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COMMENT

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NEW DIVIDEND REGIME

The federal government introduced draft legislation on June 29, 2006, to implement changes to the taxation of dividends. The changes were originally announced on November 23, 2005, in order to level the playing field between income trusts and public companies. Income trusts have become the investment of choice for many investors because corporate tax is avoided on the income. In contrast, a dividend is paid as an after-tax distribution from a corporation, which means that there is both corporate and personal tax on a dividend.

Corporate tax rate	20%	36%
Corporate income	$1,000	$1,000
Corporate tax	200	360
Cash available for a dividend	800	640
Shareholder taxation (30%)	240	192
Shareholder's cash position	560	448
Effective tax rate	44%	55%

The old gross-up and tax credit system was based on a theoretical corporate tax rate of 20 per cent and a personal dividend tax rate of 30 per cent to create an effective (combined federal and provincial) tax rate of 45 per cent on the underlying income. To the extent the corporate tax rate was higher than 20 per cent, a form of double or over-taxation occurred. Consider the example above of a corporation taxed at 20 per cent versus 36 per cent.

The above example highlights the primary reason why investors preferred income trusts. With an income trust, the investor was taxed on the profits of the entity directly without subjecting the profits to a layer of corporate taxation. This meant that investors could often net more after-tax income with an income trust.

For example, an investor with an individual marginal tax rate of 45 per cent would pay $450 of tax on a $1,000 distribution from an income trust. For a controlling shareholder in a business earning less than the small business deduction threshold, the combined personal and corporate tax rate would be almost identical. However, for income above that threshold or where the dividend was received from a large public corporation, there was a substantial difference in the amount of net cash available to the investor. As illustrated above, where the corporation pays tax at a 36 per cent rate, the total tax on $1,000 of income is about $552 ($360 in the corporation, plus $192 at the individual level).

To level the playing field, the federal government has proposed a new set of gross-up and dividend credit mechanisms. The current gross-up and dividend credit system will remain for income that has received preferential treatment from the small business deduction, and for private company investment income. The new gross-up and dividend credit system will be used when the income has been subject to the higher corporate tax rates. Consider the following example of a corporation taxed at 20 per cent (i.e., active business income

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earned by a small business corporation) and 36 per cent (i.e., active non-manufacturing income earned by a public company or a private company in excess of its small business deduction system will remain for income that has received preferential treatment from the small business deduction, and for private company investment income. The new gross-up and dividend credit system will be used when the income has been subject to the higher corporate tax rates. Consider the following example of a corporation taxed at 20 per cent (i.e., active business income earned by a small business corporation) and 36 per cent (i.e., active non-manufacturing income earned by a public company or a private company in excess of its small business deduction).

Corporate income	$1,000	$1,000
Corporate tax (20%/36%)	200	360
Cash available for a dividend	800	640
Dividend received by shareholder	800	640
Gross-up (25%/45%)	200	288
Taxable amount	1,000	928
Shareholder taxation (45%)	450	418
Dividend tax credit (21%/39%)	210	359
Shareholder's cash position	560	581
Effective tax rate	44%	42%

As noted above, the new 45 per cent gross-up and 39 per cent tax credit will be used on all dividends that were paid from corporate income subjected to the "high" rate. Such dividends will be called "*eligible dividends*." Under the new rules, a Canadian-controlled private corporation (CCPC) will track income that did not receive tax preferential treatment in its "*general rate income pool*" (GRIP). A public corporation will track income that did receive tax preferential treatment in its "*low rate income pool*" (LRIP). The rules include provisions for dividends passing through holding companies and wind-ups/amalgamations.

A CCPC must elect to have a dividend designated as an *eligible dividend*. On the other hand, a non-CCPC is deemed to pay dividends out of its LRIP until the balance is reduced to nil. A CCPC that over-elects with respect to its *eligible dividends* will be subject to a penalty of 30 per cent of the amount of the over-election.

While the federal government has already released draft legislation, not all of the provinces have followed as quickly. Some have introduced matching legislation, some have followed the proposals but on a phased-in basis and a few have yet to respond. The specific tax results illustrated above will depend heavily on the specific provincial rates.

From an estate planning point of view, this new dividend regime may affect certain post-mortem plans. For example, any plans that involve the redemption of shares will create deemed dividends and necessitate the decision as to whether to elect to treat such dividends as *eligible dividends*. To the extent that an estate can receive an *eligible dividend* "cheaper" than funding a capital gain on the terminal tax return, redemption strategies within the first tax year of the estate will be recommended

I/R 2101.07

GIFT OF APPRECIATED SHARES

The 2006 federal budget was music to the ears of many Canadian charities. The reason for such excitement was that the federal government had eliminated the tax associated with the gift-in-kind of publicly listed securities to a charitable organization or a public foundation. Prior to this most recent change, the rule was that the taxable capital gain triggered by such a gift-in-kind was 25 per cent of the capital gain or half of the normal inclusion rate.

Consider the following example of an individual with a $10,000 stock portfolio that has an adjusted cost base of $6,000.

If the individual were to sell the portfolio, he would incur an income tax liability of about $900 (assuming a top marginal tax rate of 45 per cent on the taxable capital gain of $2,000). If he were to sell his stock portfolio and then make a gift of the proceeds, he would have a charitable receipt for $10,000, which would generate about $4,500 of tax shield (assuming a charitable tax credit rate of 45 per cent). However, because the donor sold the shares prior to the specific donation, the $900 income tax liability would also be triggered.

Value of gift		$10,000
Tax shield of gift	$4,500	
Income taxes due	900	
Net tax shield		3,600
"Cost" of gift		$6,400

Prior to the 2006 budget announcement, if this individual were to gift his stock portfolio directly in-kind to a charitable organization or public foundation, the disposition of the portfolio would trigger tax on the capital gain of $450 (i.e., one-half of the normal capital gains inclusion rate) and a charitable tax credit of $4,500, resulting in a net cost of the gift of $5,950.

Effective May 2, 2006, however, the federal budget eliminated any tax on the gain triggered by an in-kind donation of securities, with the following results.

Value of gift	$10,000
Tax shield of gift	4,500
"Cost" of gift	$5,500

The "cost" of the gift is the economic reduction in family wealth because of the gift. Because the governments allow a tax credit equal to the top marginal tax rate in the province of residence (for donations in excess of $200), the cost is now one minus the top marginal tax rate times the value of the gift. The donor no longer needs to consider the tax cost of any gain triggered by such a donation.

By making a gift-in-kind of publicly listed securities, donors will be able to avoid any accrued income tax liability associated with the disposition. This can significantly improve the donor's position and hopefully encourage larger gifts to be arranged.

The zero capital gains inclusion rate for gains triggered by gifts-in-kind of publicly listed securities can have an interesting result for portfolios held by holding companies. A private company will receive a credit to its capital dividend account equal to the non-taxable portion of capital gains. In the case of an in-kind donation of securities, the non-taxable portion will equal 100 per cent of the capital gain. The resulting capital dividend account credit can be used to facilitate the tax-free distribution of other corporate assets. (Also note that unlike individuals, corporations do not receive a tax credit for eligible donations. Instead, the donation is deductible from the corporation's income.)

I/R 1600.05

PLANNING FOR EDUCATION

At this time of year, the thoughts of many parents have turned to the cost of education – more specifically, the high cost of post-secondary education. Many parents have just waved goodbye as their children set off for another school year; or, you may know someone who has recently ventured into the realm of post-secondary education. In either case, the surprisingly high cost is a prominent point of discussion and one that is often not of concern until it is time to write the cheque.

Statistics Canada recently released information on the cost of post-secondary education.

- *Overall, students returning to Canadian universities for undergraduate studies this fall will face greater increases in tuition than last year.*
- *Students can expect to pay on average 3.2 per cent more in tuition fees, almost twice the rate of growth in the previous academic year.*
- *Undergraduate students will pay an average of $4,347 in tuition fees for the 2006/2007 academic year, up from $4,211 the year before. This is almost triple the average of $1,464 in 1990/1991.*
- *Since 1990/1991, tuition fees have increased at an annual average rate of 7.0 per cent. In the 1990/1991 and 1991/1992 academic years alone, they went up 15.2 per cent and 16.5 per cent respectively. In contrast, since 2000, the increase has slowed to an annual average of 3.9 per cent. The recent lower fee increases reflect government moves to regulate fees.*

While the Statistics Canada information is informative, there are a lot of gaps for the planner.

- Statistics Canada reports that the average tuition by facility can range from a low of $3,334 to a high of $13,463. This means that when planning, one has to be careful in choosing the current cost of tuition and not necessarily simply default to the average amount, $4,347, as reported by Statistics Canada.
- Of particular interest is the fact that tuition increases as reported by Statistics Canada are higher than the increases in the consumer

price index (CPI) for the same periods. From July 2005 to July 2006, the CPI rose 2.4 per cent, whereas the average tuition rose 3.2 per cent. From July 1990 to July 2006, the CPI rose at an annual average rate of 2.1 per cent, whereas the average tuition rose 7.0 per cent per year. This suggests that when planning for education, it may be wise to incorporate a unique inflation rate for any tuition savings plans rather than relying on the traditional CPI.

- It is important to note that the average tuition increase was as low as 1.8 per cent and as high of 5.4 per cent, depending on the academic institution. This is valuable information that needs to be considered when undertaking education planning, particularly when selecting an appropriate index rate for the tuition savings aspects.

While tuition represents a significant amount, the cost of post-secondary education encompasses many other costs that can add up quickly when it comes time to write the cheque. Examples of these additional expenses include:

- On-campus residence for an eight-month period typically costs around $5,000. Rent for an off-campus apartment may add up to a similar cost; however, students often find that they are tied to a 12-month lease that bumps the expense. It is not unreasonable to expect a cost of about $7,000 for a shared off-campus apartment, depending upon geographic location.
- Plan to budget about $3,000 for the on-campus meal plan or a similar amount for off-campus apartment living.
- Books and supplies tend to fall within the $1,000 to $1,200 range, per school year. However, these costs can vary significantly depending on the course of study.
- Often a surprise is the accumulation of expenses that fit within the categories of miscellaneous school fees, health plans, local bus passes, publication charges, etc. A review of a recent invoice depicted approximately $1,000 in charges for these types of expenses.
- There is also the consideration of the costs associated with travel to and from home. While this is certainly a variable expense depending on choice of school and distance from home, it adds up quickly. In this example, we will budget $1,000 for the year.

These non-tuition additional expenses sum to a range of $11,000 to $13,200, which is more expensive than the tuition itself. And, in this case, there is nothing budgeted for clothes and spending money.

Parents and students have to be in a position to fund educational costs of approximately $15,000 per year for university or college, depending on the location of the institution, facility chosen, type of program and living arrangements. This amounts to $60,000 for a four-year undergraduate program. Post-graduate programs, which are becoming more popular, place additional financial pressure on families. Finally, note that these are the costs for a single student; when there is more than one child, the numbers multiply accordingly.

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