes into force. A corporation may select which shares receive eligible dividends. Only taxable dividends paid after 2005 can be designated eligible. A corporation can designate deemed dividends, but cannot designate capital dividends or capital gains dividends.

Excess designations

A new supplemental tax regime (*ITA* Part III.1, "Part III.1") applies to recover lost tax revenue from an "excess eligible dividend designation." An excess eligible dividend designation results from either a CCPC designating in excess of its year end GRIP or a non-CCPC designating while maintaining a positive LRIP. Part III.1 imposes a 20% or 30% tax on excess designations. The 30% rate applies to excess designations captured by proposed subsection 89(1)(c):

The amount of the eligible dividend, if it is reasonable to consider that the eligible dividend was paid in a transaction, or as part of a series of transactions, one of the main purposes of which was to artificially maintain or increase the corporation's general rate income pool, or to artificially maintain or decrease the corporation's low rate income pool

Generally, Part III.1 tax liability accrues to payor corporations and comes due by the corporation's balance-due day for the taxation year. However, non-arm's length shareholders in receipt of excessive eligible dividends are jointly and severally liable for their proportion of the Part III.1 tax liability.

Rectifying excess designations

Inadvertent excess designations can be rectified by treating all or part of the excess designation as non-eligible dividends, and thereby relieve Part III.1 tax liability. Once a notice of assessment for Part III.1 tax has been mailed, a corporation has 90 days to elect to otherwise treat its excess designation. The election deadline for dividends paid before Royal Assent is 30 months from the date the legislation comes into force. Elections will not be accepted past relevant deadlines.

If elections are made within 30 months after excess dividends were paid, the corporation must obtain the consent of all shareholders with known addresses in receipt or entitled to receive the original dividends. For elections made after this time, it does not matter whether the corporation knows the addresses of relevant shareholders - all shareholders in receipt or entitled to receive the original dividends must consent. The latter-affected shareholders may be liable for tax, interest and penalties on account of the corporation's election.

If a corporation elects within 30 months after paying excess dividends and all affected shareholders enjoy exemption from Part I of the *ITA*, the consent of shareholders is unnecessary.

Corporate structure and CCPC status changes

Special provisions apply to determine the income pools for corporations when amalgamating or winding up, and for changes of CCPC status. Generally, the corporation must calculate the amount which would have been its year end GRIP or LRIP balance, as the case may be, as if the corporation held its new status in the previous year. Other than by way of an acquisition of control, changes in CCPC status trigger a deemed year end⁵ and interrupt the continuity of the corporation's status throughout the year. This is relevant to claiming the small business deduction because eligibility requires a corporation to be a CCPC continuously throughout the year. Changing CCPC status under the new regime affects the GRIP and LRIP of the post-transaction entity, and its ability to pay eligible dividends.

Amalgamations and wind-ups

If a CCPC results from an amalgamation or causes a subsidiary to wind-up, the predecessors' GRIP balances or the subsidiary's GRIP balance at the end of the last taxation year (less eligible dividends paid by the predecessor or subsidiary CCPC in that year) must be added to the GRIP of the resulting or parent corporation. For a non-CCPC predecessor or subsidiary, the amount to be added reflects the GRIP balance had the corporation been a CCPC at the end of its last taxation year.

If a non-CCPC results from an amalgamation or causes a subsidiary to wind-up, the predecessors' LRIP balances or the subsidiary's LRIP balance at the end of the last taxation years must be added to the LRIP of the resulting or parent corporation. For a CCPC predecessor or subsidiary, the amount to be added reflects the LRIP balance had the corporation been a non-CCPC at the end of its last taxation year. Since amalgamating or winding up a CCPC creates a LRIP (requiring depletion before distributing eligible dividends), continuing the acquired CCPC as a separate entity may be preferable.

Addition to GRIP or LRIP: non-CCPC to CCPC / CCPC to non-CCPC

At the first taxation year-end of a CCPC that was in its previous taxation year a non-CCPC, a hypothetical GRIP balance for the previous taxation year end must be generated to determine the current year-end GRIP. This amount reflects the non-CCPC's income subject to the general federal corporate income tax rate.

A CCPC can elect to be treated as a non-CCPC.⁶ If in the previous year a non-CCPC was a CCPC, the corporation needs to determine what its LRIP balance would have been at the

⁵ Proposed subsection 249(4.1).

⁶ Proposed subsection 89(11).

previous year end to calculate its current LRIP. The hypothetical LRIP balance accounts for income that benefited from preferential taxation.

Implications for CCPCs under the new regime

Ordering of distributions

The draft legislation does not provide ordering rules for dividend distribution by CCPCs. It appears that CCPCs can pay eligible dividends that trigger a dividend refund. If a CCPC has a positive GRIP balance and RDTOH (from either Part I or Part IV tax), dividends, capable of eligible designation and triggering a dividend refund, can be advantageously distributed before year end. The following table illustrates likely ordering of dividend distributions by a CCPC.

Table III: Ordering distribution of dividends

Type of Dividend	Federal/provincial personal tax	Corporate tax refund
1. Eligible dividends triggering a refund of RDTOH	25.09% → 22.38%*	33.33%
2. Non-eligible dividends triggering a refund of RDTOH	31.34%	33.33%
3. Eligible dividends not triggering a refund of RDTOH	25.09% → 22.38%*	None
4. Non-eligible dividends not triggering a refund of RDTOH	31.34%	None

*Range reflects Ontario's plan to phase in increase in the provincial DTC over a five-year period.

Carrying back losses

Carrying back future losses to a particular year does not affect a CCPC's GRIP balance for that year and an excess designation will not result. The corporation's GRIP balance decreases for the year losses are incurred.

Pre-2006 retained earnings

Portions of earnings retained from 2001-2005 can be distributed as eligible dividends. However, eligible and other dividends from foreign affiliates received prior to a CCPC's 2006 taxation year or full-rate taxable income earned before the 2001 taxation years cannot be distributed as eligible dividends because these amounts are not includable in the GRIP calculation.

Dividends from foreign affiliates

Eligible dividends are payable from the dividends of foreign affiliates if they are received by a CCPC after its 2005 taxation year.

Investment preference

The new regime maintains and enhances the historical preference of CCPCs to earn dividends from Canadian public corporations and/or foreign affiliates, rather than from non-affiliated foreign corporations. By reducing overall taxation on both dividends from foreign affiliates and dividends from Canadian public companies, the draft legislation makes foreign portfolio investment even less attractive than before.

Specified investment businesses ("SIB")

Restructuring CCPCs taxed as SIBs such that income becomes taxable as high rate active business income may create tax advantages. In an effort to avoid high corporate investment tax rates (combined with the RDTOH system), a CCPC SIB could employ more than five full-time employees throughout the year and thereby become exempt from SIB rules.

Tax planning

Electing to change status: CCPC to Non-CCPC

A CCPC may elect to proceed as a non-CCPC under the new dividend regime.⁷ Electing to change status from CCPC to non-CCPC means all of the corporation's income will be subject to the general federal corporate income tax rate – the corporation can no longer claim the small business deduction. The corporation's GRIP balance no longer applies and its LRIP balance will have to be calculated in order to distribute income as eligible dividends. Provided a prohibitively large LRIP balance does not ensue upon election, changing status offers CCPCs a strategy for distributing pre-2001 retained earnings (from high rate taxable income) as eligible dividends.

Elections must be filed by the due-date for the year in which the corporation wishes the change to apply. A corporation may revoke its election;⁸ however, the Minister's written consent will be required for any subsequent election.⁹

⁷ Proposed subsection 89(11).

⁸ Proposed subsection 89(12).

⁹ Proposed subsection 89(13).

Implications for non-CCPCs under the new regime

Pre-2006 retained earnings

After a non-CCPC depletes its LRIP, the corporation can distribute eligible dividends as it sees fit. This means that retained earnings can be distributed as eligible dividends.

Capital gains of public companies

Distribution of the non-taxable portion of capital gains is not addressed. Public companies will need to track their capital gains in some account to ensure that the combined corporate and personal income tax on such gains does not exceed direct personal income taxation of capital gains once in the hands of individual taxpayers or income trusts.

Acquisition of CCPCs by non-CCPC

Since amalgamating or winding up a CCPC will create a LRIP (requiring depletion before distributing eligible dividends), continuing the acquired CCPC as a separate entity may be preferable.

Implications for trusts and estates under the new regime

The tax rate on eligible dividends is significantly lower than previous rates on dividends and is set to converge and eventually dip below the rate on personally realized non-exempt capital gains. It is important to re-examine and potentially modify existing estate plans to benefit under the new regime.

Estate freeze

An estate freeze offers tax and non-tax benefits before and after death. Freezing the value of property transfers future increases to other participants either directly or through a trust. Before implementing an estate freeze, it is appropriate to consider all tax implications resulting from implementation and subsequent income generation.

Generally, property is exchanged for preferred shares in a holding corporation ("Holdco") and the value of the interest is frozen at fair market value. The transfer may trigger capital gains. Issuing a second class of voting preferred shares ensures that effective control over management and distribution of income through dividends remains. Future growth accrues to new common shares that Holdco issues to new participants for a nominal sum. Freezing the value of common shares of an existing corporation does not require a transfer to a Holdco – common shares can be exchanged for preferred shares pursuant to section 86 of *ITA* and new common shares can be issued to relatives.

Redeeming preferred dividends provides an income stream, while future capital gains accrue to common shareholders. The new regime reduces the cost of preferred share redemption to the capital gains rate for eligible dividends. By 2010 in Ontario, the top marginal tax rate on eligible dividends (22.38%) will be less than the comparable rate on capital gains (23.21%). Eligible dividends can also be issued on common shares.

Additional benefits to utilizing an estate freeze include:

- Reducing tax on capital gains
 - Limits taxation to capital gain realized on the frozen interest. Capital gains from future growth benefit common shareholders on a deferred basis, especially those in lower tax brackets (who may experience overall tax savings). Shareholders of a qualified small business corporation may be able to take advantage of the \$500,000 capital gain exemption.
- Reducing taxes upon death
 - Limits death taxes on remaining property to the frozen value, thereby minimizing income taxes and probate fees.
- Splitting income
 - Reduces overall tax on the income generated by frozen property through the issue of eligible dividends. Transferring dividend income to adult children through trusts may be effective. The “kiddie tax” generally eliminates income splitting with minors. A more detailed discussion of income splitting is provided below.
- Protection from creditors
 - Insulates future capital growth from creditors otherwise entitled to the frozen interest.

Shares of active private corporations, marketable securities, rental properties and shares of a Holdco that owns such assets are suitable for a freeze. Transfers to a spouse or minor children (i.e. non-arm's length individuals) engage attribution rules, which add any interest, dividend income or capital gain (in the case of spouse) to the transferor's income. The attribution rules do not apply if property is acquired using the spouse or minor child's own capital. Spouse or child can borrow from the transferor to finance acquisition. Loans must bear interest at or above the prescribed minimum rate and interest must be paid within 30 days of year end. Transferor should generally not have sole control of trusts owning common shares for the benefit of minor children – one or more trustees could be arm's length to further distance attribution rules. Corporate attribution rules must also be considered.

Post-mortem estate planning

Death triggers a deemed disposition. Capital gains realized upon deemed disposition are included in the deceased's terminal return. On death, wind-up of a private corporation may prevent double taxation from occurring in the future on a subsequent sale. The estate incurs a capital loss to the extent its adjusted cost base (“ACB”) for the deceased's former shares (i.e. fair market value at the time of death) exceeds the deceased's paid-up capital (“PUC”) for those shares. If wind-up is completed within one year of death, the estate may elect under subsection 164(6) to treat any portion of the capital loss as a capital loss realized by the deceased in his final taxation year. By operation of subsection 84(2), winding-up results in a deemed dividend to the estate. The competitiveness of taxation of capital gains and eligible dividends (under the new

regime after 2005) makes this type of post-mortem estate planning more attractive than it once was. It is most expedient to maximize eligible dividends.

Example:

Mr. X died in 2006. At the time of death, Mr. X was the sole shareholder of Xco, which he incorporated in 1985. His shares had a fair market value of \$5,000,000 with an ACB and PUC of just \$1. If Xco winds up within one year of Mr. X's death, Mr. X's estate incurs a \$4,999,999 capital loss because proceeds of disposition are limited to \$1 of PUC and the ACB of shares in the estate is \$5,000,000. Pursuant to subsection 164(6), the \$4,999,999 may be treated as a capital loss realized by Mr. X in his final taxation year, thereby eliminating the capital gain arising upon death. Instead of the capital gain, Mr. X's estate receives a deemed dividend, pursuant to subsection 84(2).

Table IV: Combined top marginal tax rates (federal and provincial) for Ontario residents

	2005	2006	2007	2008	2009	2010
Capital gains	23.21%	23.21%	23.21%	23.21%	23.21%	23.21%
Eligible Canadian dividends	31.34%	25.09%	24.64%	23.96%	23.06%	22.38%
Non-eligible Canadian dividends	31.34%	31.34%	31.34%	31.34%	31.34%	31.34%

Subsection 164(6) permits application of capital loss in excess of the amount of capital gain realized on shares of Canadian corporations at the time of death. If the ACB of the deceased's shares exceeds their PUC,¹⁰ the excess capital loss can shelter other capital gains realized by the deceased in the taxation year of death or the three years preceding. Although in the context of a subsection 164(6) election a wind-up avoids the stop-loss rule in subsection 40(3.6), with the benefit of subsection 40(3.61), this election can be used if shares are redeemed or purchased for cancellation. Generally in situations where the deceased was not the sole shareholder, subsection 164(6) may be used provided there is a plan to buy out the estate's interest with one year of death or the estate transfers the shares to a wholly owned holding corporation.

¹⁰ This situation may arise if the shares were purchased or inherited from a previous shareholder or if a reorganization or election was used to "crystallize" the shareholder's "capital gains exemption" under section 110.6 of the Act.

Testamentary trusts

If a testamentary trust has a non-calendar year end and receives dividends in 2006 which are later designated as eligible only subsequently, a notice of objection should be filed within 90 days of the mailing date of the trust's assessment so that reduced taxation on eligible dividends can be confirmed.

Implications for shareholder-managers under the new regime

Preferences of CCPC shareholder-managers to receive salary instead of dividends may well be altered by the new regime.

Planning for shareholder-managers

Currently, an element of double taxation exists on income earned through a corporation that does not benefit from preferential small business tax rates. "Bonusing down" to the small business deduction limit addresses double taxation, however, flexibility to balance between the needs of the business to retain profits and personal needs of shareholders for funds is compromised.

Under the new regime, the overall tax cost on eligible dividends is only slightly higher than overall taxation of salaries. If retaining profits in the corporation is preferable, the difference in tax cost may be insignificant and dividend tax can be deferred. The new regime makes the deferral advantage much more attractive. Ideally (subject to shareholders needs for funds for personal use), it may well be preferable for earnings to be retained within the corporation until at least 2010 in order to take advantage of the internal rate of return and eventual taxation parity. To realize the full effect of the new regime, provinces and territories will have to legislate similar reductions in dividend taxes.

Advantages of dividend distributions

Share ownership is the basis for distribution of income through dividends, as opposed to distribution as salary which is based on services rendered. However, this distinction is less critical to shareholders of CCPCs who are corporate directors since their position usually stems from their respective share ownership.

Corporate advantages

For CCPCs, there are several advantages to taxing income within the corporation and then distributing the income as dividends.

Ontario employer health tax ("EHT")

EHT is effectively an additional corporate tax related to distributing income as salary or bonus. Currently, 1.95% of a corporation's total Ontario remuneration constitutes EHT. Corporate taxation of income and subsequent distribution of dividends avoid EHT liability. Since 1998, EHT does apply to self-employment income.

Large corporations tax ("LCT")

Retroactive to January 1, 2006, elimination of LCT removes a corporate minimum tax that otherwise makes dividend distribution comparatively less attractive to salary or bonuses.

Loss carry back

Reducing a corporation's future income taxes may outweigh the benefits of carrying back losses. Issues to consider when deciding to carry back losses include the following:

- Impact on the corporation's dividend refund for a preceeding year
- Impact on the corporation's net LCT liability due to the reduction in both taxable income and corresponding surtax liability
- Future federal or provincial corporate tax rates higher or lower than those applicable in the loss year
- Repayment of any non-refundable federal or provincial investment tax credits
- Creating a corporate minimum tax liability

Substantially reducing a corporation's taxable income by paying salaries and bonuses greatly minimizes the effect of carrying back losses in subsequent years to generate an income tax refund.

Ontario corporate minimum tax ("CMT")

A corporation's exposure to CMT may be reduced by retaining income in the corporation and paying Ontario corporate income taxes. Also, the use of CMT carry forward credits before they expire depends on sufficient taxation of corporate income.

RDTOH

A RDTOH balance accumulates by a CCPC paying Part IV tax on assessable dividends received and/or earning investment income subject to refundable tax treatment. For every \$3 of taxable dividends paid up to a corporation's RDTOH, \$1 is recoverable.

Canada pension plan ("CPP") premiums

Distributing income through dividends avoids remittance of CPP premiums, which may be viewed as an additional cost related to paying salaries. Both CPP rates and the range of earnings to which CPP premiums apply have increased. If a taxpayer receives a salary from more than one corporation, the net cost of paying CPP premiums increases because each corporation is obliged to withhold and remit CPP up to the maximum CPP premium. Unlike an individual taxpayer, a corporation cannot recover excess premiums paid.

Employment insurance ("EI") premiums

Just like CPP premiums, the cost of EI premiums may be avoided by distributing dividends instead of paying a salary.

Charitable donations

Taxing income inside the corporation (instead of paying a salary) increases the corporation's deductible amount of charitable donations and the tax creditable amount of donations for the dividend recipient. Net income enables the corporation to make deductible charitable donations. Likewise, income distributed as dividends increases a shareholder's net income and eligibility for charitable donation tax credits. Dividend gross-ups further enhance the amount of creditable donations.

Investment tax credits ("ITCs")

Taxing income within the corporation promotes use of non-refundable ITCs. A corporation can utilize ITCs in the current taxation year or in the three preceding taxation years by carrying back earned ITCs.

Individual advantages

For the individual taxpayer, there are several advantages to taxing income within the corporation and then distributing the income as dividends.

Income splitting

Subject to provisions for attribution and tax on split income, distributing dividends may facilitate income splitting. Absent any other income in 2006, an adult taxpayer may receive up to approximately \$65,825 in eligible dividends (or a taxable eligible dividend of approximately \$95,446) without having to pay federal income tax; however, an alternative minimum tax ("AMT") liability of \$2,590 would result. The AMT threshold and inclusion rate remain at \$40,000 and 100% respectively. In light of discrepancies between federal margin income tax and AMT tax rates,¹¹ AMT is likely to apply to individual taxpayers across all income brackets who receive eligible dividends. Receiving salary, as opposed to dividends, may reduce AMT exposure. AMT may be recoverable in the future taxation years.

Likewise in 2006, an adult taxpayer may receive \$35,115 (or a taxable non-eligible dividend of \$43,894) in non-eligible dividends without having to pay federal income tax.

¹¹ While the top federal marginal income tax rate on eligible dividends is 14.55%, the AMT tax rate is 15.25% for 2006 and 15.5% for 2007 onwards.

Table V: Federal income tax free dividend income for 2006

2006	Eligible dividends	Non-eligible dividends
Federal Income Tax		
Dividend received	\$65,825	\$35,115
Gross-up	+ 29,621	+ 8,779
Taxable dividend	\$95,446	\$43,894
Federal tax before credits	\$19,450	\$7,201
Dividend tax credit	- 18,450	- 5,853
Basic personal tax credit	- 1,348	- 1,348
Federal income tax	Nil	Nil
Federal AMT		
Dividend received	\$65,825	\$35,115
Annual exclusion	- 40,000	- 40,000
Taxable amount	\$24,825	Nil
Federal tax before credits	\$3,938	Nil
Basic personal credit	- 1,348	Nil
Federal AMT	\$2,590	Nil

Cumulative new investment losses ("CNIL")

Enhanced capital gains exemptions ("ECGEs") provide a shelter for capital gains up to \$500,000 resulting from the disposition of certain assets (qualified small business corporation shares, qualified farm property and qualified fishing property). The use of ECGEs is restricted by an individual's CNIL balance. A individual's CNIL balance is the amount by which investment expenses claimed after 1987 exceeds investment income received after 1987. Receiving dividends instead of salary reduces an individual's CNIL balance and may enhance availability of ECGEs to the individual. Likewise, distributing dividends addresses problems that may arise from the retention of profits within an operating entity, since the corporation's shares may not qualify for the \$500,000 capital gains exemption, if a corporation retains excess cash.

ECGE dividend test

ECGEs on the disposition of any shares of a corporation may be disallowed if a significant portion of the capital gain results from the corporation's failure to pay sufficient dividends on non-prescribed shares. Thus, by paying dividends on non-prescribed shares, an individual taxpayer may avoid being denied ECGEs.

Old age security ("OAS") clawback

If the taxpayer has sufficient funds to cover personal expenditure, retaining income within a corporation may reduce or eliminate the OAS clawback. In years when eligible dividends are received, the 45% gross-up means reaching the OAS net income threshold requires a smaller amount of dividends in 2006 and onwards, than in 2005. Even so, lower taxation of eligible dividends is likely to offset any additional clawback.

Safe income on hand

For shareholder-managers planning a future sale of shares in their corporation, retaining corporately taxed income within an operating corporation ("Opco") or holding corporation ("Holdco") may offer a future tax deferral. However, safe income can be lost. If a shareholder-manager holds an interest in an Opco through a Holdco and plans to benefit from the safe income of Opco before selling the interest in Opco, the shareholder can transfer the Holdco interest to a new corporation ("Newco") and have either Holdco pay a dividend to Newco or trigger a deemed dividend to Newco by increasing the paid-up capital of Holdco's shares held by Newco. The Canada Revenue Agency ("CRA") computes Holdco's safe income on a consolidated basis with Opco. This means that dividends paid to Newco are considered paid out of Opco's safe income and cannot be eligible dividends under the new regime because Holdco's share of eligible income of Opco is not included. Rather, the benefit from eligible income in Opco flows to purchasing shareholders. The sale of an interest in a widely held private corporation produces the same result.

Personal tax instalments

Bi-annually distributing dividends from a corporation may avoid or reduce the recipient's obligation to pay quarterly tax instalments on dividend income. The benefits of deferring personal tax instalments may not be realized by taxpayers who receive OAS and do not fall into the top-marginal rate bracket. Personal tax instalments for 2006 should adjust for any changes to the taxpayer's salary-dividend mix and lower taxation of eligible dividends.

Creditor proofing

To reduce an operating corporation's exposure to creditors, excess funds can be distributed tax-free to a holding company as inter-corporate dividends. In the event Opco requires funds, Holdco can advance money on a securitized basis. Establishing a Holdco raises various issues, like the impact Holdco may have on the availability of ECGEs on a future sale of the shares of Opco to the shareholder-manager.

Provincial harmonization

On August 3, 2006, the Ontario Minister of Finance announced that the Province will adjust provincial dividend taxation to parallel the proposed federal regime. Ontario plans to raise the provincial dividend tax credit on eligible dividends from 5.13% to 7.7% of the taxable dividend by 2010.

Ontario dividend tax credit

Table VI

	2005	2006	2007	2008	2009	2010
Dividend Tax Credit	5.13%	6.5%	6.7%	7.0%	7.4%	7.7%

Satisfying requirements

Compliance requirements

CCPCs

A CCPC must compute its GRIP balance at the end of its 2006 taxation year. To prepare for this computation, CCPCs should calculate their GRIP inclusions for 2002 to 2005 full-rate taxable income.

Non-CCPCs

To take advantage of designating dividends already paid in 2006 as eligible, non-CCPCs should calculate their LRIP balance as soon as possible. Going forward, a non-CCPC's LRIP balance should be calculated before declaring dividends to determine whether an eligible dividend designation is available. If a nominal LRIP balance is anticipated or the calculation is too onerous, a non-CCPC may prefer to forgo the calculation, designate all dividends as eligible and pay the 20% penalty on its LRIP balance because paying penalties may be more cost-effective.

Filing requirements

Starting in 2006, Canadian-resident corporations that pay taxable dividends in a taxation year are required to file a return for the year under Part III.1. The return must be filed in prescribed form by the corporation's filing due date for the year and estimate the corporation's liability for Part III.1 tax.

Conclusion

The new regime introduces new concepts and adjusts preferences. While the process for distributing dividends is more complicated, benefits under the new regime present planning opportunities for individuals, corporations, estates and trusts. However, it is important to consider all tax implications resulting from alternations of existing plans. Until the proposed legislation is finalized and enacted, the full impact of the new regime remains unknown.

Appendices

Schedule I: GRIP

$$\text{GRIP} = A - B$$

$$A = C + 0.68(D - E - F) + G + H - I$$

$$B = 0.68(J - K)$$

$$\text{GRIP} = [C + 0.68(D - E - F) + G + H - I] - [0.68(J - K)]$$

C	Corporation's GRIP at the end of its preceding taxation year.
D	Corporation's taxable income for the particular taxation year. If the corporation is a deposit insurance corporation in the particular taxation year, nil.
E	Taxable income for the particular taxation year benefiting from small business deduction.
F	Corporation's aggregate investment income (other than eligible dividends) for the particular taxation year.
G	Total amount of eligible dividends and dividends from foreign affiliates deductible under section 113 received by the corporation in a particular taxation year.
H	Total of amounts of determined under subsections 89(4) to (7).
89(4)	Adjusts GRIP for a change in CCPC status (non-CCPC to CCPC).
89(5)	Flows through a predecessor's GRIP on an amalgamation.
89(6)	Flows through a subsidiary's GRIP on a wind-up.
89(7)	Adds an amount for certain CCPC's equal to 63% of taxable income after 2000 and before 2006 less dividends paid in those years.
I	Eligible dividends paid in the previous year less the excess eligible dividend designations (nil for a new CCPC).
J	Corporation's total full rate taxable incomes for the three previous years determined without reference to specified future tax consequences.
K	Corporation's full rate taxable incomes for the three previous years.

Schedule II: LRIP

$$\text{LRIP} = (\text{A} + \text{B} + \text{C} + \text{D} + \text{E} + \text{F}) - (\text{G} + \text{H})$$

A	Non-CCPC's LRIP at the end of its preceding taxation year.
B	Non-eligible dividends received by the non-CCPC in the taxation year and deducted under section 112.
C	Total of amounts determined under subsection under subsection 89(8) to (10).
89(8)	Adjusts LRIP for a change in CCPC status (CCPC to non-CCPC).
89(9)	Flows through a predecessor's LRIP on an amalgamation.
89(10)	Flows through a subsidiary's LRIP on a wind-up.
D	80% of a (proposed) subsection 89(11) non-CCPC's aggregate investment income.
E	If a non-CCPC was not a CCPC (i.e. credit union) in its preceding taxation year, income subject to SBD in the preceding taxation year.
F	Four times the amount, if any, deducted by a non-CCPC investment corporation under subsection 130(1) for its preceding taxation.
G	Taxable dividends already paid in the year by a non-CCPC (other than eligible dividends and certain dividends paid by investment corporations or mortgage investment corporations).
H	Excessive eligible dividend designations made by a non-CCPC in the particular taxation year, but before the particular time.

