

Update

Tax Law

December 12, 2006

New Dividend Tax Rules to be Enacted

Under the May 2006 federal budget, the Government of Canada announced proposals to implement an enhanced dividend tax credit for dividends paid by Canadian corporations to Canadian individual shareholders. The dividend tax credit would allow such dividends to be taxed at a lower preferential tax rate. The proposals were issued to address the Government's concerns at that time over the tax impact of income fund structures, but they have far broader implications and generally affect Canadian corporations at large.

What is the current status of the proposals?

Implementing legislation has been subsequently released, requiring corporations to designate dividends paid after 2005 as "eligible dividends" in order for the preferential dividend tax rate to apply. Accordingly, this new legislation must be considered by corporations before the payment of any dividends (including any deemed dividends which may arise, for example, on the redemption or purchase for cancellation of shares). If certain compliance requirements are not met at the time the dividends are paid, the preferential tax rate may be lost. In addition, such designations on intercorporate dividends can affect a corporate recipient's ability to pay eligible dividends to its own shareholders.

This new legislation is expected to be enacted before the end of December 2006, and will have immediate implications for corporations that pay dividends.

What do you need to do?

Corporations that pay dividends will need to consider the following:

- **Contemporaneous Written Notification:** Any dividends paid by a corporation after enactment of the new legislation will require written notification to be given to the recipient shareholders at the time of

payment in order to be validly designated as eligible dividends. Late designations generally will not be permitted after a dividend has been paid. For publicly-listed corporations, the Canada Revenue Agency has indicated that notification could be made in the press release announcing the payment of the dividend or on the corporation's website.

- **Application to Dividends Previously Paid:** For any dividends paid by a corporation during 2006 and before enactment of the new legislation, the corporation will have 90 days from the date of enactment to notify the shareholders in writing that the dividends are eligible dividends. This means that action must be taken during this 90-day period in respect of dividends previously paid in 2006. The notification in respect of previous intercorporate dividends could affect the ability of a corporation to pay eligible dividends subsequently.
- **Tax to Corporation Paying Dividends:** The determination of whether an eligible dividend designation is appropriate in a given circumstance must be made separately in respect of each dividend. An incorrect determination could result in the payor corporation becoming liable to a special tax. Accordingly, tax advice should be obtained as early as possible before eligible dividends are paid.

Should you have any questions with respect to the application of the new legislation, please do not hesitate to contact a member of the tax section.

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