

New legislation on income trusts and pension income splitting

On October 31, 2006, the federal government announced new tax policies regarding income trusts, pension income splitting for seniors and the age credit. Do these changes impact your personal finances and investments? AIM Trimark has provided the following analysis to help you understand the new rules.

Income trusts defined

Income trusts invest in businesses that produce income that is, in turn, passed on to investors in the form of distributions.

The market capitalization of income trusts has grown exponentially over the last five years – an ongoing concern for the government because the more corporations convert to income trusts, the higher the government's tax revenue loss.

Past success of income trusts

In the past, a corporation could avoid paying corporate income taxes by converting to an income trust. How?

Instead of going public through a traditional initial offering of common shares, a corporation would convert to an income trust. Each year, any income earned inside the income trust would be “flowed out” to investors, free of any tax, and thus only be taxed once – in the hands of investors.

The federal government responds

The government's October 31 announcement is the latest in a series of tax policy announcements spanning a two-year-plus period that attempted to deal with the loss of corporate tax revenues.

March 2004 – The government proposed tax restrictions on the amount that Registered Pension Plans (RPPs) could invest in income trusts. Because RPPs are non-taxable, they don't pay any tax on distributions received from income trusts. While RPP members ultimately would pay tax when monies are withdrawn, this is many years in the future.

May 2004 – Yielding to pressure from the pension industry, the government suspends the RPP proposals.

September 2005 – The government issues a discussion paper proposing three possible tax policy approaches to deal with income trusts:

- Limiting the quantum of interest expense deduction on high-yield debt, often used by income trusts to eliminate any corporate tax in the operating company;
- Imposing a corporate-type income tax on flow-through entities; and
- Fixing the personal/corporate integration system (enhancing the dividend tax credit system).

November 2005 – In an attempt to balance the tax treatment of corporations and income trusts, new dividend rules are introduced to enhance the dividend tax credit – an approach only marginally successful.

Unbalanced tax treatment continues to be problematic

Because non-residents and tax-exempts, like RPPs, RRSPs and RRIFs, aren't entitled to the dividend tax credit, they continue to prefer the income trust structure, wherein no corporate tax is taken at the source.

In addition, withholding tax on distributions paid to non-residents is applied at the federal level, excluding the provinces from receiving this type of revenue. Furthermore, unlike corporations, which typically pay tax in the province(s) where they are located, in the income trust structure, tax revenues shift to the investors' province of residence, representing another source of potential provincial tax revenue loss.

The new rules:

Tax income trusts like corporations

As announced on October 31, income trusts' income will be taxed at corporate tax rates.

Investors who receive these new types of taxed distributions will be taxed as if they received distributions of Canadian dividends.

For new trust conversions (established from November 1, 2006 onward), the proposal will be effective for the 2007 tax year.

For existing publicly traded income trusts, the new tax will not come into effect until 2011.

Pension income splitting for seniors

Effective in 2007, Canadian residents with income that qualifies for the pension tax credit will be eligible to allocate up to 50% of that income to their spouse or partner.

This change should be very positive in terms of seniors' ability to pay less tax as a couple. Moreover, spousal plans, including spousal RRIFs, may become less important as an individual can now simply convert to a RRIF and transfer half of the income to a spouse or partner.

Age credit enhancement

There's good news for Canadians eligible for the age credit: a federal income tax credit for people 65 years of age and older. Effective retroactively to January 1, 2006, the amount on which the age credit is computed has been enhanced to \$5,066 from \$4,066. With this enhancement, the age credit will now be fully phased out (at a phase-out rate of 15 cents per dollar of net income above \$30,270) when net income reaches \$64,043, up from \$57,377.

For more information about this topic, contact your advisor,
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