

WHAT'S NEW

YEAR END TAX PLANNING - 2006

As the end of 2006 approaches, this WHAT'S NEW is a reminder to review your personal tax situation. Personal tax planning is important to the management of your financial affairs and should be considered throughout the year and not just late in the year.

The aim of tax planning is straightforward: minimize your tax burden or defer taxes to a later tax year. Tax planning can include preventing events that could create unwelcome tax consequences.

This WHAT'S NEW will assist residents of Quebec who wish to take advantage of opportunities that exist for minimizing income taxes for 2006 and subsequent years. It is based on existing and proposed legislation and the current interpretation of tax laws by the Canada Revenue Agency (CRA), Revenue Quebec and the courts.

This WHAT'S NEW also covers recently announced changes to the taxation of income trusts.

IMPORTANT DATES AND DEADLINES

Many deductions and credits are available only if payments are made by December 31, 2006 or early in 2007. Important deadlines are summarized below.

Amounts to be paid by December 15, 2006

- final personal income tax instalment for 2006

Amounts to be paid by December 31, 2006

- investment counsel fees
- carrying charges on investments
- safety deposit box fees
- professional membership and union dues
- charitable donations
- medical expenses
- moving expenses
- interest expense (if claimed on a cash basis)
- alimony and support payments

- certain legal, tax, and accounting fees
- political contributions
- tuition fees
- tax shelter investments
- employment expenses (office in home, travel expenses, etc.)
- to ensure the settlement date occurs in 2006 for dispositions of most publicly traded securities, we recommend trades be executed on or before December 22, 2006
- contributions to Registered Education Savings Plans to qualify for 2006 Canada Education Savings Grant

Information returns to be filed by January 15, 2007

- an employee must advise their employer of their intent to elect to defer benefits from stock options exercised in 2006

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Amounts to be paid by January 30, 2007

- any interest owing for 2006 on loans to family members (including loans to family trusts) must be paid by January 30, 2007 so that the income attribution rules will not apply for 2006 and subsequent years
- any interest owing by an employee to his or her employer must be paid by January 30, 2007 in order to reduce the interest benefit on a low-interest or interest-free loan for 2006

Amounts to be paid by February 14, 2007

- if an employee is provided with an automobile for work and uses it for personal use, it may be appropriate for the employee to repay the 2006 personal operating costs paid by his or her employer by February 14, 2007. This repayment will reduce or eliminate the taxable benefit for the personal operating costs paid for by the employer. This benefit must be included in income at the rate of 22 cents (19 cents for an automobile salesperson) per kilometre of personal use.

Information returns to be filed by February 28, 2007

- T4s, T4As/relevé 1s, T5s/relevé 3s and the respective summaries for 2007

Amounts to be paid by March 1, 2007

- deductible contributions to an individual's RRSP or a spousal RRSP (for 2006)
- repayments of RRSP Home Buyers Plan (for 2006)

Amounts to be paid / information returns to be filed by March 15, 2007

- first personal income tax instalment for 2007

Amount to be paid by May 1, 2007

- balance outstanding on 2006 personal taxes payable

CHANGES TO THE TAXATION OF INCOME TRUSTS

On October 31, 2006, the Honourable Jim Flaherty, Minister of Finance unveiled his Tax Fairness Plan for Canadians, designed to restore balance and fairness to the federal tax system by creating a level playing field between income trusts and corporations.

For months many publicly traded Canadian corporations have announced their intention to convert to income trusts, or have already converted to income trusts. While operating within the current tax rules, these corporations have sought more favourable tax treatment by capitalizing on the flow-through nature of the taxation of income earned by trusts thereby bypassing taxation at the corporate level.

In the opinion of the Department of Finance, this trend was creating an economic distortion that is threatening Canada's long-term economic growth and shifting any future tax burden onto hardworking individuals and families. Furthermore, tax-exempt entities that are unit holders of these trusts, including registered pension plans and registered retirement savings plans, pay no tax whatsoever whereas non-resident unit holders pay only the withholding tax on distributions. If left unchecked, these corporate decisions would result in billions of dollars in less revenue for the federal government to invest in the priorities of Canadians, including more personal income tax relief. These decisions would also mean less revenue for the provinces and territories.

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The Department of Finance had previously announced changes to the taxation of dividends paid by large corporations, effective for 2006, by lowering the tax payable by individuals who receive them in the hope that this would remove the bias in favour of income trusts. Judging by the apparent lack of response from the corporate community, the Department felt compelled to take further action.

The measures announced by the Minister are summarized below.

1. New Taxation System for Income Trusts and their Investors

The distributions made by almost all publicly traded income trusts and limited partnerships that qualify as "specified investment flow-throughs" (SIFTs), will be subject to tax at the level of the SIFT at a special rate that is intended to approximate the combined federal and provincial tax rate applicable to corporations.

Under current law, income trusts are entitled to deduct from their income the amounts that they distribute to unit holders.

Since these trusts typically distribute all of their income, the tax burden is effectively shifted to their beneficiaries. Under this new proposed system, this deduction will no longer be allowed with respect to income other than portfolio income. On the other hand, limited partnerships are not required to pay income tax at all since all of their income is taxed in the hands of the limited partners. It is therefore proposed that limited partnerships be taxed in a manner similar to trusts on their non-portfolio income. SIFTs will be taxed at a special rate designed to equate to the sum of the federal general corporate tax rate plus a 13% notional provincial tax.

It is noted that real estate investment trusts

(REITs) will be excluded from these measures and will therefore continue to be subject to the current rules.

Based on currently enacted corporate rates and the proposed rate reduction for 2011 that is described below, the special tax rate applicable to SIFTs will be 34% for 2007, 33.5% for 2008, 33% for 2009, 32% for 2010 and 31.5% for 2011 and subsequent taxation years.

If an income trust does not distribute all of its income, the portion that is not distributed will be subject to tax at the same rates currently applicable to income retained in a trust, generally the highest federal and provincial personal income tax rates applicable to individuals.

Income subject to this new tax will be treated as an eligible taxable dividend from a Canadian corporation in the hands of the unit holder, i.e. for individuals, subject to a 45% gross-up and a dividend tax credit.

These measures will not apply to SIFTs that began to be publicly traded before November 2006 – or their investors – for taxation years that end before 2011. For SIFTs that begin to be publicly traded after October 2006, the changes will apply for the later of their 2007 taxation year and the taxation year in which they begin to be traded.

Note that the treatment of distributions of capital amounts, considered as "return on capital", is unchanged by the proposed measures described above.

2. Reduction of General Corporate Tax Rate

The 2006 Budget announced that the general corporate tax rate would be reduced from 21% to 19% between now and 2010. It will now be reduced by another one-half point to 18.5% in 2011.

3. Increase in the Age Credit Amount

The age credit, a special federal income tax credit for Canadians 65 years of age and over, previously established at \$4,066 for 2006, will be increased to \$5,066 effective for the 2006 taxation year.

This credit is subject to an income test that targets the assistance to seniors who need it most. The unused portion of the credit may be transferred to a spouse or common-law partner. For 2006, the age credit amount begins to be phased out when net income reaches \$30,270. The phase-out rate is 15%, which means that the credit would be fully phased out when net income reaches \$57,377. With this enhancement, the age credit will be fully phased out when net income reaches \$64,043.

4. Introduction of Pension Income Splitting

Canada's income tax system generally requires each individual taxpayer to report and pay tax on all of the income they earn. Recognizing the special challenges of planning and managing retirement income, and to provide targeted assistance to pensioners, a new mechanism for pension income splitting has been introduced.

This measure will allow any Canadian resident who receives income that qualifies for

the existing pension income tax credit to allocate to their resident spouse (or common-law partner) up to one-half of that income. This measure will significantly increase the incentive to save and invest for family retirement security.

For individuals aged 65 years and over, eligible pension income includes lifetime annuity payments under a registered pension plan, a registered retirement savings plan or a deferred profit-sharing plan and payments out of or under a registered retirement income fund. For individuals under 65 years of age, eligible pension income includes lifetime annuity payments under a registered pension plan and certain other payments received as a result of the death of the individual's spouse or common-law partner.

The amount allocated will be deducted in computing the income of the transferor (the person who actually received the pension income) and included in computing the income of the transferee (the person to whom some or all of the pension income is allocated). Since it will in many cases increase the transferee's tax payable, both persons must agree to the allocation in their tax returns for the year in question.

The pension income splitting allocation will be available for the 2007 and subsequent taxation years, and must be made one year at a time.

WHAT'S NEW

FOR FURTHER INFORMATION:

AMMAR COUSINEAU
 ALTMAN TÉLIO HADID
 1 WESTMOUNT SQUARE, SUITE 250
 MONTREAL, QUEBEC H3Z 2P9
 TEL: (514) 931-4411
 FAX: (514) 931-3066
 E-MAIL: acath@acath.qc.ca