PLANNING MATTERS

Leith Wheeler INVESTMENT COUNSEL LTD.

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Tax Topics

Budget Update

In recent budgets the Federal Government has demonstrated a measure of creativity within the framework of the Canadian taxation system by introducing new strategies aimed at providing assistance to homeowners and individuals trying to save money.

The introduction of the Tax-Free Savings Account (TFSA) in the 2008 federal budget was an innovative idea that has the potential to reap long-term benefits for many taxpayers. Beginning in 2009, any individual who is a resident of Canada and 18 years of age or older can establish a TFSA and contribute up to $5,000[1] per year to their TFSA. The contributions grow tax-free inside the TFSA and can be withdrawn at any time, also tax-free. Further, withdrawals from a TFSA can be re-contributed the following year. Compared to an RRSP as a savings vehicle there are some similarities and some major differences – although the contributions in an RRSP also grow tax-free, withdrawals by the annuitant will always be taxable. On the other hand, contributions to the RRSP are deductible from income, whereas contributions to a TFSA are not.

More recently, the January 27, 2009 federal budget proposed a one-time new Home Renovation Tax Credit worth up to $1,350 of tax savings per family. If passed into law, homeowners will have from January 28, 2009 until January 31, 2010 to incur expenditures in excess of $1,000 but not more than $10,000 that are in respect of a renovation or alteration of a dwelling, including the land upon which the dwelling is situated. Examples of eligible expenditures include renovating a bathroom, laying new flooring or carpet, installing a new furnace or painting the interior or exterior of the house. Importantly, valid receipts will be required to support eligible expenditures.

Continuing with the theme of home ownership, the Home Buyers Plan RRSP withdrawal limit has been increased from $20,000 to $25,000 for 2009. The Home Buyers Plan allows Canadian-residents that already have an RRSP to borrow funds from their RRSP for the purpose of purchasing or building their first home. Also, a new non-refundable First-Time Home Buyers' Tax Credit was proposed in the 2009 budget. Worth up to $750 of tax savings, first-time buyers who acquire a home after January 27, 2009 can benefit from this measure once passed into law.

Dividend Update

One of the lesser understood changes that have come about in recent years' fiscal legislation is related to the taxation of dividends received from Canadian corporations. Prior to 2006, all dividends paid by Canadian corporations and received by an individual shareholder in Canada were taxed in the same manner. Income tax was calculated by using an integration mechanism that first grossed-up the taxable amount of the dividend and then reduced the tax calculated by applying a dividend tax credit. The intention of this mechanism was to avoid double taxation by reducing the shareholder's personal tax on the dividend by a notional amount somewhat similar in amount to the tax that had already been paid by the corporation.

This all changed in 2006 with the introduction of "eligible dividends". For years after 2005, dividends received by a shareholder are characterized as either "eligible dividends" or "dividends other than eligible dividends". The type of dividend is effectively determined by the rate of tax paid by the corporation that is paying the dividend and it is up to the corporation to designate what type of dividend it is paying. Generally speaking, where a corporation has paid full-rate tax on its profits, it can distribute the after-tax profits by way of eligible dividends to its shareholders. Most public companies will be in this position. Alternatively, companies that pay lower rates of tax on their profits, such as privately-held small business corporations, generally pay dividends that are characterized as "other than eligible dividends", the taxation of which continues to fall under the original mechanism.

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[1] Indexed to inflation for years after 2009.

Where the shareholder is a Canadian-resident individual, eligible dividends produce a larger dividend tax credit. Those individuals paying tax at a high marginal rate will prefer eligible dividends since overall personal tax will be less than with other types of income. To illustrate, for 2009, an individual taxpayer residing in BC, Alberta, or Ontario(2) with taxable income in excess of $126,264 will be taxed on each additional $1 of income received as follows:

Type of Income (Actual)	BC (2009)	Alberta (2009)	Ontario (2009)
Eligible Dividends	19.92%	14.55%	23.06%
Dividends Other than Eligible Dividends	32.71%	27.71%	31.34%
Interest and Regular Income	43.70%	39.00%	46.41%
Capital Gains	21.85%	19.50%	23.20%

As the above table shows, the rate applicable to eligible dividends received in 2009 is currently less than the rate applicable to capital gains. However, as general corporate tax rates are expected to decline over the next few years, the personal tax rate on eligible dividends is also expected to increase.

Notably, the dividend tax credit mechanism creates some interesting planning opportunities for a high rate taxpayer that is financially supporting one or more family members in a low marginal tax bracket or is able to split his or her income through a testamentary trust. For example, where a family member has no other sources of income for the year but dividends, he or she may receive a certain amount of dividends before paying any personal income tax. This is a result of the dividend tax credit applying to fully eliminate the federal and provincial tax otherwise payable on the dividend.

The following table illustrates the amount of each type of dividends that can be received "tax-free"(3) by an individual in 2009 (assuming no other income is received in the year):

Actual Amount of Dividends Received	Residing in BC (2009)	Residing in Alberta (2009)	Residing in Ontario (2009)
Eligible Dividends	$ 50,320	$50,320	$ 50,320
Dividends Other than Eligible Dividends	$ 32,400	$20,640	$ 37,500

Where an income-splitting arrangement has been properly established, streaming dividends to a low-income family member may be very tax-efficient for the family unit. An example of such an arrangement could be a situation in which a discretionary family trust owns an investment portfolio that generates dividends. If the beneficiaries of the trust include children or grandchildren that are financially dependent upon the family, the trustee could pay an amount of the dividends from the trust to the low-income children without incurring any taxation to the child. As a result of the dividend tax credit mechanism, dividend income-splitting arrangements can result in significant annual tax savings to a supporting taxpayer.

As can be seen, understanding the taxation of dividend income is not as simple as just applying one's marginal tax rate to the amount received. Although the Canadian government has mostly succeeded in aligning the taxation of public company dividends to be competitive with capital gains, the gross-up and dividend tax credit mechanism begs some additional consideration. One of the positive considerations is that dividends provide an income-splitting opportunity to high income investors that may not be available with other types of investment income. Not everyone may be able to benefit but it's worth talking to your accountant to find out.

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(2) The BC, Alberta, and Ontario personal tax rates listed above include any changes announced in the respective 2009 provincial budgets.

(3) Also taking into account the impact of Alternative Minimum Tax (AMT). Note that if the dividends are received by a testamentary or inter vivos trust, AMT may apply at a lower amount. For Ontario residents, the amounts do not consider the impact of the Ontario Health Premium which is applied at increasing amounts to an individual's taxable income over $20,000.