3000-700 9th Avenue SW
Calgary, AB
Canada T2P 3V4
Tel. 403.298.2400
Fax.403.262.0007
www.millerthomson.com

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Mortgage Investment Corporations

By Greg Shannon

June 2005

MORTGAGE INVESTMENT CORPORATIONS

GENERAL OVERVIEW

A mortgage investment corporation ("MIC") is a type of corporation entitled to special non-taxable status (as a conduit for flowing interest income earned on residential mortgage loans to its shareholders) under Section 130.1 of the *Income Tax Act* (the "Act").

Canada Revenue Agency's ("CRA") philosophy behind this special tax status is simple; it has deemed it appropriate, in its wisdom, to attract more money to the Canadian mortgage market for residential financing. Therefore, CCRA will not tax a MIC, provided however, it adheres to special rules contained in Section 130.1 of the Act.

The shares of the MIC are an "eligible investment" for deferred investment plans, including registered retirement savings plans ("RRSPs") and registered pension plans ("RPPs"). Investment in an MIC is particularly attractive for these types of plans. This is because the MIC does not pay any tax when its income is flowed out as dividends, nor do the plans pay any tax when they receive the dividends. The beneficiaries of the plans do not pay tax until they collapse their plans and actually receive the funds therein.

Shares of a MIC are "qualified investments" for deferred profit sharing plans, RRSPs, and RPPs. However, shares in an MIC will be disqualified under the Act, as an investment for any of these deferred income plans, to the extent that any time during the year the MIC holds, as part of its property, a mortgage from or other indebtedness of a person who is an annuity beneficiary, or an employer under the deferred income plan, or another person who does not deal at arm's length with such person. The net effect of this provision of the Act is to prevent funds of a deferred income plan from being available in any way for the benefit of an annuitant, beneficial or employer under a deferred income plan or any person not dealing at arm's length with them. In essence, this prohibits a MIC from holding a mortgage on homes of the shareholders of the MIC.

A MIC is also an attractive investment vehicle for plans because currently the Canadian tax rules prohibit plans from borrowing funds. Plans are therefore restricted to earning income on funds contributed to them. Therefore, through holding shares in a MIC, plans can enhance their income generating capability by leveraging their available capital.

Furthermore, although plan holders may wish to invest in mortgages, unless there is considerable amount of money in their plans, they will only be able to invest in one or two small mortgages at best. Through investing in a MIC, there becomes available a very large pool of capital. Therefore, plan holders can invest in a number of mortgages, thereby reducing the risk.

It is quite normal for plans to achieve rates of return of between 10 to 15%, or more, compounded, through investing in MIC's. The potential accumulation of funds through plans using such a high compound rate is very dramatic.

As with any investment undertaking that involves residential mortgages there are risk factors. Many of these risk factors can be minimized by employing an effective mortgage portfolio manager and establishing strict lending parameters for mortgage loans, based on the underlying value of the security (i.e. restricting mortgages to 75% of value of the property).

In summary, special tax rules allow a MIC to obtain tax deductions for dividends it pays and these will be fully taxable to the recipient. But, if the recipient is a RRSP, the receipt will be tax deferred in the plan. The result can be a very attractive after-tax rate of return on investment.

The MIC must have at all times greater than 20 shareholders, none of which may own in excess of 25% of the share capital of the corporation. In the first taxation year of the MIC, these requirements are relaxed somewhat and will be considered to be met throughout the year to the extent they are met at the end of the taxation year.

The articles of incorporation for a MIC can indicate that there are preferred shareholders and common shareholders. While it is possible that the preferred shareholders have a fixed dividend, in addition they must participate equally with the common shareholders.

At all times in excess of 50% of the assets of the MIC must be invested in residential mortgages or deposits held in Canada Deposit Insurance Corporation, insured institutions or credit unions.

Certain debt/equity ratios must also be maintained by the MIC at all times, as follows:

(a) to the extent that at least 50% and less than two-thirds of the property, measured at its tax cost, is held by the MIC in residential mortgages and insured deposits, a three to one debt to share equity ratio, at maximum, is allowed; and

(b) in those situations where in excess of two-thirds of the cost, on a tax basis, of the property of the MIC is residential mortgages or insured deposits, a five-to-one debt to share equity ratio maximum is applicable.

Failure to satisfy all of the above requirements will result in a MIC failing to qualify as a MIC for income tax purposes, thereby losing all of the tax advantages of this particular status. It is essential that one closely monitors the various criteria set forth above during the operation of the MIC in order to ensure that they are met at all times.

Should you have any further questions or concerns with respect to MIC's, please do not hesitate to contact Greg P. Shannon of our Miller Thomson LLP Calgary Office at (403) 298-2482; or e-mail gshannon@millerthomson.com.