

The New Dividend Taxation Rules

Despite what climatologists may be saying, the late arrival of snow this winter is most probably due to a particularly warm trend this fall resulting from the flurry of new taxation provisions. The measure that appeared in the news most often was undoubtedly the government's decision to tax distributions by income trusts. However, the reams of paper devoted to the discussion of income trusts reduced our focus on the new dividend taxation rules which will apply as of January 1, 2006 and will have a direct impact on a number of Canadian taxpayers.

SUMMARY OF THE NEW MEASURES

The new dividend taxation rules now provide for the classification of dividends as "eligible dividends" (as compared to "other dividends"); they also provide for the creation and maintenance of accounts referred to as the general rate income pool (GRIP) and the low rate income pool (LRIP), as well as the introduction of an enhanced tax credit for eligible dividends. When these rules come into force (which should happen shortly), they will apply to all dividends paid by Canadian corporations as of January 1, 2006.

The government of Québec decided to adopt these measures in its Budget dated March 24, 2006, effective as of that date. However, while Québec chose to increase the Québec dividend tax credit applicable to eligible dividends, it also took the opportunity to reduce the credit applicable to other dividends.

ADJUSTMENT OF THE DIVIDEND TAX CREDIT

In summary, the following are the effective dividend gross-up and tax credit rates at the federal, Québec and Ontario levels following the new measures:

Me Martin Raymond is a member of our Business Law Group. Specialized in taxation law, he works primarily on matters involving personal tax planning and corporate restructurings for a clientele comprised of small and medium-sized businesses. He is particularly involved in files dealing with the amalgamation and winding-up of corporations, their share capital structure and their financing.



	Québec	
	From January 1, 2006 to March 23, 2006	As of March 24, 2006
	%	%
Eligible dividends		
Dividend gross-up	25.00	45.00
Dividend tax credit	10.83	11.90
Other dividends		
Dividend gross-up	25.00	25.00
Dividend tax credit	10.83	8.00
	Federal	Ontario
	As of January 1, 2006	
	%	%
Eligible dividends		
Dividend gross-up	45.00	45.00
Dividend tax credit	18.97	6.50
Other dividends		
Dividend gross-up	25.00	25.00
Dividend tax credit	13.33	5.13

TAX RATE APPLICABLE TO DIVIDENDS

The following tables illustrate the combined marginal tax rate (federal and provincial) on dividend income received by an individual residing in Québec or Ontario:

Québec			
	2005	From January 1, 2006 to March 23, 2006	As of March 24, 2006
	%	%	%
Eligible dividends (grossed up by 45%)			
- Federal	16.36	12.15	12.15
- Québec	16.46	16.46	17.55
Total	32.82	28.61	29.70
Other dividends (grossed up by 25%)			
- Federal	16.36	16.36	16.36
- Québec	16.46	16.46	20.00
Total	32.82	32.82	36.36

Ontario		
	2005	As of January 1, 2006
	%	%
Eligible dividends (grossed up by 45%)		
- Federal	19.59	14.55
- Ontario	11.75	10.54
Total	31.34	25.09
Other dividends (grossed up by 25%)		
- Federal	19.59	19.59
- Ontario	11.75	11.75
Total	31.34	31.34

ELIGIBLE DIVIDENDS AND OTHER DIVIDENDS

Only "eligible dividends" can benefit from the enhanced dividend tax credit. They must be expressly designated by the corporation declaring them and the corporation must give written notice thereof to its shareholders. The application of these rules will vary depending upon the status of the corporation paying the dividend, namely whether it is a corporation that qualifies as a Canadian-controlled private corporation (CCPC) or a corporation that is a non-CCPC.

CORPORATIONS THAT ARE NOT CCPCS

Corporations that are not CCPCs, such as public corporations, are subject to a combined general tax rate (federal and Québec) of 32.02%. Henceforth, these corporations will be required to maintain and calculate an LRIP (low rate income pool) which essentially includes all dividends received from a corporation that is subject to a reduced tax rate. The LRIP is to be calculated only as of January 1, 2006 and, unlike the GRIP, there will be no opening balance. In contrast to the GRIP of a CCPC, the LRIP of a public corporation must be calculated immediately before the date on which the dividend is paid by the corporation. A corporation that pays a dividend, when it has a positive balance in its LRIP, must first pay the dividend from the LRIP. Only corporations that do not have a positive balance in their LRIP may designate the dividend paid by them as an eligible dividend. The designation of an eligible dividend when the paying corporation has a positive balance in its LRIP will give rise to a special tax of 20% payable by the corporation on the excess designation. No penalty will be imposed upon an individual who has received a dividend mistakenly designated by the corporation and the individual's dividend tax credit will not be adjusted.

CCPCS

Given that CCPCs benefit from a combined tax rate (federal and Québec) of 21.12% on the initial portion of active business income earned by them (this portion is \$400,000 as of January 1, 2007), only the portion of their taxable income which is not subject to the reduced rate can give rise to the enhanced dividend tax credit. Corporations that qualify as CCPCs must establish a GRIP (general rate income pool) in order to determine whether their shareholders can benefit from the new dividend tax credit. The opening balance for the GRIP must be calculated as of January 1, 2001. Then, the GRIP of a CCPC is to be calculated only at the end of its taxation year, regardless of the date on which a dividend is paid by the corporation.

A CCPC with a positive balance in its GRIP can allow shareholders to benefit from the enhanced dividend tax credit by expressly designating the dividend as originating from the GRIP at the time it is paid. The dividend will then be referred to as an "eligible dividend." The designation by a CCPC of an eligible dividend which exceeds its GRIP balance will give rise to a special tax of 20% payable by the corporation on the excess designation. An individual who

has received such a dividend will not be liable for the mistaken designation and no adjustment will be made to the individual's dividend tax credit.

ADMINISTRATIVE GUIDELINES

On December 20, 2006, the Canada Revenue Agency issued administrative guidelines to simplify the application of the new rules as regards eligible dividends paid in 2006. These measures will not apply after 2006. Among other things, for 2006 only, corporations will be able to designate eligible dividends on the T3 or T5 slips or notify their shareholders through their financial statements (quarterly report or annual balance sheet). Consequently, it is still time for corporations to take the appropriate measures to allow

their shareholders to benefit from these new measures for dividends received during the 2006 taxation year.

This text presents the new rules in plain language; however, these rules are highly complex and raise a number of issues which have not yet been resolved, particularly as regards CCPCs. If the appropriate calculations and designations are made, a number of taxpayers will be able to enjoy substantial tax savings upon the filing of their income tax returns for the year ended December 31, 2006.

We invite you to contact our taxation specialists for a better understanding of the effects of these measures on you or your business.



1000 De La Gauchetière Street West, Suite 2900
Montréal, Québec H3B 4W5 CANADA
Telephone: (514) 878-4311 Fax: (514) 878-4333
www.dgclex.com

Please contact us for more information
regarding this article.

The lawyers in our Taxation Practice
Group are:

Steve Boucrafié
Jules Brossard
Daniel Courteau
Claude Désy, FCA

Yves Hébert
Pierre-Paul Persico
Martin Raymond