

## Tax and Investment Funds Alert

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### Income Trusts: Canadian Government Proposes to Reduce Taxes on Corporate Dividends to Level Playing Field

#### Background

Over the past several years the Federal government has shown concerns over the potential loss of tax revenues from the numerous conversions of Canadian corporations into income trusts. By way of background, in the case of a corporation, tax is paid first at the corporate level and then the after-tax income may be distributed in the form of dividends which are taxed at the shareholder level. In a typical income trust structure little or no income tax is paid at the entity level as all income is distributed to and taxed only in the hands of the unitholders. The overall amount of tax paid in a corporate structure is greater than the amount of tax that would be paid if the income of the corporation were earned and taxed directly in the hands of the shareholder. The discrepancy in tax rates currently is approximately 10% in the case of an investor who is an individual resident in Canada taxed at the highest marginal rate.

On September 8, 2005, the Department of Finance (Canada) released a consultation paper on tax and other issues relating to publicly-listed flow-through entities such as income trusts and limited partnerships and invited interested parties to make submissions by December 31, 2005. In addition, on September 19, 2005, the

Federal Government announced it would postpone providing advance tax rulings respecting flow-through entity structures during the consultation process.

#### The Announcement

On November 23, 2005, the Minister of Finance abruptly ended the consultation process and announced the government's intention to address the concerns by reducing the tax burden on corporate dividends in order to level the playing field between public corporations and income trusts. It was also announced that the Canada Revenue Agency would resume providing advance tax rulings on flow-through entity structures.

The reduction in the tax burden on dividends will be implemented by providing for an enhanced dividend tax credit for individuals commencing in 2006 which, if similar amendments are made in Ontario, will effectively reduce the current top rate of tax on dividends for an individual resident in Ontario from approximately 31% to 21%.

Not all dividends will be eligible for the enhanced dividend tax credit. It is generally intended to apply only to dividends from public Canadian corporations that are subject to the general corporate income tax rate.

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It also will apply to dividends received from Canadian controlled-private corporations to the extent that their income (other than investment income) is subject to the general corporate income tax rate.

According to the announcement, the enhanced dividend tax credit will cost the Government of Canada approximately \$300 million per year starting in 2006.

### Non-Residents and Tax-Exempt Investors

Despite the intention to “level the playing field,” from an income tax perspective, income trusts should still be preferred over public corporations by tax-exempt and non-resident investors because their after-tax return will still be greater. In the case of tax-exempt investors, there is theoretically no tax leakage at all in an income trust structure.

In the case of a non-resident investor in an income trust, there only will be withholding tax on distributions, typically imposed at a rate of 15% under most of Canada’s tax treaties. In the case of many income trusts there is no withholding tax on distributions of returns of capital. By comparison, a non-resident investor in a Canadian corporation will also generally be subject to a 15% withholding rate

on dividends under most of Canada’s tax treaties, but the amount available for distribution in a corporate structure will be less than in a trust structure due to the imposition of corporate income taxes.

Generally, non-residents are not subject to Canadian capital gains tax on a disposition of units of a Canadian income trust or on a disposition of publicly listed shares of Canadian corporations. This remains unchanged.

### Legislative Enactment

The implementation of the proposal requires the enactment of legislation after the next federal government is formed in early 2006.

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