



In Touch *with* Tax

talkin'
TAX

Green • Chencinski • Starkman • Eles LLP
CHARTERED ACCOUNTANTS



2011 - 2012 PERSONAL TAX COMMENTARY

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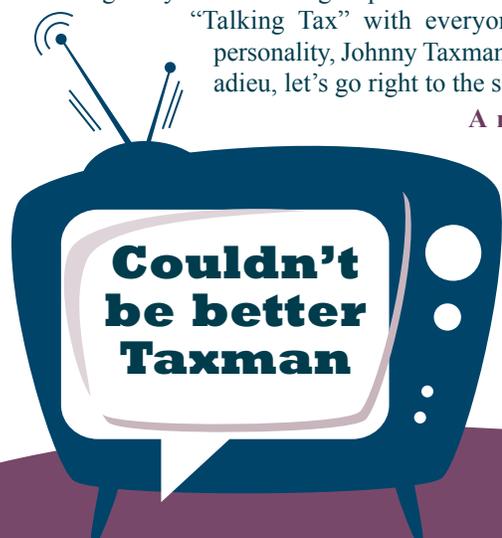
Heeere's JOHNNY

Oprah, Jay Leno, David Letterman, Conan, Jimmy Kimmel, Ellen DeGeneres and yes, even Dr. Phil. The list of talk show hosts goes on and on and on. It seems that you can't turn on the TV these days and not be bombarded by the plethora of talk show programming.

There is an endless stream of topic matters covered by this type of program. The lives of celebrities, health issues, true crime stories, and more. You name it and it is sure to be seen on one of the many talk show formats that span the airwaves. However, there is one topic that doesn't get the coverage it deserves. One topic that affects almost all Canadian viewers, that is near and dear to their hearts. That's right, everyone's favorite topic: Tax!

Never one to let a good idea go to waste, the writers at GCSE have developed a new talk show program that is guaranteed to be a sure fire hit. We call it "Talkin Tax". Hosted by everyone's favorite talk show host Johnny Taxman, the show is scheduled to premiere this coming April to coincide with the height of tax season. Designed to air very late in the evening (when all accountants are slavishly working on their client files,) it is sure to be a big hit for those suffering from insomnia.

You lucky readers, are now in for a real treat, as we are about to give you a small glimpse of the pilot episode of "Talking Tax" with everyone's favorite tax personality, Johnny Taxman. Without further adieu, let's go right to the show".



Announcer:
Heeere's
Johnny (the
Tonight Show)
**Johnny
Taxman:**
Thanks Ed.

We've got a really big show! (The Ed Sullivan Show). Welcome to the inaugural episode of Talkin Tax, where what you see is what you get! (The Flip Wilson Show). I would like to bring out my first guest, everyone's favorite accountant, senior partner of the accounting firm, Brooks, Frank and Robinson, Mr. Willis Robinson. Mr. Robinson loves to field a few questions. Come on Down! (The Price s Right) Willis. [The accountant enters to massive applause and cheering...who would expect otherwise. He takes the seat right beside Johnny Taxman's desk].

Johnny Taxman: "You look mahvelous" (Saturday Night Live – Billy Crystal). It's great to have you on our show Willis. How you doin? (Friends).

Willis Robinson: Couldn't be better Taxman. April is my time to shine. I love it when a plan comes together. (The "A" Team). Everyone at Brooks, Frank and Robinson are burning the midnight oil to develop those excellent personal tax planning tips that will save our clients those precious tax dollars. Yeah, that's the ticket (Saturday Night Live – Jon Lovitz).

Johnny Taxman: Danger Will Robinson (Lost in Space). Your principal adversary, the government, is lurking in the shadows, ready to attack any and all of your fabulous planning. Let's be careful out there ("Hill Street Blues").

Willis Robinson: Holy crap, Taxman (Batman). Let's get ready to rumble (any boxing/wrestling event – Michael Buffer). All of our tax planning is designed to stand the test of time. Our planning is Dyn-o-mite (Good Times). We take extra care to make sure all of our RRSP, capital gains exemption and income splitting

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planning works.

The truth is out there (The X Files).

We love the taste of “the thrill of Victory” and not “the agony of defeat” (Wide World of Sports). We work tirelessly to make sure we stay on the right side of that ledger.

Johnny Taxman: Well isn't that special (Saturday Night Live – Dana Carvey). Yada, Yada, Yada (Seinfeld). But where's the beef? (Wendy's Ad).

Willis Robinson: D'oh (The Simpsons). Who loves you baby? (Kojak). You are one tough host Taxman. At Brooks, Frank and Robinson we back up our words with action. How sweet it is (The Jackie Gleason Show). Tax planning is a tricky game. Tax planning is not a once a year activity. Good planning should be carried out throughout the year. We spend countless hours developing all our planning ideas. Would you believe...maybe one hour a week? (Get Smart).

Johnny Taxman: Whatchoo talkin' bout Willis? (Different Strokes). I know the gang at Brooks, Frank and Robinson are more diligent than that.

Willis Robinson: Just accounting humor Taxman. We are two wild and crazy guys (Saturday Night Live – Steve Martin and Dan Aykroyd). We focus our personal tax planning tips on two principal objectives, the first objective is simply the reduction of taxes. Don't want client's thinking you missed it by that much (Get Smart). Our second and equally important objective involves trying to defer taxes to future years. Deferring taxes is an often forgotten objective in the game, but taxpayer's should not discount its value. And that's the way it is (CBS Evening News – Walter Cronkite). Deal or no deal (Deal or no Deal).

Johnny Taxman: I know nothing! (Hogan's Heroes). That's why you are the real Taxman Mr. Robinson. Sock it to me (Laugh-In).

Willis Robinson: Just one more thing... (Columbo). I've brought along our new tax planning booklet for 2011-2012. Who says a little shameless plug now and then is a bad thing. Veery Interesting (Laugh-In), that while our tax tips are designed primarily for the 2012 season, there some tips that may still relate to 2011. If you follow our advice you will live long and prosper (Star Trek). Despite the fact we spend countless hours

developing our tips manual, it's not designed to replace the advice and counsel of a good sound professional.

Johnny Taxman: Baby, you're the greatest (The Honeymooners). Is that your final answer? (Who wants to be a Millionaire).

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Announcer: So that's the end of our program. We hope you enjoyed our show. Now let's turn it over to Johnny Taxman to sign off.

Johnny Taxman: Thanks for tuning in for the last 60 minutes. All of us at Talkin' Tax work 24 hours a day with Glee and Good Times to help save you tax. So tell all your Friends and All in the family. Our planning won't put you in Jeopardy or make you Lost. Don't Curb your enthusiasm as The Price is Right. Our Mission's not Impossible. It's Happy Days when we can save you tax. So stick with our tax tips and you can reap a Bonanza. Maybe you too can be the next Six Million Dollar Man.

Willis Robinson:
Yes. Goodnight John-Boy (The Waltons).



TAX PLANNING TIPS

A number of tax planning tips are scattered throughout this commentary. In order to focus on these strategies, we have italicized in maroon those comments in the document where we offer advice or tips of a planning nature. It is important to emphasize that many of the tips offered may require the assistance of a professional tax advisor.

TAX DEFERRAL PLANS

Registered Retirement Savings Plan (“RRSP”)

A RRSP is one of Canada’s favourite tax planning tools. Canadians have invested vast sums of money in RRSPs and the amount of contributions made on an ongoing basis continues to increase as the RRSP contribution limit steadily climbs.

An RRSP allows an individual to make tax-deductible contributions to a retirement savings plan offered through various financial institutions. The income earned in the plan is sheltered from income tax; however, all contributions and accumulated earnings are taxable when withdrawn. The combined benefits from the tax deductions and tax-free accumulation of income in a RRSP are too favourable to pass up. Hence, a RRSP may serve as an excellent planning tool to defer the taxation of income, and to accumulate retirement savings.

There have been certain tax schemes designed to allow a person to access his/her pool of RRSP funds without recognizing the amount in income. This trend has been addressed by the government through the introduction of certain anti-avoidance rules, discussed under the “new RRSP Anti-Avoidance Rules” section.

Contribution Limits & More

The contribution limit is \$22,450 in 2011. Where an individual does not participate in an employer-sponsored pension plan, his or her deductible contribution to a RRSP will be limited to the lesser of 18% of the preceding year’s earned income and the annual contribution limit (i.e. \$22,450 for 2011). Accordingly, 2011 contributions are based on 2010’s earned income. Because of this, individuals can determine their maximum RRSP contribution room early in the year.

The following chart sets out the applicable RRSP contribution limits for the 2011 and 2012, and the amount of earned income required in the previous year to permit the maximum contribution. The limit will increase each year in proportion to the increase in the average Canadian wage.

| <u>Contribution Limit</u> | <u>RRSP Annual Contribution Limit</u> | <u>Earned Income Required In Previous Year For Maximum Contribution</u> |
|---------------------------|---------------------------------------|---|
| | \$ | \$ |
| 2011 | 22,450 | 124,722 |
| 2012 | 22,970 | 127,611 |
| 2013 | Indexed | Indexed |

Where the individual participates in an employer-sponsored pension plan, the rules become more complex.

For members of a pension plan, the RRSP contribution limit determined above will be reduced by the prior year’s Pension Adjustment (PA). This PA represents the value of pension benefits that accrued to an employee in a particular year. A pension adjustment reported on each employee’s 2010 T4 slip will reduce the RRSP contribution limit otherwise determined for 2011. The purpose of the pension adjustment is to put RRSPs for all individuals on the same playing field as employees with Registered Pension Plans. The RRSP limit may also be reduced if the employer reports a 2011 Past Service Pension Adjustment (PSPA). This will occur if past service benefits have been added to a pension plan on a retroactive basis.

If a corporation adds past service benefits for a shareholder who owns at least 10% of the shares of the corporation, the shareholder’s current year deduction limit will be decreased immediately. If the shareholder had already made his/her RRSP contribution for the year, an over contribution may occur immediately. (See Excess RRSP Contributions below for discussion concerning the penalty tax on over contributions.) It is possible to reduce the PSPA, and eliminate the over contribution problem, by transferring an equal amount from the RRSP to the pension plan.

If an individual leaves his employment without full vesting of his pension benefits, he may be entitled to a pension adjustment reversal (PAR). The PAR is designed to rejuvenate RRSP contribution room that was lost to Pension Adjustments that were calculated while the individual was an employee. PARs that result from employment changes will increase RRSP contribution room for the year that employment changes.

The GCSE 2012 Tax Estimator is operational.

Simply visit us at gcse-ca.com and click on the Tax Estimator box, and follow the instructions. Subject to the restriction outline, the Tax Estimator will generally give you a reasonable idea of your 2011 tax results. This Tax Estimator will also provide a reasonable estimate of 2012 taxes.

Many taxpayers have already been notified by the CRA as to their RRSP contribution limit for 2011. This information should have been included as part of the Notice of Assessment received by taxpayers for their 2010 tax returns. The 2011 RRSP Deduction Limit Statement section of the form reports any unused contribution room (discussed later) from earlier years. In addition, it also reports the amount of “undeducted” RRSP contributions available to be used in 2011. This amount represents the RRSP contributions made in earlier years that have not previously been deducted. However, as with any document received from the government, an overriding caution applies: let the taxpayer beware. The information supplied by the CRA should be used as a guide only. The government calculation should be checked for accuracy, especially in circumstances where additional information was submitted after the return was originally filed. If a taxpayer did not receive a notice advising of the RRSP contribution limit, this information can be obtained from the CRA. Note that in the case of undeducted contributions, the CRA will only have the accurate information if all of the RRSP contribution slips/amounts have been reported in the tax returns.

As noted, the maximum 2011 RRSP contribution limit is calculated based on 2010 earned income. Earned income includes gross salaries (after deducting employment expenses), business income/loss (i.e. self-employed or as an active partner), taxable alimony and maintenance receipts, rental income/loss, and disability pension from the Canada Pension Plan. It excludes interest income, dividend income, capital gains, any income or losses from limited partnerships (other than from rental property), and other pension benefits and retiring allowances. Deductible alimony, maintenance payments, rental losses, union or professional dues reduce earned income.

Because of the one year earned income lag for determining contributions noted earlier, taxpayers may find themselves deducting RRSP contributions in years in which their only income is from investments (e.g. the year after retirement). Conversely, taxpayers with significant earned income in one year may be unable to utilize their RRSP contribution because of insufficient earned income in the prior year (e.g. first year of employment).

Some basic RRSP concepts continue to apply. For example, *to be deductible from 2011 income, contributions to a RRSP must be made by February 29, 2012.* Contributions made in the first 60 days of 2012 can be deducted in 2011 or any future year. *An individual may also contribute to a RRSP for his or her spouse as long as the contributions to both plans do not exceed the maximum contribution limit of the contributor.* The advantages of a spousal contribution are explored in more detail in our Income Splitting section.

Contributions to an individual’s own RRSP can be made up to the end of the calendar year in which an individual turns 71. *An individual over the age of 71 can make spousal contributions, as long as the spouse is younger than 71.*

As with any deduction, the tax savings that result from a RRSP contribution depend on the taxpayer’s effective marginal tax rate. RRSP deductions are more beneficial to individuals with higher income. The effective marginal tax rates are illustrated in Schedule 1 (on page 22).

Carryforward of Unused Contribution Room

Flexibility is the name of the game under the existing RRSP regime. This flexibility essentially surfaces in one of two forms. *RRSP contributions need not be deducted even if they can be claimed in a given year. A taxpayer can wait until a future year, perhaps when he/she is subject to a higher tax rate, to take the deduction.* In the meantime, income on this contribution is still accumulating in the RRSP on a tax-deferred basis.

In addition, and perhaps more importantly, taxpayers who do not contribute their maximum RRSP limit in a given year are able to carryforward the unused excess (known as unused contribution room) indefinitely and increase the available RRSP deduction in future years. This carryforward provision permits a taxpayer to make a tax-deductible contribution even if he/she has no earned income in that year or in the previous year. The amount deducted in that future year can be from a new contribution or from previously undeducted contributions.

Consider the following scenario: Mr. Carson’s earned income in 2009 was \$50,000 and the PA reported on his 2009 T4 was \$3,000. Based on this, his RRSP contribution limit for 2010 was \$6,000 [(18% x \$50,000) - \$3,000]. Carson chose not to make a contribution in 2010. In 2011, Carson can contribute the \$6,000 unused contribution plus his calculated contribution limit for 2011. Keep in mind that Carson could have contributed this \$6,000 to his RRSP in 2010 and chosen not to deduct it on his 2010 tax return. This approach would be prudent if Carson’s taxable income in 2010 was below \$41,000 (i.e. lowest tax bracket in 2010) and he knew that he was going to be subject to a higher tax rate in a future year. The tax savings can be significant when you consider that the difference between the lowest and the top marginal tax rates is approximately 26%.

As noted earlier, after the year in which a person turns 71, he/she is no longer able to make new contributions to his/her own plan. He/she will continue to generate contribution room, however, if he/she continues to have earned income. Further, previously contributed but undeducted amounts may be claimed beyond age 71 for these reasons, it may be advantageous to make an intentional over contribution in the year one turns 71. *Individuals should consider making an “extra” RRSP contribution in December of the year in which they turn 71 (and before collapsing their RRSP plan) equal to their available RRSP limit for the following year (plus the \$2,000 over contribution limit).* Although a 1% penalty tax will be charged for the month of December, this cost is outweighed by the value of the RRSP deduction in the “age 72” year. This concept may not be easy to understand at first glance. If you are approaching age 71, be sure to contact your trusted tax advisor for more information.

If contribution room can be generated after age 71, *an individual may utilize the contribution room by contributing to a spousal plan until the year the spouse turns 71*. As noted in our Income Splitting section, the contributing spouse may be subject to tax on withdrawals from a spousal RRSP, if the contributing spouse has made a contribution to the spousal plan in the year, or in the preceding two years. If the spouse turns 71 within that period, and transfers the RRSP to a RRIF, the spouse will be required by the RRIF rules to withdraw amounts from the plan each year (see comments in the RRIF section). As long as only the minimum amount is withdrawn, the contributing spouse will not be subject to tax on these withdrawals from the spousal RRIF.

Excess RRSP Contributions

Taxpayers may contribute to their RRSP in excess of their allowable limit without penalty, subject to certain restrictions. The over contribution limit is \$2,000. Taxpayers may consider over contributing to their RRSP, cumulatively, up to this \$2,000 limit. Under the rules, over contributions will accumulate from year to year but are offset by new contribution room which is created each year. Penalty tax will arise when undeducted contributions exceed the contribution room carried forward from prior years plus the current year limit by more than \$2,000. Since current year limits are based on prior years earned income, this limit should not be difficult to determine. The penalty tax is 1% per month of the excess amount. If the over contribution was due to a reasonable error, the CRA may waive the penalty tax. Don't count on it.

If an over contribution is made to a RRSP, the taxpayer may withdraw the excess amount. This approach would be prudent where the penalty tax would be applicable or where the contribution would not be deductible in the carryforward period. This withdrawal may be received tax free if it is withdrawn in the year of contribution, the year the notice of assessment for that year is received or the year following the year of assessment. Hence, the taxpayer has a possible three-year window in which to withdraw the over contribution. If the over contribution was intentional, the ability to make this tax-free withdrawal may be lost.

RRSP Rollovers

The types of special contributions that can be made to a RRSP have been narrowed over the years. RRSPs can generally be transferred to other RRSPs or RRIFs (see next section) without any problems.

Periodic pension payments (including Canada Pension Plan and Old Age Security payments) cannot be transferred to a RRSP on a tax-free basis. However, *lump sum pension withdrawals from a registered pension plan (RPP) or a deferred profit sharing plan (DPSP) to a RRSP are generally permitted if the funds are transferred directly between the plans*. In certain cases, such amounts can only be transferred to locked-in RRSPs that place restrictions on the ability to take funds out of the RRSP before

retirement. Ontarians may apply for permission to take funds out of locked-in plans in case of serious financial hardship or shortened life expectancies.

Retiring allowances can be transferred, within certain limits, on a tax-free basis into a RRSP. These limits allow for the transfer of a retiring allowance (i.e. amounts received in respect of a loss of employment) to a RRSP of up to \$2,000 for each calendar year (or part year) of employment until 1995, plus an additional \$1,500 for each year of employment before 1989 in which the individual was not a member of an employer-sponsored pension plan. To be deductible in 2011, the RRSP contribution must be made by February 29, 2012. As an alternative, the employer can transfer the retiring allowance directly into a RRSP. This transfer cannot be made to a spousal RRSP.

RRSP Withdrawals At Maturity

Individuals who will be age 71 at the end of 2011 have until December 31, 2011 to deal with their plans. The taxpayer has essentially three options with respect to the payout of funds in a RRSP:

- lump sum withdrawal;
- purchase of a life or fixed-term annuity; or
- transfer to a Registered Retirement Income Fund (RRIF).

A taxpayer need not wait until the specified age limit to utilize any of these alternatives. Withdrawals under any of these methods can be implemented earlier than required, however, *prudent planning would dictate accumulating funds in the RRSP until the last possible date to take maximum advantage of the compounding of the tax deferred savings*. Personal circumstances, however, may require earlier withdrawal of such funds.

The first alternative, the lump sum withdrawal, while simple, results in tax on the full amount in the year withdrawn. Amounts withdrawn are subject to withholdings at source, which are credited against the ultimate tax owing on the withdrawals. A withdrawal up to \$5,000 is subject to 10% withholding; the withholding on withdrawals over \$5,000 and up to \$15,000 is 20%; and over \$15,000 is 30%. This alternative is rarely chosen, as the tax bite could be enormous.

If an annuity is purchased, none of the RRSP will be taxed immediately. *The full annuity payments will be taxed when received. Taxpayers may wish to annuitize their RRSPs prior to the age limit if they feel the interest rates are favourable or to utilize the \$2,000 pension income tax credit. Numerous annuity options are available and advice should be sought at that time.*

Finally, the taxpayer can convert his RRSP into a RRIF. A RRIF is similar in most respects to a RRSP. However, a minimum amount must be withdrawn from the RRIF each year, except in the year the fund was established. This withdrawal is subject to tax. RRIFs are discussed in more detail in a separate section of this commentary.

The advantage of an annuity may be the assurance of a fixed level of income that continues to be paid over the term of the annuity. A RRIF only lasts as long as funds remain in the plan. With an annuity, a taxpayer relinquishes control over the investments. This factor may be important if one can get a better rate of return than that offered under the annuity or if the annuitant wishes to continue managing his or her assets. The appropriate decision is based on the individual's personal investment philosophy and cash requirements.

A taxpayer can utilize a combination of any of the above alternatives in converting the RRSP into retirement income. In particular, a taxpayer may choose to convert his or her RRSP into both an annuity and a RRIF.

Homebuyer's Guide to RRSPs

So you want to buy a home, but you just can't find that down payment? Look no further than your own RRSP. The ability to use funds in a RRSP to assist in the purchase of a home may turn that dream into reality.

Under the Homebuyer's Plan, individuals can "borrow" up to \$25,000 from their RRSP to acquire a home in Canada, without including the amount withdrawn in income. Both new and existing homes qualify as long as the home being purchased is intended to be the principal place of residence. The person who is the annuitant of the RRSP must be a registered owner of the home.

Any withdrawals under the Homebuyer's Plan can only be made by a "first-time" homebuyer. A first-time homebuyer is an individual, who along with his/her spouse, has not owned a home at any time in the four calendar years prior to the withdrawal from the RRSP. If an individual's spouse has owned a home in that period, and the individual has lived in the home during the marriage, that individual will not qualify for the Homebuyer's Plan. Accordingly, *if one individual owns a house prior to marriage, it may be wise for the other individual to withdraw funds from his/her RRSP for the Homebuyer's Plan prior to marriage, if the couple intends to buy a new house.* Once married (including a common law relationship), this withdrawal will be prohibited.

Each spouse is entitled to a \$25,000 withdrawal from his/her own plan. Taxpayers can make more than one withdrawal in a given year and the withdrawals can be made from any plan that they have, as long as the total withdrawals do not exceed the \$25,000 limit. The Homebuyer's Plan can be used again in the future as long as previous withdrawals have been repaid to the RRSP and a home has not been owned in the past five years.

Form T1036, available from the CRA, must be used when such withdrawals are made. Such withdrawals are not subject to withholding tax. The withdrawals should be made after the purchase agreement for the house is signed since the form requires the address of the home. Generally, the home must be acquired by October 1 of the year following the year of the RRSP withdrawal.

If the home purchase does not close, an individual can usually return the funds to his/her RRSP without tax consequences. Alternatively, another home can be purchased to meet the commitment under the Homebuyer's Plan.

This plan allows taxpayers to borrow from their RRSPs. Consequently, amounts withdrawn from a RRSP under this plan must be repaid to avoid tax on the withdrawal. These repayments are not tax deductible. At a minimum, the amount withdrawn must be repaid in 15 equal annual instalments. Repayments must start in the second year following the year of withdrawal. As with RRSP contributions, repayments can be made within 60 days after December 31 of that second year. For example, for withdrawals in 2011, the first repayment must be made by March 1, 2014. Any contributions made to a RRSP in a given year can be designated as a repayment of the Homebuyer's withdrawal on a form filed with the personal tax return. The amount of the contribution not so designated may be treated as a normal RRSP deduction.

Different results will occur if the repayments are less than or more than the minimum annual amount. Consider Mr. Homebuyer who withdraws \$15,000 from his RRSP in 2011 to buy a home. He would be required to repay \$1,000 per year to his RRSP for 15 years commencing in 2013 (actually by March 1, 2014). If he repays less than \$1,000 in any year, the shortfall will be taxable. Taxpayers may choose to repay more than the equal annual requirement. This reduces both the outstanding balance and future annual repayments. *Since income on investments held in a RRSP accumulates tax free, taxpayers with excess cash may wish to rejuvenate their RRSP sooner by repaying these loans faster and sheltering the income from tax.*

If a RRSP withdrawal is made to acquire a home, any contribution made to the RRSP less than 90 days before the withdrawal will generally not be deductible. However, amounts contained in a RRSP prior to this 90-day period will be considered to be withdrawn on a first-in, first-out basis for purposes of determining the portion of the non-deductible contribution. For example, if Mr. Homebuyer with \$20,000 in his RRSP, \$6,000 of which was contributed in the last 90 days, withdraws \$15,000 for a house, \$1,000 of the \$6,000 contribution will not be deductible. In effect, you can withdraw, without penalty, funds already in the RRSP prior to the 90 days before the withdrawal. These rules operate on a plan-by-plan basis.

Special rules exist for individuals who become non-residents or die with amounts owing to their RRSP under the Homebuyer's Plan. In both cases, the outstanding amount will be included in income, unless it is repaid to the RRSP within a specified time limit. In the case of death, if there is a surviving spouse, he or she can elect to take over the obligation to repay the RRSP to avoid the immediate income inclusion.

There are considerable merits to using RRSP funds to purchase a home. However, as with any plan, taxpayers should be aware of the rules and how they work, before they step through the door.

RRSP and Education Costs

Under the Life Long Learning Plan, students in full-time training or post-secondary schools may withdraw up to \$10,000 per year, tax free, from their RRSPs over a four year period to a cumulative maximum of \$20,000 to finance their educational costs. The RRSP annuitant or his/her spouse must be enrolled, or have been accepted, as a full-time student in a program, which qualifies for the tuition and education tax credits (see our comments in the Deductions, Credits and Related Matter section). The program must, however, entail at least three consecutive months of study, instead of the three consecutive weeks required for the education tax credit. The withdrawn amount must be repaid to the RRSP in 10 equal annual instalments; otherwise the amounts will be included in income. The first repayment is due 60 days after the fifth year following the year that funds are withdrawn. In other words, if an amount has been withdrawn in 2011, repayment must begin in 2016 (by March 1, 2017). Earlier repayment may be required if the student does not attend or complete the appropriate educational program. There is no limit as to the number of times you can participate in this program.

New RRSP Anti-Avoidance Rules

The 2011 Federal budget altered the landscape for the types of investments that can be made in an RRSP through the introduction of various pervasive anti-avoidance rules. These rules are designed to prevent individuals from holding certain types of investments in their RRSP's and from using these accounts for tax planning arrangements the government deems unacceptable. These rules to a large degree mirror the rules that exist for Tax-Free Savings Accounts (TFSA's).

In general terms, these new rules have changed the playing field by introducing the following:

- 1) Treating certain investments, such as private company shares, that were qualified investments when they were originally acquired, as prohibited investments under the new rules. Private company shares qualify only if you and related parties own less than 10% of the company's shares.
- 2) Introducing a new RRSP advantage tax for situations where the government feels the benefits obtained inappropriately exploit the tax attributes of an RRSP; and
- 3) Provisions to prevent aggressive transfers of securities in and out of an RRSP that allow a taxpayer to increase an RRSP's balance to shelter more income from tax or reduce the balance of an RRSP to avoid tax on withdrawals.

All of these new rules are extremely complicated and require significant discretion on the part of the government in their application. The taxes and penalties applicable if you are offside on any of these new rules are significantly onerous.

These new rules take effect as of March 22, 2011. In most situations it would be prudent to remove any prohibited investments from your RRSP prior to 2013 to avoid the potential application of the proposed penalty of 50% of the fair market value of any prohibited investments. This is a separate penalty of 100% levied on any advantage realized which may be reduced to 42.9% under certain circumstances.

Planning Points

Because the majority of banks and other financial institutions roll out their RRSP advertising campaigns to coincide with the contribution deadline, most taxpayers make their annual contributions at that time. Taxpayers should *consider making their RRSP contributions early in the year of deduction*, since income earned in the plan remains sheltered from tax. This is especially true when investment funds are available early in a year. Early contributions will also provide for larger balances in the RRSP at retirement time. The ability to accumulate income on a tax-free basis produces some remarkable results. Remember that the contribution limit is based on the previous year's earned income.

If RRSP contributions are deducted from gross pay by the employer, the employer can reduce source deductions based on the net pay. This may result in a reduction in taxes paid upfront to CRA, which is preferable to the alternative of waiting until after the tax return for the year is filed to recover these taxes.

RRSPs do not necessarily have to be used only in the context of retirement planning. Sometimes it is good tax planning to withdraw funds from a RRSP prior to retirement. *In years when a taxpayer's income is low, a RRSP withdrawal may be prudent* since the tax rate that is applicable may be lower than usual. In addition, *if a low-income year follows a high-income year, a RRSP contribution in the first two months of the low-income year may be beneficial.* This contribution can be deducted in the previous high-income year and withdrawn shortly thereafter to be taxed in the lower-income year, and may result in a tax savings of up to \$7,800 (based on the maximum 2011 contribution limit). *RRSP withdrawals should be in amounts of \$5,000 or less to keep tax withholdings to a minimum.*

While interest on funds borrowed to make a RRSP contribution is not deductible, there may be circumstances where this procedure is warranted. *If the interest rate on the money borrowed is comparable to the rate earned on the funds invested in the RRSP, and the loan will be repaid within a relatively short period of time, then it may be worthwhile to borrow funds to contribute to a RRSP.* Since the carry forward period for utilizing unused RRSP contributions is indefinite, it may be better to wait and make "catch-up" RRSP payments when the cash is available.

Consider contributing or selling shares or other investments to a RRSP. This can be done through an in-kind contribution to a RRSP or a sale at fair market value. Extreme caution must be exercised

not to run afoul of the new penalty tax on asset swapping transactions when assets are sold to a RRSP other than as a contribution. Capital gains may be triggered as a result of this transaction. Any capital losses generated on transfers to a RRSP are denied. *Consider selling loss stocks outside a RRSP and contributing the cash to the RRSP.* The capital losses triggered from the sale are available personally against capital gains. *The RRSP should not purchase the same shares within 30 days;* otherwise the superficial loss rules will apply to deny the loss.

In order to transfer investments into a RRSP, the RRSP must be a self directed RRSP. Not all investments can be transferred to a RRSP. The tax rules are very specific as to which property is a “qualified investment” for RRSP purposes. This transfer is advantageous to taxpayers who desire to make a RRSP contribution, but do not have the available cash. It also enables a taxpayer to obtain funds from a RRSP on a potentially tax-free basis. Any taxpayer considering this planning opportunity should also note that the benefits of any dividend tax credits arising from dividends on shares transferred to a RRSP are lost because these credits do not flow through the RRSP to its owner. Furthermore, the full value of the capital gain earned by the RRSP will be taxable when funds are withdrawn. Since the funds can accumulate tax-free in the RRSP, the deferral aspect may outweigh the higher possible tax cost when the funds are withdrawn. *Consider transferring only fixed income investments to a RRSP, and continue to hold equities outside the plan.*

The administration fee associated with a self-directed RRSP should be paid outside the RRSP rather than from the RRSP account. Although such fees are not tax deductible, the payment outside the RRSP will not reduce the funds growing on a tax-free basis inside the RRSP.

The benefits of spousal RRSP contributions and the related rules are discussed in the Income Splitting section.

The new definition of a “prohibited investment” may prevent a RRSP from owning a mortgage on the annuitant’s home unless the mortgage is administered by an approved lender and the mortgage is insured. As with any mortgage, there are costs associated with implementing this plan. Since the mortgage held by your RRSP is comparable to a conventional mortgage on a home. The principal advantage to this type of plan may only be psychological; i.e. the comfort of loaning money to yourself. However, there will be a benefit if the rate of return on the mortgage exceeds the return that could otherwise be obtained on the RRSP funds.

Interestingly, under the RRSP Homebuyer’s Plan, a spousal plan may be particularly beneficial. Under the Homebuyer’s Plan, contributions to a spousal RRSP can be withdrawn to purchase a home. Any amounts not repaid to the RRSP over the 15-year period will be included in the spouse annuitant’s hands and not the spouse contributor’s hands. This differs from an ordinary withdrawal from a spousal plan, which is taxable in the contributor’s hands, unless the appropriate waiting

period has been met. Accordingly, *if the spouse annuitant is not taxable or is in a low tax bracket, it may be appropriate to ignore the repayments and pay the tax on the withdrawal over the 15-year period.*

Registered Retirement Income Fund (“RRIF”)

A RRIF is in essence a continuation of a RRSP. In most cases, it can hold the same investments as those in a RRSP. All income earned in a RRIF accumulates on a tax-free basis. However, unlike a RRSP, contributions cannot be made to a RRIF and certain amounts must be withdrawn annually from the RRIF to be taxed in the plan holder’s hands. No minimum withdrawal is required in the year the plan is entered into.

The amount that is required to be withdrawn increases each year (see following table), levelling out at 20% once the plan holder reaches age 94. The table below also outlines the minimum RRIF payments in each year. If the person is under 71, the minimum RRIF payment in each year, is $1/N$ of the value of the RRIF at the beginning of the year, where N is the number of years left until the individual or his/her spouse turns age 90.

Payments can continue from a RRIF until the death of the annuitant or his/her spouse. A taxpayer always has the option to withdraw more than the minimum amount. However, individuals with other sources of retirement income will likely be better off retaining as much money as possible in a tax deferred RRIF.

In the early years of a RRIF, if the taxpayer only needs to withdraw the minimum amount for retirement purposes, the value of the RRIF will likely increase each year as a result of the continued tax deferred savings. Eventually, however, the plan will be depleted, as the minimum withdrawal requirements increase.

The following table summarizes the minimum withdrawal from a RRIF each year. The Age column refers to the annuitant’s age at the beginning of the year.

| % RRIF | | % RRIF | | % RRIF | | % RRIF | |
|--------|-------|--------|-------|--------|-------|--------|-------|
| Age | Value | Age | Value | Age | Value | Age | Value |
| 71 | 7.38 | 78 | 8.33 | 85 | 10.33 | 92 | 16.12 |
| 72 | 7.48 | 79 | 8.53 | 86 | 10.79 | 93 | 17.92 |
| 73 | 7.59 | 80 | 8.75 | 87 | 11.33 | 94 | 20.00 |
| 74 | 7.71 | 81 | 8.99 | 88 | 11.96 | 94+ | 20.00 |
| 75 | 7.85 | 82 | 9.27 | 89 | 12.71 | | |
| 76 | 7.99 | 83 | 9.58 | 90 | 13.62 | | |
| 77 | 8.15 | 84 | 9.93 | 91 | 14.73 | | |

RRIFs will be subject to the same anti-avoidance rules that apply to TFSA and RRSPs.

Registered Pension Plans (“RPPs”)

Many taxpayers are employed by organizations that offer the opportunity to participate in company pension plans (known as RPPs). Under such plans, employers make deductible contributions on behalf of employees. Employees are not taxed on such amounts until they receive them, which is usually after retirement. Employees can usually make contributions to such plans. There are essentially two types of RPPs, as follows:

- (1) Money Purchase Plan - pension benefits are determined based on the amount of contributions to the plan and the investment earnings made on such contributions; and
- (2) Defined Benefit Plan - pension benefits are determined without reference to the plan’s earnings, but rather are based on a formula that factors in an individual’s average wage and years of employment.

The amounts that can be contributed and deducted depend on the type of plan.

The limits under a Money Purchase RPP are similar but not identical to those for RRSPs. Under a Money Purchase RPP, the tax deductible contribution for 2011 is limited to the lesser of 18% of the current year’s (i.e. 2011) employment income and \$22,970, less employer contributions to the plan. The limit is indexed each year.

The amounts that can be contributed to a Defined Benefit RPP and deducted for tax purposes are not limited in the same manner as RRSPs or Money Purchase RPPs. The limit is based on actuarial principles and other specific rules based on the maximum pension allowed to a Canadian individual. The provisions of the RPP ensure this restriction is met by limiting how much an employer/employee can contribute to obtain this maximum pension entitlement.

Any contributions to and earnings in a RPP have a bearing on the computation of the pension adjustment (PA). As noted earlier, this PA has an impact on the amount members of a pension plan can contribute to a RRSP.

RRIF type payouts can be made from a money purchase pension plan. This measure allows money purchase plan members to choose to benefit from the flexibility a RRIF offers without having to assume greater responsibility for investment. The rules for withdrawals will be the same as for a RRIF. It also permits the transfer of funds back into a pension plan on a tax deferred basis by former members who had previously transferred their money purchase account to a RRSP or RRIF.

Individual Pension Plans (“IPPs”)

A shareholder/manager may be able to set up a personal pension plan called an IPP to provide for retirement. An IPP is a defined

benefit RPP designed for one individual as opposed to a group. The plan is funded by tax deductible contributions made by the company. A member of an IPP may also be able to make contributions to a RRSP, but at significantly lower contribution amounts due to the PA and PSPA adjustments to the RRSP contribution limit.

Generally, IPPs may be appropriate for owner/managers earning significant salary income. The main advantage of an IPP is that contributions are likely much higher than those allowed under the RRSP rules. In addition, an IPP may provide better protection from potential creditors.

IPPs normally provide for past service benefits. As noted previously, the past service benefit may result in the shareholder/manager triggering an immediate over contribution into his/her RRSP, if the current year contribution has already been made. Such past service contributions can be significant and can provide the company with a large deduction for the year of contribution in lieu of paying a bonus to the owner/manager.

The cost of funding the past service under an IPP for an older participant is often higher than the PSPA for the same period. The shortfall may be contributed by the employer on a tax deductible basis. Changes have been made to eliminate this advantage. After March 22, 2011, IPP contributions must first be satisfied from RRSP assets of the shareholder/manager or a reduction in his/her unused RRSP contribution room before new contributions from the corporation will be allowed. It is further proposed that RRIF-like withdrawals apply in the year the shareholder/manager reaches 72 beginning in 2012. If the IPP member reaches 72 in 2011 or earlier, the required withdrawals will start in 2012. These changes will reduce the attractiveness of IPP’s.

The costs of setting up an IPP should be carefully examined when weighing the benefits of such a plan. With an IPP, actuarial valuations are required at the outset and every three years after commencement. In addition, various forms must be filed on an annual basis.

Registered Education Savings Plan (“RESP”)

There is no doubt that RESP’s have obtained considerably more RESP-ect over the last number of years as a result of a number of enhancements to the rules.

A RESP is a contract between a subscriber (the taxpayer) and a trustee whereby a beneficiary designated by the subscriber will receive future payments towards a post-secondary education. This has been expanded to include part-time programs of at least 12 hours of course work per month. A person can only be designated as a beneficiary if he/she has a social insurance number and is a Canadian resident. There are different plans available to suit the subscriber’s investment requirements. These plans are typically utilized to build an education fund for one’s child/grandchild, but, depending on the type of plan, can also be

used for a friend or relative's child or even for the individual contributor himself. Payments from an RESP can be used to cover a student's living expenses and educational costs, such as tuition and books.

There is no annual limit on contributions made to a RESP. The lifetime limit on contributions per beneficiary is \$50,000.

Contributions made by the subscriber are not tax-deductible. Income earned by the plan is not taxed immediately in the hands of the subscriber. Rather, payments of income (including the CESG grant referred to below) from the plan are taxed in the beneficiary/student's hands when received. Payment for students enrolled in a part-time program is limited to \$2,500 for each 13-week semester or term. The subscriber and the beneficiary can withdraw contributions to the plan without tax consequences because a deduction was not obtained for that contribution. Subject to the terms of the plan, the subscriber and/or beneficiary can generally control the timing of income recognition by choosing to receive a withdrawal of contributions prior to receiving income.

The advantage of a RESP is that the income accumulates in the plan tax-free and will likely bear a smaller tax burden in the hands of the beneficiary/student than if it were earned directly by the subscriber. In the past, a disadvantage resulted if the designated beneficiary did not attend a qualified institution, in which case the subscriber only received the amounts contributed to the RESP but lost the accumulated income in the plan. Special rules apply when none of the RESP's beneficiaries are post secondary students by age 21 and the plan has been in existence for at least 10 years. Up to \$50,000 of RESP income can be transferred to the subscriber's or the subscriber's spouse's RRSP up to the extent of available RRSP contribution room. Any excess income will be subject to a punitive 20% tax, in addition to the regular tax on the income.

Self-administered RESPs are also available. Different plans may be suitable for children of different ages and may give different degrees of control over the plan investments. Family plans are available and provide the flexibility to shift funds among the various children who are beneficiaries of the plan in the event that certain beneficiaries decide not to pursue post-secondary education. Beginning in 2011, transfers between an individual's RESP to a sibling's RESP will be permitted without tax penalties and without triggering the repayment of CESGs. The beneficiary of the recipient RESP must be younger than 21 when the plan was opened.

Under the Canada Education Savings Grant (CESG) program, the federal government will provide a direct grant to the RESP of 20% of the first \$2,500 of RESP contribution to a maximum of \$500 per year for each beneficiary. The total available grant is \$500 for each year that the individual is under age 18.

In cases where the \$2,500 maximum RESP contribution for CESG is not used in a given year, it may be carried forward to

a subsequent year. The total CESG per beneficiary per year is capped at the lower of \$1,000 and 20% of the unused CESG room.

The CESG rate is increased for middle and low-income families. The enhanced rate is 40% of the first \$500 contributed to the RESP in the year, if the child's family has qualifying net income (generally family net income for the second preceding calendar year) of \$41,544 or less. The rate is 30% if the family income is greater than \$41,544 but not more than \$83,088. Any contribution in excess of the first \$500 will receive CESG at the normal 20% rate. The \$41,544 and \$83,088 amounts are indexed annually. There is no carry-forward of unused access to the enhanced CESG.

The maximum CESG that may be paid in respect of any one beneficiary is \$7,200, regardless of the applicable CESG rate.

If the child doesn't attend post-secondary school, the principal amount of the CESG grant received will have to be repaid. The CESG grant and income earned on the grant funds will be taxed when they are withdrawn from the RESP.

As noted previously, although the annual contribution limit has been removed, there is still a lifetime limit of \$50,000 per individual. An excess contribution will attract a penalty tax of 1% per month that the excess remains in the plan. Even if the excess is subsequently withdrawn, it will still erode the beneficiary's \$50,000 lifetime limit. *Over contributions should be avoided.*

The maximum period over which the income in the RESP can be sheltered from tax is 25 years.

Canada Learning Bond (CLB)

Each child born on or after January 1, 2004 is eligible for a CLB in each year that the child's family is entitled to the child tax benefit supplement (see Deductions, Credits and Related Matter section for details of the supplement).

The initial CLB (payable for the first year of entitlement, up to and including the year the child turns 15) will be \$500. Subsequent CLB will be \$100. The CLB is payable only into a child's RESP. It cannot be shared with other beneficiaries in a family plan or group plan. At the time the initial CLB of \$500 is paid into the child's RESP, an additional amount of \$25 will be paid into the RESP in recognition that there may be expenses associated with the opening of an RESP account. Any CLB entitlement not paid into an RESP by the time the child turns 21 will be forfeited. The CESG grant will not be paid on the CLB amounts paid into the RESP.

Registered Disability Savings Plans (RDSP)

A RDSP may be established for the benefit of a disabled person. These plans are similar to RESPs. Income in these plans accumulates on a tax-free basis. Contributions are not deductible

and only the income earned from the contributions are taxable to the beneficiaries when withdrawn. There is a lifetime contribution limit of \$200,000 to all plans for the same beneficiary, but there is no annual contribution restriction. The beneficiary must be eligible for the Disability Tax Credit.

Contributions can be made up to the year the beneficiary turns 59. Payments to the beneficiaries must begin by the end of the year the beneficiary turns 60, subject to maximum annual limits, until the beneficiary dies or the plan is terminated. RDSP beneficiaries with certified shortened life expectancies are generally not subject to the maximum annual withdrawal limit and are not required to repay the CDSG and CDSB grants referred to below.

Similar to a RESP, the government will supplement contributions with the Canada Disability Savings Grant (CDSG). The amount of eligible grant will be based on family net income and will be paid at multiples of one to three times the contribution amount, subject to an annual cap. The maximum lifetime grant amount is \$70,000 and grants will cease to be paid after the year the beneficiary turns age 49.

In addition, lower income families can receive a Canada Disability Savings Bond (CDSB) of up to \$1,000 per year to a maximum of \$20,000, over the beneficiary's lifetime. Once approved, the Bond will continue to be paid automatically in subsequent years as long as the beneficiary remains eligible.

Both the CDSG and the CDSB received in the preceding 10 years must be repaid in the event of a withdrawal or termination of the plan.

Unlike a RESP which allows a subscriber or beneficiary to control the timing of income recognition, each payment from a RDSP is considered to be paid in part from contributions (to the proportion that total contributions to the plan is to the total value of the plan's assets) and the balance is taxable as income.

Tax-Free Savings Account (TFSA)

An individual is able to make a non-tax-deductible contribution of up to \$5,000 per year to a TFSA. Income (such as interest and dividends) and capital gains earned in the plan will not be taxable, and neither are withdrawals from the plan.

Only an individual who is at least 18 years old can own such a plan, and the plan must be registered with the tax department as a TFSA. Although a TFSA is an individual plan, *it is a useful tool for splitting income with a lower income spouse because the attribution rules will not apply to income earned in the plan, even if distributed.*

If the contribution is less than the maximum \$5,000 permitted in a year, the unused contribution room can be used in any future year. There is no maximum carry forward period. The \$5,000 will be indexed annually based on inflation and rounded to the nearest \$500.

Withdrawals may be made at any time for any amount, and will not be taken into consideration in calculating income-based benefits or credits. Withdrawals made in a year will be added to the next year's contribution room.

The following example assumes that the TFSA dollar limit remains at \$5,000. Mr. Prudent made a contribution of \$5,000 to his TFSA in each of 2009 and 2010 and \$4,000 to his TFSA in 2011. In 2012, he withdrew \$3,000 from his TFSA. His contribution room at the end of each year will be as follows:

| | |
|-------|---|
| 2009: | Nil (the TFSA dollar limit of \$5,000 less the actual contribution of \$5,000) |
| 2010: | Nil (the TFSA dollar limit of \$5,000 less the actual contribution of \$5,000) |
| 2011: | \$1,000 (the TFSA dollar limit of \$5,000 less the actual contribution of \$4,000) |
| 2012: | \$6,000 (the unused \$1,000 from 2011 plus the \$5,000 for 2012) |
| 2013: | \$14,000 (the unused \$6,000 from 2012, the \$3,000 withdrawn in 2012 and \$5,000 for 2013) |

Given the nature of the rules *it is advisable to hold investments that are expected to increase significantly in value in a TFSA.* The only problem is in trying to secure such investments.

At the death of the account holder, if the assets are transferred to a surviving spouse's TFSA, or if the surviving spouse is named as the successor holder of the account, the TFSA will continue its tax-free status. Otherwise, income earned after the death of the account holder will be taxable.

The other rules governing a TFSA are similar to those applicable to a RRSP. A TFSA is not permitted to carry on any business and is subject to the same investment restrictions imposed on a RRSP. It must pay a 1% penalty tax if it holds non-qualified investments. Over-contributions to a TFSA are subject to a penalty tax of 1% per month. Interest on money borrowed to invest in a TFSA is not deductible. Any investment counsel and administration fees paid in respect of a TFSA are also not deductible.

There is no \$2,000 safe harbour as is available in respect of over-contributions to a RRSP. As noted previously, a withdrawal does not increase the current year's contribution room. In addition, in calculating what is an excess contribution, a withdrawal is taken into consideration only if it relates to a previous over contribution. It is, therefore, easier to have an inadvertent excess contribution and incur the 1% penalty tax. If Mr. Prudent should decide sometime in 2012 to contribute \$9,000 into his TFSA (the \$6,000 contribution room for the year plus repayment of the \$3,000 he withdrew earlier in the year), he would have over contributed by \$3,000 from the time he made the \$9,000 contribution to the end of the year. If, however, Mr. Prudent made the inadvertent overcontribution at an earlier point in the year, and withdrew the excess in the same year, there would only

be an over contribution for the number of months the \$3,000 remained in the TFSA. It is extremely important not to treat the TFSA as a bank account and make series of withdrawals and contributions without considering the possible application of the 1% penalty.

These rules had caught many taxpayers by surprise when the CRA began to assess the penalty tax for 2009. Fortunately, the CRA conceded that the rules were complicated and not well understood by both the financial institutions and the taxpayers, and was willing to waive the penalty if a taxpayer can establish that the over contribution was inadvertent, and corrective action was taken immediately.

The government has also implemented changes to forestall the use of the TFSA in tax planning schemes. If these rules apply, there will be a special tax of up to 100% of the offside amounts. In addition, withdrawals of amounts affected by these rules will not be considered normal withdrawals, and will not create TFSA contribution room.

The rules are similar to the new RRSP anti-avoidance rules but apply to transactions that occurred after October 16, 2009.

CAPITAL TRANSACTIONS

Capital Gains and Losses

Dispositions of property are either classified as being on account of income or on account of capital. This distinction is important because gains derived from capital transactions are taxed at lower effective rates compared to gains from income transactions. Conversely, the treatment of capital losses are less tax advantageous than income losses. There are other special rules that favour certain capital transactions, but we'll address this later.

The question of income vs. capital has been frequently litigated in the Canadian courts. Whether a transaction is an income or a capital transaction is a complicated matter and is beyond the scope of this commentary. The following example may, however, help to illustrate the difference. If an individual speculates on real estate with the intention of selling it, especially within a short time, it is likely any gain on sale would be considered income in nature rather than capital. Alternatively, if an individual acquires a building from which a business will be operated, or to derive rent therefrom, a sale of such property would likely be considered a capital transaction. Capital gains generally arise on the disposition of property such as shares and investment real estate.

Capital gains or losses are generally calculated by deducting the tax cost of the property and disposition costs, such as commissions and legal fees, from the proceeds of sale. The net result is then adjusted by the capital gains inclusion rate to determine the taxable portion of the capital gain/loss.

Tax cost is generally the original cost of the property. In some cases, the tax cost is adjusted by various factors including a step up in the cost of the property as a result of the capital gains election that was available in 1994 (we'll elaborate on this point later).

The taxation of capital gains was first introduced in 1972. Prior to that, capital gains were not subject to tax. When the system was introduced, rules were put into place to ensure that only the gain that accrued after 1971 would be subject to tax. Accordingly, in determining the capital gain on a property owned prior to 1972, the Valuation day (V-day) value at December 31, 1971 must be determined. In most cases, this V day value will serve as the cost base for the property for purposes of determining the capital gain/loss.

The capital gain/loss is only recognized in the year of sale. In addition to actual dispositions, the Income Tax Act contains provisions that may notionally treat a capital property as sold at its fair market value at specified times even though the property is not actually sold. These situations can be particularly onerous since the gain and resultant tax occur without the usual cash flow that results from an actual sale. For example, a capital property may be treated as sold on the owner's death, when the owner becomes a non-resident of Canada, and when the property is gifted to another person. (See separate sections on Death of a Taxpayer and Emigration from Canada for details).

The capital gain inclusion rate is currently 50%, equivalent to its historic introductory rate. As noted in the Charitable Donations section, a 0% inclusion rate applies to a capital gain from the donation of certain securities and ecological property. That is, those dispositions are tax-free.

The effective tax rate on capital gains realized in 2011 is reflected in Schedule 1 (on page 22). The top effective rate of tax on capital gains in Ontario in 2011 is 23%. This rate is substantially lower than the top tax rates applicable to other sources of income. As a result, there is a preference for realizing gains on account of capital instead of on account of income. The reverse is true, when losses are realized. Therefore, where possible, gains should be classified as capital gains and losses as business losses. However, the gains or losses on similar properties should be treated consistently as either capital or income in nature.

As we noted earlier, sometimes the distinction between capital gains and business profits is not clear-cut. *A person who is not a trader of securities may file an election to ensure that stock market trades are treated as capital dispositions.* Once filed, all Canadian securities that are owned must be treated as capital property. Thereafter, any losses triggered on the disposition of such property cannot be claimed as business losses.

Where possible, it may make sense to sell an asset after December 31 to postpone the tax on the gain until the next year. Triggering losses before December 31 may be appropriate as

long as there are prior gains to which the losses can be applied.

It may also make sense, where possible, to split the capital gain (e.g. by claiming the capital gain reserve) over two years if there are few other sources of income. This approach may better “average” income by taking advantage of lower marginal tax rates in each year. In addition, this approach may help avoid any potentially applicable minimum tax.

Restrictive Covenants (Non-Competition Payments)

In a sale of a business, it is not unusual that the purchaser will require the vendor to give certain restrictive covenants, such as an agreement not to compete in the same business or in the same geographical area within a fixed or indefinite period. The CRA considered amounts paid in respect of the restrictive covenants to be taxable as proceeds of disposition. Reacting to somewhat surprising court decisions that concluded that non-competition payments paid to the vendors in a sale of shares are not taxable, new rules were proposed in 2003, but have not yet been passed into law. Effective October 8, 2003, proceeds received for giving a restrictive covenant is taxable as ordinary income. The vendor and the purchaser may jointly elect to treat the amount received in connection with the sale of shares or a partnership interest on an arm's length disposition, as proceeds of disposition to the extent that the covenant increases the fair market value of the shares or partnership interest. The rules should be reviewed with great care, as the election to treat the payment as additional proceeds is not available under all circumstances. The excess, if any, will be treated as ordinary income.

The election must be filed by the person granting the restrictive covenant by the tax return filing due date. Elections due before the legislation is passed are considered to be filed on time if they are filed no later than 180 days after the legislation is passed into law.

Utilization of Capital Losses

Allowable capital losses are only deductible against capital gains and cannot be deducted against other sources of income.

Allowable capital losses (which are 50% of capital losses) generated in a year must first be applied against taxable capital gains in the same year. Any excess amount of allowable capital losses may be carried back three years or forward indefinitely to be applied against taxable capital gains in those other years. Due to the changes in the inclusion rate for capital gains and losses through the years, the amount of the losses carried forward must be adjusted to the relevant inclusion rate of the year or years in which the losses are applied. Where a taxpayer has used the capital gains exemption in any of the three previous years, the *loss carryback claim may have no benefit. In these instances, it may be prudent to trigger a capital gain in order to use the losses.*

The CRA notifies taxpayers who have unused capital losses in the narrative section of the Notice of Assessment. While the Notice of Assessment does provide information as to the quantum of these losses, it is important to note that the amount reported has been converted to the 50% inclusion rate.

Tax rules are also in place to prohibit the “artificial” creation of losses. If a loss on the sale of capital property, such as shares, is incurred, and the same or an identical property is repurchased within 30 days of the original sale, then the loss will not be deductible. The denied loss will be added to the cost base of the newly acquired shares. A similar result occurs if a taxpayer's spouse or a corporation controlled by the taxpayer or his/her spouse purchases the same property. This type of loss is known as a “superficial loss”.

Capital losses may also be denied in other circumstances. For example, losses cannot be triggered on sales of capital property to your RRSP or TFSA. The new anti-avoidance rules that may apply if assets are transferred between a registered plan and a non-registered investment account will make such transfers inadvisable except in the course of making a contribution. (Please see the Tax Deferral Plans section for more details.) Many other “stop loss” rules are in place to prevent the artificial triggering of losses. However, *losses can normally be generated on sales to children or other related parties.* The attribution rules (noted in the Income Splitting section) may play an important role in these types of family transactions.

No capital loss is available on the disposition of personal use property, such as vacation property, furniture, or artwork. Capital gains on personal use property are generally only taxed to the extent the sale price on any item exceeds \$1,000. In the last few years, there were a number of tax schemes designed to take advantage of these rules, and as a result, these rules have been tightened. If personal use property is acquired and donated to a charity as a part of an arrangement, the full amount of the gain (the difference between the fair market value of the property and its cost) will be taxable, even if the amount eligible for the donation credit may be reduced to cost due to the proposed donation rules.

Capital Gains Reserves

Capital gains need not always be reported in full in the year of disposition. When a taxpayer sells capital property, but does not receive the full proceeds in the year of sale (e.g. vendor take-back mortgage), in most cases he/she need only report a capital gain in proportion to the actual proceeds received. For example, a vendor who sells a property for \$500,000 and receives \$200,000 before December 31 of that year need only report 40% of the total gain in the year of sale. The remaining 60% of the gain may be claimed as a capital gains reserve. The claiming of a reserve is discretionary. However, a minimum of 20% of the gain must be reported each year on a cumulative basis, so that the entire gain is reported by the fourth year after the year of

sale. Non-residents are not eligible to claim a capital gains reserve. *The maximum capital gains reserve should be claimed to defer recognition of a portion of any capital gains realized during the year.*

The five-year reserve (i.e. 20% of the gain reported each year) noted above will apply to the arm's length sale of most types of capital property. In cases where a share of a small business corporation is sold to children, grandchildren or great-grandchildren, tax on the gain can be deferred over a 10-year period.

Capital Gain Rollover

If someone realizes a capital gain on the sale or involuntary disposition (such as expropriation or theft) of certain property, the gain can be deferred to the extent the person reinvests the proceeds in a replacement property within a certain period of time. A capital gain realized on shares of a corporation is not eligible for this deferral.

However, a person may defer any capital gain realized on investments in small businesses if the investments are replaced by investments in other small businesses. There is no requirement to track the use of the proceeds and actually use the same cash. The deferral is available in addition to the enhanced \$750,000 capital gains exemption referred to below.

The original investment must be in ordinary common shares of an active small business corporation, which is similar, but not identical, to a small business corporation ("SBC"), discussed in the Capital Gains Exemption section. The investment must be replaced in the year of disposition or within 120 days after the end of that year. Shares of professional corporations, or real estate corporations, are not eligible for the deferral.

Allowable Business Investment Loss ("ABIL")

Most people investing in a business venture expect to generate a profit and don't necessarily plan for a loss. However, when a loss occurs they are quick to look for some tax relief. How do some taxpayers spell relief? - ABIL. When entering into any business transaction, it is important to consider the downside risk. Careful planning in structuring one's affairs at the outset may ensure that an ABIL claim is available at a later date.

An ABIL is essentially an allowable capital loss calculated at the applicable inclusion rate on the disposition of shares in, or debt owing from, a small business corporation ("SBC"). The term SBC is discussed in the Capital Gains Exemption section. If sold, the shares or debt must be disposed of to a person dealing at "arm's length" (unrelated) with a taxpayer. An ABIL also includes the loss on shares of a bankrupt SBC or an uncollectible debt from a SBC. To claim the loss on shares, formal bankruptcy proceedings need not be instituted. As soon as the corporation ceases to carry on business and is insolvent, an ABIL may be claimed.

For purposes of claiming an ABIL, a corporation will be considered to be a SBC if it was a SBC at any time in the 12-month period before the sale. Where a corporation sells its business and the corporate winding-up process is prolonged or where a corporation ceases operations, the taxpayer's ability to claim an ABIL on any shares/debt of the corporation is available for 12 months.

If an allowable capital loss qualifies as an ABIL, the loss may be deducted in the year of the loss against all sources of income (e.g. employment, investment, etc.), not just capital gains. An ABIL, if unutilized in the year, may be carried back three years or carried forward ten years. After ten years, if still unused, the ABIL will convert back to an ordinary capital loss and then can be carried forward indefinitely. However, the amount of an ABIL that can be claimed against other income is reduced by the amount of any capital gains exemption claimed in prior years. This reduction is treated as an allowable capital loss that may be carried back three years and carried forward indefinitely. Correspondingly, if an ABIL is claimed in a year against other income, taxable capital gains equivalent to the amount of the ABIL claimed must be generated in subsequent years before the capital gains exemption can be further utilized.

These provisions are very complicated, and the CRA requires detailed documentation to support such claims. However, taxpayers who are faced with such losses are able to obtain some tax relief to mitigate the losses from a bad business investment.

Capital Gains Exemption Election

While the ability to utilize the \$100,000 capital gains exemption no longer exists, its memory still lingers on. The government eliminated the exemption on February 22, 1994 but allowed taxpayers who had properties with accrued gains on that date to use an "election" mechanism to take their last stab at the \$100,000 exemption. The cost of the asset(s) elected on was stepped-up by the amount of the gain triggered by the election.

It is important that all taxpayers who have utilized this election procedure keep track of the new "tax" costs of their investments so that the correct capital gain or loss is recorded at the time of disposition.

With the elimination of the \$100,000 exemption, the only capital gains exemption that remains is for the disposition of shares of a small business corporation or qualified farm or fishing property. The balance of our discussion in this area will focus on the former.

The \$750,000 Capital Gains Exemption

The Basics

The exemption is available only to Canadian residents who are individuals. Corporations are not eligible. It also applies to

capital gains flowed through to individual beneficiaries of trusts. The exemption is discretionary in that a taxpayer has the option of claiming it when it is available.

Individuals who dispose of shares of a small business corporation (SBC) are eligible for a lifetime capital gains exemption of \$750,000. The \$750,000 exemption is reduced to the extent that the taxpayer has previously claimed the capital gains exemption.

There is no question that this exemption represents a major concession to taxpayers who have SBC shares. In many cases, a purchaser would prefer to acquire a corporation's assets rather than the shares of the company from the shareholder. Even so, it is often possible to negotiate the deal as a share sale, and the opportunity to claim the capital gains exemption should be considered where appropriate.

As discussed elsewhere, ABILs and allowable capital losses of other years can have an impact on the amount of exemption that may be claimed. In addition, an upcoming section indicates that CNIL balances also play a role in this claim. It is important to keep these factors in mind when determining the availability of the exemption.

There is a special election available that allows an individual to take advantage of this exemption if a corporation goes public without having to actually sell the shares. Once the company goes public the exemption is no longer available.

Taxpayers wishing to claim the exemption must file a tax return even if there is no tax payable for the year. Failing to do so may result in loss of the exemption.

Small Business Corporations (“SBC”)

This enhanced exemption, totalling up to \$750,000, is available on the sale (or deemed disposition) of shares of a qualifying SBC. In simple terms, a qualifying SBC is a Canadian-controlled private corporation (“CCPC”), which uses all or substantially all (i.e. at least 90% according to the CRA's interpretation) of its assets in an active business carried on in Canada. In the case of a capital gain triggered on death, the shares need only to have met this 90% test at any time in the 12 months prior to death. To be a CCPC, the corporation must be privately owned and not controlled by non-residents or public corporations.

This 90% test is based on the fair market value of assets of the corporation without deduction for liabilities. In certain cases, a holding company which owns shares of a SBC may qualify as a SBC.

Excess investment assets can disqualify a corporation from SBC status. *Corporations that carry on an active business but also have substantial investment assets such as marketable securities, term deposits or rental properties should consider taking steps*

to segregate these assets from the business assets in order to “purify” their SBC status. There are a variety of methods to effect this, all of which require careful planning to ensure the desired result. In any event, it is often crucial that this purification is carried out well before the sale of corporate shares is contemplated. Otherwise, the capital gain generated on the sale of shares may not be eligible for the exemption. Since a sale or deemed sale (e.g. on death) of shares may occur with little warning, *it would be prudent to maintain SBC status at all times, if possible.* It is generally difficult, if not impossible, to “purify” a corporation immediately prior to a sale.

A corporation need only meet the 90% test at the time of disposition of the shares. However, two other tests must also be met before the enhanced capital gains exemption is available. Firstly, the vendor or a related person must have owned the shares throughout the 24-month period prior to the disposition. One exception to this 24-month holding period is the sale of shares of a corporation formed through the incorporation of a proprietorship or partnership involved in an active business. The second test requires that more than 50% of the value of a corporation's assets were used in an active business in Canada throughout the 24-month period preceding the sale. These rules become further complicated where the shares of a SBC are owned by one or more holding companies.

Surprisingly, even when the sale of SBC shares is eligible for the exemption, the gain may not be entirely tax-free in the year of sale. Alternative minimum tax (“AMT”) may be payable in the year of disposition. The maximum combined Federal and Ontario AMT relating to the exemption will be approximately \$37,000 in 2011. Although this tax would likely be recovered in future years through the use of the AMT carryforward mechanism (refer to the AMT section for details), the impact of this tax should not be forgotten when the decision is made to claim the capital gains exemption.

In certain situations, the tests outlined above may be difficult to meet, and therefore individuals should be aware of these rules so that they can take the necessary steps to stay onside. Even though these rules are extremely complex, the tax benefits of complying with them are significant enough to warrant considerable attention.

Cumulative Net Investment Loss (“CNIL”)

The CNIL rules can have a major impact on a taxpayer's ability to access the capital gains exemption. The rules are designed to restrict taxpayers with significant write-offs from interest and other carrying charges from claiming the exemption. The impact of these rules should not be taken lightly.

The CNIL rules operate to reduce net taxable capital gains eligible for the exemption by “investment losses”. A taxpayer will only be eligible for the exemption to the extent his or her cumulative net taxable gains realized since 1985 exceed his or her CNIL. The interaction of the CNIL pool and the exemption

is quite complicated and may make it difficult to determine a taxpayer's entitlement to the exemption in any given year. This is especially true if the gain is generated early in the year before the CNIL can be determined.

The CNIL pool is cumulative and is calculated at December 31 of each year. If at the end of any year the cumulative amount of investment income exceeds investment expenses, the CNIL pool will not be a factor in computing the exemption. If an individual is disposing of property and expects to use the capital gains exemption, it is important that he has accurate information regarding his CNIL balance. This information can be obtained from the CRA, if necessary.

One cannot get a true picture of the potential effect of these rules until taking a closer look at the components of the CNIL pool. In general, an individual's CNIL at the end of a year is the amount by which the individual's investment expenses for each year after 1987 exceed investment income in those years. Investment income for a year includes interest and taxable dividends, a share of income from a limited partnership or other similar arrangement where the individual is not actively engaged in the business, and income for the year from the renting or leasing of real property. Investment expenses include the following:

- deductions, including interest, with respect to property that will yield interest, dividends, rent or other investment-type income;
- carrying charges, including interest, with respect to an interest in a limited partnership or any other similar arrangement where the individual is not actively engaged in the business;
- the individual's share of a loss from any partnership or arrangement described above;
- the individual's share of deductions from various tax shelter arrangements; and
- any loss for the year from the renting or leasing of real property.

The CNIL account will also be reduced by certain net capital gains that are not eligible for the capital gains exemption.

As is evident from the preceding, the types of expenses caught by the CNIL pool are extensive. The basic premise is that if a taxpayer borrows funds to make an investment, he should not be able to both write-off the interest and generate tax-free capital gains. Taxpayers who borrow funds to purchase shares of a SBC may find that when it comes time to dispose of these shares, the enhanced exemption will be diluted by the interest expense claimed in prior years. The CNIL limitation applies even if the capital gain and the investment expenses are unrelated. Accordingly, the CNIL pool creates an additional consideration for tax planning.

The following example illustrates the operation of the CNIL. It assumes the taxpayer did not have capital gains eligible for the exemption in prior years nor a CNIL balance at the beginning of the year. As a result, the CNIL balance at the end of the year will be equal to the excess of the current year investment expenses over the current year investment income.

| | | |
|--|--|-----------------|
| Investment expenses | | \$ |
| Interest | | 10,000 |
| Limited partnership loss | | 30,000 |
| Other carrying charges | | <u>2,000</u> |
| | | 42,000 |
| Investment income | | |
| Interest | | (4,000) |
| Taxable dividend | | <u>(8,000)</u> |
| CNIL | | <u>30,000</u> |
| Capital gain realized | | <u>100,000</u> |
| Taxable capital gain (50%) | | 50,000 |
| Less: CNIL | | <u>(30,000)</u> |
| Capital gain eligible for exemption | | <u>20,000</u> |

In this example, access to the exemption in the year is restricted to \$20,000, leaving \$30,000 subject to tax.

Some Exemption Planning Ideas

There are no guarantees that the \$750,000 exemption will remain a fixture in the Canadian tax system. Therefore, proper planning in this regard remains important. The following planning ideas are only applicable to qualifying small business corporation shares.

Even though the capital gain may be tax-free through use of the exemption, triggering the gain does increase a taxpayer's net income. Accordingly, this may result in the clawback of old age security and reduction of various other credits whose entitlement is based on net income. However, it also increases the amount of charitable donations that may be claimed in the year.

Crystallization of An Eligible Capital Gain

Taxpayers can generate tax-free capital gains through non-arm's-length transfers (i.e. transfers between related parties), otherwise known as "crystallization" transactions. Gains generated on sales to other family members or to a related corporation would be eligible for the exemption and, at the same time, increase the tax cost of the assets in the hands of the recipient. *All eligible taxpayers should consider whether crystallizations or similar planning would be appropriate to protect against a withdrawal of the exemption in the future.* The costs associated with this type of planning must be considered before proceeding.

The crystallization of capital gains by minors from sales of shares of private corporations to related persons is no longer

available. Please refer to the commentary in the Income Splitting section on the rules.

Careful planning is also required to ensure that taxpayers remain outside the attribution rules noted in the Income Splitting section.

Multiplying the Capital Gains Exemption

Taxpayers who own shares in a SBC may be able to generate additional \$750,000 exemptions for other family members. This could be carried out through a process known as an estate freeze, whereby existing shareholders convert their shares into fixed-value preference shares. New common shares would be issued/given to other family members (i.e. spouse/children). These family members may be eligible for the enhanced exemption on the future disposition of these shares. If this plan is contemplated, it may be prudent to have the original shareholder make a gift of the newly issued shares to comply with the 24-month holding period rule. This latter step may also have certain beneficial family-law implications. Obviously, the non-tax aspects of such a transaction must also be carefully considered before implementation.

Neutralizing the CNIL Impact

The CNIL rules may adversely affect an individual's eligibility for the \$750,000 exemption. Accordingly, where possible, *steps should be taken to neutralize the effect of the CNIL rules*. The following suggestions will help in this regard:

- remunerate shareholders of closely-held corporations with dividends rather than salary;
- charge interest on shareholder loans to closely held corporations to create interest income; and
- structure one's affairs so that borrowed funds are used for business purposes while investment purchases are financed with available cash.

Other

Sole proprietors or partnerships who intend to sell their businesses should consider incorporating their interests and selling shares of the new corporation to take full advantage of the enhanced capital gains exemption. The corporation must of course qualify as a SBC.

Individuals who own qualifying property and who have wills or are party to shareholders' agreements should have these documents reviewed to ensure they are flexible enough to provide for utilization of the enhanced exemption.

In any of these situations, the planning should be done very carefully to ensure that all potential pitfalls have been avoided.

Principal Residence

As most taxpayers know, any gains realized on the sale of a principal residence can be received free of tax. However, since 1982, a family unit (consisting of spouses and unmarried children under 18 years of age) can designate only one residence as its principal residence in any year.

The principal residence can be a home, cottage, condominium or similar property. The taxpayer must occupy the property for at least a portion of the year. The taxpayer need not live in the residence full time (e.g. it can be an occasional residence such as a cottage). Included in the definition of principal residence is the land necessary for the use and enjoyment of the home. This issue can become more convoluted when the land in question exceeds one-half hectare (approximately 1.2 acres). If the zoning bylaws require a larger minimum lot size, the size of the land may not present a problem.

If a couple owns two properties that are eligible to be designated as principal residences, the decision as to whether the designation should be made when the first of the two properties is sold should be made with the other property's inherent gain in mind. The CRA does not require the filing of the principal residence designation form in the year of sale unless there is income tax payable on the sale. However, if the form has not been filed, the CRA will assume that the designation has been made in respect of that home for each year of ownership. It will not accept a designation on the sale of the second home for the same years. *If the gain per year of the property to be sold is lower than the other, it may be preferable to pay the tax on the sale to preserve the ability to designate the other property on its eventual sale.*

As noted, each spouse can designate a separate home as his or her own principal residence for each year he or she owned a property prior to 1982. *In situations where one spouse owned two residences that were acquired prior to 1982, it may be beneficial to restructure the ownership so that each spouse owns one of the properties.* This approach could result in better utilization of the principal residence exemption that relates to pre-1982 accrued gains.

It may make sense to transfer the ownership of a second residence to adult children (over age 18). It is also possible to transfer ownership to a trust set up for the benefit of the adult children, if direct ownership by the children is not desirable. If the adult child owns no other residence, he/she can utilize the principal residence exemption on the transferred property when he/she or the trust sells the property. The initial transfer may result in tax to the parent since the transfer is deemed to take place at fair market value. Any planning in this regard should be done very carefully.

Circumstances may arise where a taxpayer initially purchases a rental property for investment purposes, and in later years converts that property into a personal dwelling. In the year of

change, the taxpayer is deemed to dispose of the rental property for its fair market value at that time. However, the capital gain that would otherwise arise can be deferred until the time the property is sold if the taxpayer files the appropriate election with his or her tax return for the year of sale. It is important to note that this election is only valid if the taxpayer has not claimed capital cost allowance (“CCA”) with respect to the property in any taxation year ending after 1984. Accordingly, *taxpayers should not claim CCA while the house is a rental property if it might become a principal residence*. In addition, this property can only be designated as a principal residence for up to four years during which it is rented.

A similar election is available when a taxpayer converts a principal residence into a rental property.

Under the appropriate circumstances, *a taxpayer may be able to utilize the principal residence exemption to convert non deductible interest into deductible interest*. Assume a husband and wife own a principal residence, which they wish to convert into a rental property. If they borrow to purchase their new home, the mortgage interest will not be deductible. However, if the higher income spouse borrows to buy the other spouse’s interest in their former residence, the interest will be deductible, because the loan is used to purchase a rental property. The other spouse will claim the principal residence exemption on any gain realized on the sale to his/her spouse, and can use the proceeds to buy the new home.

INVESTMENT INCOME

Taxation of Dividends

Dividends are taxed at rates preferential to other types of investment income such as interest. The preferential tax on dividends results from the government’s attempt to maintain the concept of tax integration, which reflects the fact that a corporation paying a dividend has already paid tax on the distributed income. Necessary adjustments are made through a complicated dividend gross-up and tax credit system.

The tax payable on dividend income depends on whether the corporation which paid the dividend has designated the dividend as an “eligible dividend”. An “eligible dividend” is paid out of private corporation business income which has been subject to the high corporate rate of tax, i.e. not eligible for the small business deduction. It also includes dividends from public corporations, either received directly or flowed through private corporations..

The corporation paying the dividend has the onus to identify whether a dividend is an “eligible dividend” to the recipient at the time of the dividend payment. If the dividend is not an “eligible dividend”, it will be subject to a 25% gross up. Accordingly, the taxable amount is \$1.25 for every \$1 of such

dividends received. The taxpayer will claim a corresponding combined federal and provincial tax credit of approximately 25% (including surtaxes) of the cash amount of the dividend to be applied against taxes payable. The gross-up and dividend tax credit system is intended to put the taxpayer in the same position as if he or she earned the income directly, instead of through the corporation. At the top Ontario personal tax rate, such a dividend will attract a tax of approximately 33%.

Eligible dividends eligible for the enhanced treatment will be grossed-up by 41% in 2011, and will be decreased as a result of reduction in corporate tax rates to 38% in 2012. The combined top federal and Ontario personal tax rate on eligible dividends will be 28.2% in 2011 and 29.5% in 2012. *Accordingly, it may make sense to pay out all eligible dividends from private corporations in 2011 before the rate increases*.

For the balance of this commentary, the “eligible dividend” will be referred to as Large Corporation dividend in order to distinguish it from other types of dividends.

The tax rates on dividends at other income levels are noted in Schedule 1 on page 22. As that schedule indicates, the top tax rate on Large Corporation dividends is higher than that applicable to capital gains.

In 2011, an individual without any other source of income may receive up to \$38,000 of ordinary dividends, or \$50,500 of Large Corporation dividends without attracting any tax other than the Ontario Health Premium. The maximum amount of ordinary dividends that can be received without attracting the Ontario Health Premium is \$16,000, whereas the maximum Large Corporation dividends that can be received without attracting the Ontario Health Premium is \$14,000.

Needless to say, tax plays an important role in investment decisions. Different types of income are subject to different rates of tax, which affect the ultimate yield on the investment. For example, a top rate taxpayer who received approximately \$72 in Large Corporation dividends would be in the same after tax position as an individual with \$100 of interest income. In other words, an investor earning a 10% rate of return on his interest bearing investments would be roughly in the same after-tax position as an investor earning a 7% dividend return.

Stock dividends received from a Canadian corporation are subject to the same rules as those noted above. In this case, the actual (declared) amount of the stock dividend (based on the increase in the paid up capital of the shares) is used to calculate the gross-up and tax credit, as well as the cost base for the shares received.

In certain cases, a Canadian private corporation may pay capital dividends to its shareholders from its capital dividend account. Capital dividends are tax-free to the shareholders. A corporation’s capital dividend account consists of the untaxed portion of capital gains generated by the corporation, life

insurance proceeds received by the corporation as a beneficiary of a life insurance policy, and capital dividends received by the corporation. The capital dividend account is reduced by capital losses. Therefore, *where a corporation has a capital dividend account, it should be paid out before realizing any subsequent capital losses*. Certain CRA reporting requirements must be met to avoid potential penalties.

Dividends may also be received through mutual funds. They receive the same tax treatment as normal dividends. However, such funds also may pay “capital gains” dividends to reflect capital gains earned by the funds. Such dividends are treated as capital gains for tax purposes. Often income or gains earned through mutual funds are not actually paid out to the unit holders, but reinvested in additional units. It is important to keep track of such reinvestments as the cost of the additional units are relevant in computing the gain or loss on an eventual sale of the fund units.

The recipient of dividends is normally required to include the amount in income. However, in some rare cases *it may be beneficial (and permissible) to report dividends received by one's spouse*. In order to take advantage of this measure, the transfer of dividends between spouses must increase the spouse's claim for the married tax credit.

Dividends received from foreign corporations, subject to the comments concerning foreign investment vehicles, are not subject to the gross-up and tax credit rules, but are included as “regular” income in Canadian dollars. Any foreign tax withheld on such dividends is available, subject to certain limitations, as a tax credit against Canadian taxes payable.

The tax differential between earning investment income directly and using a corporation to earn investment income is negligible in 2011. *Beginning in 2012, there will be a gradually increasing deferral advantage as well as overall tax savings to having investment holding companies* due to the reduction of corporate tax rates scheduled for the next few years.

There may be other circumstances when it may be beneficial to incorporate investment income, such as to avoid the Old Age Security Clawback, or U.S. Estate tax on U.S. holdings, both discussed elsewhere in the commentary. Other costs of incorporating such income must be considered prior to implementing this type of planning. Please refer to our commentary in the Incorporation section for additional information.

Interest Income

Interest income, from any source, is taxed at the same rate as business and employment income. Interest earned must be reported as income on an annual basis. Financial institutions will issue a T5 slip indicating the amount of interest earned each year. The amount reported on the T5 will usually include the amount of interest income received during the year, unless the

term of the investment extends beyond one year. In those cases, interest must be accrued and reported each year, even though it may not be paid until a later date. For example, if an investment that matures in 2012 is made on August 1, 2010, interest up to July 31, 2011 must be reported on the 2011 return, even if the interest is not payable until the investment matures. Similarly, interest from August 1, 2011 to July 31, 2012 would be reported on the 2012 tax return. Alternatively, interest accrued to December 31 of each year could be reported annually.

As is the case with dividends, interest from foreign sources must be reported in Canadian dollars for Canadian tax purposes. Any foreign tax withheld is generally available as a foreign tax credit against the Canadian tax on foreign source income.

Mutual Funds and Income Trusts

Mutual funds and income trusts have become increasingly popular investments over the past number of years. There are a large variety of such investments available and they usually take the form of publicly traded trust units. Traditional mutual funds invest in securities that will generate a mix of interest (shown as “other” income), dividends and capital gains to the investors. Income trusts generally invest in businesses, which usually produce a steady cash flow, such as real estate. Income allocated from both traditional mutual funds and income trusts are usually reported to the investors on T3 slips.

Distributions from the trust units are often a combination of income and return of capital. Returns of capital are typically not taxable but reduce the cost base of the trust units, thereby increasing the ultimate capital gain on sale.

The government introduced a new tax on income trusts (except certain real estate-based trusts) that is scheduled to be phased in over time for new trusts. These rules are effective 2011 for existing trusts. This tax was designed to put income trusts and corporations on an equal footing. A number of income trusts have already reorganized into corporations. Time will tell whether the balance will follow.

Foreign Investments

FEE! **FIE!** FO! FUM! The government smells the blood of the taxpayer!

For a long time, the Canadian government, as well as many other governments around the world, have been concerned with taxpayers avoiding tax through offshore investing. As explained elsewhere in our commentary, an individual resident in Canada is subject to tax on his or her world income.

As an example, if an individual invests \$100,000 offshore and directly earns \$5,000 of interest, this income is reportable in Canada. If foreign taxes were paid on this income, the individual would be entitled to claim a foreign tax credit on the Canadian return.

What if the funds were invested through an offshore corporation? Unless dividends were paid, the income would be the offshore company's income. Two existing set of rules, known as Foreign Accrual Property Income ("FAPI") and the Foreign Trust rules caught this type of planning. These will be explained more fully in the following paragraphs.

However, the FAPI and Foreign Trust rules only applied in specific circumstances. The government was concerned that other investing arrangements allowed taxpayers to avoid all the existing rules.

The government proposed rules known as Foreign Investment Entities ("FIE") which were intended to capture these other types of investments. After many years of revisions, the government appears to have finally capitulated and abandoned these rules. Under recently released proposals, only income from investments with a tax-avoidance motive will need to be reported using the general prescribed rate plus 2% beginning in 2010. The cost of the investment will be adjusted for the amount included in income.

The scope of Canadian taxation of Foreign Trusts have also been expanded. The investor is forced to include passive income earned in the foreign trusts into income even if undistributed (in the case of commercial trusts), or the non-resident trusts may be deemed to be Canadian resident trusts, if the rules apply. These rules, once enacted will apply for the 2007 taxation year onwards.

Generally, all these rules attempt to capture all

investment/passive income, no matter what arrangement or vehicle is used, on an accrual basis (when earned, not when received). Foreign entities that earn active business income are generally not caught under these rules.

Foreign Spin-Offs

From time to time, a corporation may decide to focus its operations on one or more core businesses. As a result of this process, non-core operations may be transferred to a separate corporation, and the shares of this corporation may be distributed to the shareholders. This is generally known as a "spin-off". A spin-off involving Canadian corporations is generally tax-free to the Canadian shareholder. If a foreign corporation distributes shares of another foreign corporation to its shareholders on a spin-off transaction, the value of the shares are taxed as if the shareholder has received a dividend. An important exception is available in the case of certain U.S. public company spin-offs. The cost of the original shares will be split between the two U.S. corporations' shares based on their relative fair market values, and no tax is currently payable on the value of the spin-off shares. To be eligible for this treatment, the U.S. corporation must file detailed information concerning the spin-off with the CRA no later than six months after the spin-off. The investor must also file an election and report details of the spin-off transaction to the CRA on a timely basis.

Related Matters

The difference between the proceeds on maturity and the discounted price of stripped bonds or government treasury bills is taxed as interest over the life of the investment. For these

| SCHEDULE 1 2011 Marginal Tax Rates ¹ on Investment Income | | | | |
|---|-----------------|-----------------------------------|--------------------------------|----------------------|
| Tax Bracket ² | 2011 Interest % | 2011 Dividend CCPC ³ % | 2011 Large Corp ⁴ % | 2011 Capital Gains % |
| 0 – 10,527 | NIL | NIL | NIL | NIL |
| 10,527 to 13,262 | 15.0 | 2.08 | NIL | 7.50 |
| 13,262 to 37,774 | 20.05 | 2.77 | NIL | 10.03 |
| 31,774 to 41,544 | 24.15 | 7.90 | 1.85 | 12.08 |
| 41,544 to 66,519 | 31.15 | 16.65 | 11.72 | 15.58 |
| 66,519 to 75,550 | 32.98 | 17.81 | 12.50 | 16.49 |
| 75,550 to 78,370 | 35.39 | 20.82 | 15.90 | 17.70 |
| 78,370 to 83,088 | 39.41 | 23.82 | 18.32 | 19.71 |
| 83,088 to 128,800 | 43.41 | 28.82 | 23.96 | 21.71 |
| Over 128,800 | 46.41 | 32.57 | 28.19 | 23.21 |

¹Combined federal and Ontario tax rates include all surtaxes, but exclude Ontario Health Premiums, which applies to taxable income over \$20,000, for a maximum of \$900.

²2011 tax brackets. 2012 brackets are higher due to indexation.

³Dividends paid (from both CCPC/non-CCPC) from income that benefited from the small business deduction.

⁴Dividends paid (from both CCPC/non-CCPC) from business income that had not benefited from the small business deduction.

investments, interest must be accounted for on the accrual basis. Despite this fact, *taxpayers acquiring treasury bills in 2011 can defer the reporting of interest income on these investments to 2012 by selecting a maturity date of January 1, 2012 or later, instead of December 31, 2011.* In making this decision, both the merits of the investment (e.g. rate of return) and effective marginal tax rates in each year should be considered. If the term of the investment contract is longer than one year, taxpayers may find themselves paying taxes before receiving their income. As a result, such investments are usually more attractive in a RRSP.

As noted elsewhere, interest and dividend income reduces the balance in the CNIL pool, which may have a direct bearing on the taxpayer's ability to claim the enhanced capital gains exemption.

When borrowing for investment purposes, it is important to attempt to ensure that the interest expense incurred is tax deductible. This matter is discussed in more detail in the Deductions and Credits section.

INCOME SPLITTING

Rules

Income splitting, previously "taboo" in the eyes of our friends at the government is gradually becoming an accepted practice. Seniors are permitted to income split with respect to pension income (see next section for more details). One spouse can give the other spouse money to contribute to a Tax-Free Savings Account (see Tax Deferral Plans for a description of the plan) without concern about the attribution rules. Can further income splitting measures be far behind? It is premature at this point to speculate as to whether the current government will proceed with a proposal announced during the 2011 election to allow spouses to split up to \$50,000 of income each year. If introduced, the measure would be a significant change in the government's way of thinking. However, we are not there yet.

Is income splitting good tax planning or some devious method to avoid paying one's fair share of tax? No doubt CRA has believed the latter. Accordingly, CRA has historically done its darndest to attack various income splitting tactics. But don't give up hope, not all of the income splitting plans (under existing rules) have been terminated, and we'll cover them in this section of our commentary.

The objective of income splitting is to transfer income that would otherwise be taxed in the hands of a high-rate taxpayer to another family member (perhaps a spouse or a child) in a lower tax bracket. In addition, income splitting enables a family unit to maximize the use of various statutory credits such as the basic personal tax credit. As noted elsewhere in this commentary, income splitting may also help couples limit the impact of the Old Age Security Clawback.

Tax rate differentials between low-rate taxpayers and those taxed

at higher rates are not as great as they once were. Despite this, the difference between the lowest and highest tax bracket is still around 26%. In addition, as a result of indexing, the threshold for the highest tax bracket is almost \$129,000 in 2011. As long as individuals continue to be taxed at graduated tax rates, the opportunities to income split should be explored.

As noted, the government has consistently attacked this area of tax planning, primarily through the attribution rules which are specifically designed to curtail the shifting of income between closely related individuals. These rules only apply to income from investments and not income from business or employment. The government also has the "Kiddie Tax" in its arsenal, which considerably expands the scope of its attack on income splitting arrangements with minors. More about that later.

Spouses and Related Minors

The government's major tools to combat income splitting are known as the attribution rules. The application of these rules results in the transferor of property being taxed on the income derived from the property transferred or loaned to a spouse or a related minor. For example, if a wife gave or lent her husband \$10,000 to buy shares of a public company, then the dividends received on those shares would be taxable to the wife. Any capital gains or losses that are subsequently realized on the sale of the shares would also be taxed in the hands of the wife. These rules apply even if the gift or loan were made before marriage.

There is no attribution on capital gains or losses generated on property transferred to a related minor (i.e. under age 18). Related minors include children, grandchildren, brothers, sisters, nieces and nephews. The attribution rules for minors will cease to apply in the year the child reaches age 18. In most cases, a gain or loss may result on a transfer of property (other than cash) to a minor, since the transfer is deemed to take place at fair market value. Only the future gain or loss that occurs after the date of transfer will accrue to the minor.

These rules have also been expanded to apply in certain situations where an individual transfers property or loans funds to a corporation in which his or her spouse or a related minor has an interest. It is relevant to note that these rules will not apply to loans made to corporations that carry on an active business, or to loans between corporations.

Other Related Individuals

The attribution rules may also apply to loans made to any related individual, not just minors and spouses. In particular, this provision may come into play where loans are made to adult children or parents. Once a loan falls within these provisions, it may not be possible to avoid attribution of income by simply repaying the loan. Bear in mind that attribution deals only with income from assets acquired through such loans. Personal loans, including non-interest-bearing loans, given to children to purchase a home, are unaffected.

It is important to stress that on loans to non-spouse relatives, attribution only affects income and not capital gains realized from assets purchased with the loan proceeds. This rule also does not apply to transfers or sales of property unless the consideration includes indebtedness with less than a market rate of interest. Loans to corporations owned by other related individuals will not be subject to these rules.

Other Miscellaneous Notes

The attribution rules will also apply to income from limited partnership interests acquired with such “tainted” loans.

Finally, any planning undertaken to circumvent these rules by shifting income or deductions from one family member to another to obtain tax benefits may fall within the grasp of the General Anti-Avoidance Rule (GAAR), the CRA’s ultimate weapon. In a Supreme Court of Canada decision, GAAR was found to apply when a taxpayer used the attribution rules in his favour in such a manner.

A number of other rules that have not been mentioned could also have application to any income splitting plans. These rules are not for the meek. Do not make a move in this area without talking to your tax advisor.

Kiddie Tax

Under the Kiddie Tax provisions, minor children will be taxed at a federal rate of 29% (which happens to be the highest marginal tax rate) on certain types of income. These include dividends from private corporations, as well as income from trusts or partnerships which sell goods or provide services to or in support of a business carried on by a related person or corporation. It is interesting to note that for purposes of this tax, nieces and nephews are not considered to be “related” to their uncles and aunts. For fiscal periods beginning after December 20, 2002, it is proposed that income from trusts or partnerships which earn interest, rent or other property income derived from a parent’s business will also be subject to the Kiddie Tax. These rules are waiting reintroduction. These rules will affect existing arrangements, and should be reviewed with a tax advisor.

Some enterprising teenagers may own their own businesses, which may range from providing summer painting or winter snow removal services, to a business in the dot.com sector. If these businesses are owned through private corporations, *the children should receive salaries instead of dividends*, because dividends will be subject to the Kiddie Tax, even if there are no connections with any businesses operated by their parents.

The news is not all bad. The attribution rules will not be applied to the income subject to the Kiddie Tax. If the Kiddie Tax applies, the total taxes may still be lower than the parents’ tax on the same income, as the surtaxes will not apply at the lower income levels. For example, an ordinary dividend of \$40,000

to a parent at the highest marginal tax bracket in 2011 will attract additional tax of approximately \$13,000. A child with no other income will pay combined federal and Ontario Kiddie Tax of approximately \$11,200, a saving of \$1,800 in surtaxes.

The Kiddie Tax is similar to a minimum tax in that only the dividend tax credit and the foreign tax credit can reduce the tax. Other tax credits or deductions cannot be claimed against this tax.

There are many private corporations which are owned by trusts set up for the benefit of minor children. Under rules applicable until March 21, 2011, the trust may sell these shares back to the parents, and trigger a capital gain especially if the shares are eligible for the capital gains exemption. The trust may then reinvest the proceeds in investments which will not attract the Kiddie Tax.

The 2011 Budget introduced rules that have eliminated this planning opportunity. Under proposed rules, capital gains triggered on a non-arm’s length sale of private corporation shares on or after March 22, 2011 will be treated as dividends, not capital gain. The resulting dividends will be treated as ordinary dividends, not eligible dividends, as the eligible dividend designation would not have been made. Obviously, the capital gains exemption would also not be available.

Where a sale of the shares to the parents is tax prohibitive or not desirable, *a holding company may be set up to accumulate the dividends from the operating company*. Dividends will only be paid to the trust and allocated to adult beneficiaries.

The commentary in the Planning Opportunities section will refer to other ways to avoid the Kiddie Tax.

The impact of the Kiddie Tax is far reaching. A professional tax advisor should be consulted when such an arrangement is considered.

Planning Opportunities

While it is apparent that income splitting has become more difficult over the years, there are still planning opportunities that can be exploited. The following comments touch briefly on a few of the alternatives still available.

Tax-Free Savings Account

Each person 18 years or older will be entitled to contribute \$5,000 (subject to indexation in future years) per year to such an account. *The higher-income parent should gift the lower income spouse and any adult children the necessary funds to make the contribution to their own plans*. The attribution rules do not apply to income earned in such plans. Please refer to the Tax Deferral Plan section for more details on this vehicle.

Transfers or Loans to Earn Business Income

The attribution rules do not apply to property transferred or loaned to a spouse or minor child to earn income from business. The spouse or minor child should not use the gifted or loaned property to invest in a passive interest in a partnership because income from such a partnership is deemed to be property income for the purpose of the attribution rules. However, a parent can provide the necessary capital to finance an enterprising teenager in his/her business venture without causing attribution to apply.

Market Loans and Sales

None of the attribution rules noted earlier apply to loans that are made at a commercial rate of interest. A loan should be made from the higher-income spouse to the other spouse at a low rate. If the spouse receiving the loan is able to invest wisely, the family unit will be able to split income to the extent that the spouse's investment yield exceeds the interest paid on the loan. The interest rate charged on the loan should approximate the lower of the market rate for similar loans and the prescribed rate of interest charged by the CRA at the time the loan is made. The current prescribed rate is a low 1%. If interest rates are expected to rise, there may be an advantage to lending money to other family members and to locking in at the lower rates. *It is important that the interest on such loans is paid within 30 days of the end of each year in which the debt was outstanding; otherwise attribution will apply throughout the remaining term of the loan.*

Income splitting with minor children can still be achieved as long as the minor children invest in non-offending securities such as public corporation shares. Income earned on these shares will not be subject to the Kiddie Tax. Minor children may also consider using the money to invest in other assets such as interest bearing investments, or a rental property. Interest, rent and royalties are also not subject to the Kiddie Tax. However, as discussed previously, the government has proposed changes, which will subject these types of income earned from a parent's business to the Kiddie Tax, if they are earned through partnerships or trusts. *Nieces and nephews may earn these types of income from their uncles' or aunts' business without being subject to the kiddie tax.*

Similarly, *transfers of property for fair market value consideration will not be subject to attribution.* If part of the consideration includes debt, the rule noted above with respect to market loans is applicable. Taxpayers will benefit from this approach if the property appreciates in value after the transfer and/or if the yield from the property exceeds the prescribed interest rate. As noted earlier, *if the property transferred is later sold and generates a capital gain, any gain earned by children or other non-spouse relatives will not be attributed back to the transferor.* Minors should beware of inadvertently triggering the Kiddie Tax on a non arm's length transfer of certain property.

If a capital loss is generated on the transfer of property to a

spouse, the loss will be denied. Complicated rules exist that set out both the timing of the recognition of the loss and the individual who must report it.

Income Earned on Attributed Income

The attribution rules do not apply to income earned on income which has already been subject to attribution. After a number of years, and depending on the original amount loaned or transferred, this income may be sizeable. It is important that adequate documentation be kept to support this amount.

Gifts to Children 18 and Over

Once a child turns 18 years of age, the attribution rules and the Kiddie Tax described above are no longer applied to gifts made to such individuals. *Therefore, amounts can be gifted to such a child and any related income is taxed in the child's hands.* It is also possible to make the gift in the year the child turns 17, as long as the funds are invested so that the income is not received (or deemed received) until the year in which the child turns 18. Depending on the circumstances, this may enable the child to utilize the basic personal and other credits that might otherwise go unused. Income can be generated in the child's hands to the extent that these credits are fully absorbed and result in the child paying no tax. The parent obtains a corresponding reduction in the amount of income that would otherwise be taxed, and achieves tax savings at the marginal tax rate. Keep in mind, a gift is not a loan. Therefore, the parent must be willing to give up legal and beneficial ownership, if not practical control over the asset transferred.

Gifts to Minors

Since capital gains on property transferred to minors do not attribute back to the transferor and will generally not attract the Kiddie Tax (see comments under that section for the new rules applicable to non arm's length transfers), *it may be prudent to transfer appreciating assets to minors.* Any income/loss that is generated from the transferred asset will be attributed and taxed in the parent's hands as long as the child is a minor, but the capital gain on future sale of the asset will be taxable to the children. In certain jurisdictions, a trust may have to be used to facilitate this plan if minors cannot own assets directly. The above comments regarding relinquishing legal and beneficial ownership of the asset are also applicable.

Salaries to Spouse/Child

If a taxpayer operates a business, whether through a corporation or in an unincorporated form, *reasonable salaries may be paid from the business to the taxpayer's spouse or children.* In the case of an unincorporated business, the salaries reduce the income to be reported by the proprietor and are taxed in the hands of the spouse or children, presumably at a lower rate. The key to this type of salary arrangement is payment of a reasonable amount in relation to the services provided.

Recently, CRA has been paying closer attention to such payments from the point of view of ensuring that payroll deductions have been withheld and remitted. It is important, therefore, to make sure that family members are put on the payroll and both the employer's and the employees' share of the source deductions are remitted.

In an unrelated but similar regard, amounts can be paid to a related child 18 years of age or older for childcare in respect of younger siblings. The amount paid would be deductible as childcare by the lower income parent and included in the recipient's hands as income. The child performing the childcare services can earn \$10,500 annually without paying tax. This payment can also be made to the grandparents or other adult relatives of the children.

Sale of Non-Income-Producing Properties to Higher-Income Spouse

Consider the case of a husband and wife who have joint ownership in the family home. *The low-income spouse can sell his/her interest in the home to the higher-income spouse for cash or income producing assets.* This transaction should take place at fair market value. It results in the conversion of a non-income-producing asset into an income-producing asset in the hands of the lower-income spouse. Any resulting gain can be sheltered through using the principal residence exemption. This type of scenario can be carried out with other non-income-producing asset.

Such planning should be considered carefully for more than tax reasons. Sometimes concern for personal or professional liability would dictate that an individual divest himself or herself of any significant assets, including the family home.

Payment of Personal Expenses

The higher-income earner's capital should be used to pay household and other personal expenses and the lower-income spouse's tax liability/instalments. This maintains the lower-income spouse's capital for investment purposes.

Similarly, *a parent can finance a child's tuition fees and living expenses through a gift or a loan.* The child can then invest amounts earned through summer employment, and the earnings would not be subject to attribution.

Spousal RRSP

Individuals can contribute to RRSPs, within certain limits, for their spouses and claim the deduction themselves. These plans should be kept separate from RRSP plans to which the spouse has contributed directly. The choice of the spouse as the annuitant has no current income splitting benefits. However, the use of a spousal RRSP will generally permit income splitting between spouses in the future, when funds are withdrawn from the RRSP.

If amounts are withdrawn from a spousal RRSP before its maturity, the income may be taxed in the hands of the contributor. Any amounts paid to the RRSP by the contributing individual in the year of withdrawal and the two previous years, up to the amount of the withdrawal, must be included in his or her income rather than in the annuitant's income. Therefore, if properly planned, a spousal RRSP can be used to transfer income into the hands of the lower-income spouse prior to retirement.

| SCHEDULE 2 2011 Federal/Ontario Kiddie Tax Rates | | |
|---|---|---|
| Actual Amount of Dividend/Split Income (\$)¹ | Combined Federal/Ontario Rate on Dividends² | Combined Federal/Ontario Rate on Other Split Income |
| Dividends: CCPC | | |
| 0 – 73,180 | 27.91 | |
| Over 73,180 | 32.57 | |
| Dividends: Large Corporation | | |
| 0 – 90,772 | 24.43 | |
| Over 90,772 | 28.19 | |
| Other split income | | |
| 0 – 54,590 | | 40.16 |
| Over 54,590 | | 46.41 |

¹Assumes no other sources of income.
²Only dividend tax credit and foreign tax credits are allowed against kiddie tax.

On a final note, *spousal RRSP contributions should be made before the end of the calendar year, as opposed to the following January/February if possible.* Because of the rule noted above regarding which spouse pays tax on the withdrawal, this step will allow an individual to withdraw the funds one year earlier to be taxed in the lower-income spouse's hands. For example, amounts contributed to a spousal RRSP in December 2011, can be withdrawn in January 2014 (assuming no other spousal contributions are made between December 2011 and January 2014) and taxed in the recipient spouse's hands.

Child Tax Benefits

Income earned on child tax benefit payments and the Universal Child Care Benefit (UCCB) payments received in respect of a child is not subject to attribution as long as the funds are kept separately in the name of the child.

A single parent has the option of including the UCCB in the income of the child.

Assignment of CPP Benefits

Individuals can direct that up to 50% of their Canada Pension Plan benefits be paid to their spouses. If so directed, a portion of the other spouse's CPP is also automatically assigned back to the first spouse. Both spouses must be over age 60 to do this. This procedure is only warranted if one spouse has higher CPP benefits than the other and is also in a higher tax bracket. This transfer may have an adverse impact on the married tax credit.

PENSION INCOME

Generally, all pension income received from any source is taxable in Canada. This includes the Old Age Security ("OAS"), Canada Pension Plan ("CPP") and all private pension plans, including Retirement Compensation Arrangements. OAS may be subject to a clawback (repayment), with a corresponding deduction to eliminate the income inclusion (see comments below). Foreign pensions, whether government sponsored or from private plans are generally taxable in Canada at their Canadian dollar equivalent. To the extent foreign income or withholding tax is payable on the pension income, a foreign tax credit may be claimed to mitigate the impact of double taxation. Pension income attracts tax at the same marginal tax rates as salary or interest. Pension income may qualify for a non-refundable pension income tax credit (see Deductions and Credits section).

As always, there are exceptions to the rules. Some pension income is not subject to tax in Canada. This includes certain veteran and war pensions.

Income tax treaties between Canada and foreign countries may also affect the extent to which certain foreign pensions are taxable in Canada. For example, only 85% of U.S. Social

Security payments received by residents of Canada are taxable in Canada under the treaty between the two countries. The U.S. will not impose withholding tax on such payments. For those pensioners or surviving spouses who have been receiving U.S. Social Security prior to 1996 and have continuously been resident in Canada since that time, a further deduction of 35% will be available, bringing the taxable amount to a maximum of 50%.

Similar rules would affect residents of the United States receiving OAS and CPP benefits, i.e. they will not be subject to Canadian withholding and will only be taxable in the United States as though these were benefits under the U.S. Social Security Act (i.e. only a maximum of 85% will be taxable). U.S. citizens who are residents in Canada may be taxed on benefits under the U.S. Social Security Act in both countries. They can claim a foreign tax credit in order to eliminate the double taxation.

Canadians who are members of foreign pension plans should be aware that these plans are not registered plans for Canadian purposes. Contributions to these plans made while a Canadian resident are not deductible on the Canadian tax return. Payments received from these plans may not be eligible for transfer to Canadian registered plans. Employer contributions to these plans while the employee is a Canadian resident may result in a pension adjustment, and reduction in the employee's RRSP room. These potential issues should be discussed with a tax advisor.

Old Age Security (OAS) "Clawback"

Many Canadian taxpayers are now familiar with what's been commonly referred to as the Old Age Security "Clawback". Under this system, taxpayers over certain income levels have ended up repaying all or some of their OAS receipts.

Taxpayers with net income in excess of \$67,668 will have to "pay back" a portion, if not all, of their OAS payments. The amount that is required to be repaid cannot exceed 15% of the individual's income in excess of \$67,668. Full clawback of OAS benefits occurs when income reaches \$109,764. As a concession, the amount paid back will be deductible in computing income so that a taxpayer will not be double-taxed, since these items are already included in income.

In an effort to help government cash flow, the tax on the OAS payments is now deducted from the monthly OAS cheque. The amount withheld depends on the individual's income in the previous two years. As a result of this, many high-income individuals stopped receiving OAS. The amount of OAS withheld will be credited against taxes payable on the tax return.

The calculation of the clawback is done for each individual separately. Spouses' incomes are not combined. Therefore, this measure provides additional impetus for married couples to split their income so that each spouse is below the \$67,668 limit.

Accordingly, the use of spousal RRSPs, using the new pension splitting rules and other means of income splitting should be considered to help equalize future income, where appropriate.

The following example illustrates how the clawback works:

| | |
|---|--------|
| | \$ |
| Taxpayer's net income | 80,000 |
| Old Age Security | 6,300 |
| Clawback: $(\$80,000 - \$67,668) \times 15\% =$ | 1,850 |

The \$1,850 would be added to the taxpayer's tax liability. However, this taxpayer would only be taxed on \$4,450 (\$6,300 - \$1,850) of old age security on his return. If tax was withheld from this individual's OAS payments, it will be credited against the \$1,850 liability.

Many taxpayers utilizing the enhanced capital gains exemption may find that the clawback is a one-time cost of using the exemption.

Income Splitting

All seniors receiving eligible pension income are permitted to income split with their spouses and common law partners. Eligible pension refers to pension income that is eligible for the pension deduction (see Deductions and Credits section for a detailed list of such pension income). It does not include Old Age Security or Canada Pension Plan payments.

A pensioner may allocate to his or her spouse or common-law partner up to one-half of any eligible pension income received during the year. The amount will be deducted in the transferor's return, and included in the income of the transferee. Because the decision to split the pension income affects the calculation of income and tax payable for both spouses, they must both agree to the allocation. The pensioner and the spouse have to make a joint election on a prescribed form T1032 to be filed with their income tax returns. If taxes were withheld at source from the pension income, each spouse will claim a portion of the tax paid in the same proportion as the pension income allocation. The decision to income split, and the amount of income to be allocated to the other spouse is made annually.

The transferee spouse need not be of pensionable age. However, in order to claim the pension tax credit, the allocated pension income must qualify as eligible pension to the transferee spouse. In the case of payments from a RRIF or a RRSP, that will generally require the transferee spouse to be 65 or older.

The pension income splitting will not affect benefits and tax credits that are calculated based on family income, such as the GST/HST credit. However, it will affect any tax credits that are calculated using an individual's net income. These include the age amount, the spouse tax credit, and the Old Age Security claw-back referred to previously. The decision to split pension

income may affect each partner's instalment base for the year as well. Therefore, the decision to income split should be made after taking these factors into consideration.

CPP Pension Sharing

As noted in the Income Splitting section, spouses may apply to share the portion of their CPP benefits earned during their time together. This option is particularly beneficial if the spouse receiving the CPP benefits had significant other income while the other spouse had little or no income.

DEDUCTIONS, CREDITS AND RELATED MATTERS

In this section, we will pull together some of the items that enter into the calculation of an individual's tax liability. We'll briefly describe the various steps involved in calculating taxes payable and in the process examine a number of traditional deductions and credits that form an integral part of our tax system. While modifications are made each year to the deductions and credits that make up this system, the underlying structure has remained unchanged.

Before we start, it is important to understand the difference between a tax deduction and a tax credit. A deduction reduces taxable income. Taxable income is the base on which the graduated tax rates are applied to determine an individual's tax liability. Accordingly, the benefit from a deduction is dependent on the taxpayer's marginal tax rate. Individuals with higher incomes subject to tax at higher rates obtain greater tax savings from such deductions. A deduction claimed by a high rate taxpayer is worth approximately 46%. Tax credits, on the other hand, are a deduction against taxes payable and thus generally provide the same reduction of tax for all taxpayers irrespective of their income level. The federal tax credit rate is 15%. After factoring in provincial tax and surtaxes, the combined Federal/Ontario credit is worth approximately 23% to high rate taxpayers. As a result of the operation of provincial surtaxes, credits are worth slightly more to high-income individuals. *Therefore where an option exists, the higher income spouse should claim deductions and credits.*

All of the credits discussed in this section are non-refundable in the event they exceed taxes payable. In our HST section, we describe some credits which are payable in cash to lower income individuals and rebates that are refundable in cash when they exceed taxes payable. In addition, Ontario and some other provinces provide certain credits that are also refundable in cash to lower income individuals. Some of the deductions/credits require that certain payments be made prior to the end of the year in order to be claimed on that year's tax return. Taxpayers should be aware of these rules to ensure they take full advantage of all available deductions/credits.

How Tax is Computed

This is where all the parts come together. The computation of tax is the culmination of a variety of different items, many of which are discussed in this publication.

So, where do we begin? First, income from various sources, such as income from employment, business, pensions, interest, taxable dividends and taxable capital gains, are added to obtain total income. From total income, various deductions, such as RRSP deductions (discussed in the Tax Deferral Plans section) and others noted in this section, are subtracted, to arrive at net income. Net income is an important number for a variety of reasons, including the determination of whether certain related individuals can be claimed as dependants. After this, certain other deductions are permitted, such as loss carryforwards and the capital gains exemption, to derive taxable income—the base for the computation of tax.

Federal tax is computed by applying the marginal tax rates indicated in Schedule 1 (under the interest column) on page 22 to taxable income. There are four federal tax brackets (15%, 22%, 26% and 29%). Then non-refundable tax credits and certain other credits such as the dividend tax credit are subtracted from this number to arrive at basic federal tax.

An individual will also have to pay provincial tax in the province in which he/she is a resident on the last day of the year. Similar factors used in the determination of whether an individual is a resident of Canada (see Taxation of Non-Residents) will be used to determine the province of residence. In addition, if a person carries on business in more than one province, he/she will need to allocate the business income to the various provinces, and pay tax to the various provinces on his/her share of that income.

The Ontario marginal tax rates (5.05%, 9.15% and 11.16%) will be applied to Ontario taxable income. The Ontario tax brackets and the amounts on which non-refundable credits are based are different than those for federal tax purposes due to the application of a different indexing factor.

Ontario also applies a two-tier level of surtaxes - a basic 20% surtax plus an additional 36% slapped on for “high” income individuals. The basic surtax will apply when taxable income is approximately \$66,500. The 56% surtax impacts those individuals earning approximately \$78,000. These surtaxes bring the effective highest Ontario tax rate to be approximately 17.4%, or approximately 60% of the highest federal tax bracket. Ontario residents are also subject to the Ontario Health Tax Premium of up to \$900.

All provinces have switched to a tax on taxable income system. Alberta is the only province, which applies a flat 10% on all income. The highest marginal tax rates (including surtaxes) in the other provinces range from 12.7% to 24% of taxable income. Quebec, not surprisingly, is the only province that requires its residents to file separate provincial tax returns.

Sometimes the alternative minimum tax (AMT) may come into play. Please refer to that section for more information.

Also, self-employed individuals must include CPP on self employed earnings in their total tax liability.

From this total tax (federal plus provincial plus surtaxes), instalments, tax withheld at source and refundable credits (such as the GST/HST rebate) are subtracted to determine the final refund or payment. Determining your refund from the CRA can often be a lot of fun. Of course, if the reverse is true, the game is not nearly as enjoyable.

So that’s how it works. The balance of this section takes a closer look at the more common deductions and credits in the system.

Deductions

Interest Expense

All taxpayers should make every effort to arrange their affairs to ensure that any interest expense is deductible for income tax purposes. *Borrowed funds should be used for business or investment purposes and not for personal expenditures. In the same vein, debts on which interest is non-deductible should be repaid prior to repaying deductible interest bearing debts.* Sometimes this will necessitate careful planning or perhaps rearrangement of one’s affairs to achieve the desired result.

Interest on loans incurred to make investments or to earn business income is generally deductible. As a result of a number of court cases, the CRA will now accept that interest may be deductible even if income earning is an ancillary (and not the primary) purpose of the loan. In other words, interest may be deductible even if the investment has a fixed interest or dividend rate which is less than the interest rate on the loan, as long as there is an income earning purpose. However, the CRA continues to find certain transactions that convert non-deductible interest into deductible interest to be offensive, and has had some success in challenging these in the courts. The government’s attempt to legislate a “reasonable expectation of profit” test appears to have failed and is not likely to be reintroduced.

Interest incurred on loans without an income earning purpose is not deductible. Examples of non-deductible interest include interest on loans to acquire a home or other personal assets, or used to pay income taxes. Also, interest on funds borrowed to contribute to a RRSP or a TFSA is not tax-deductible.

While the deduction of interest in excess of investment income is generally not precluded, any cumulative net investment losses (CNIL), as described in the discussion concerning capital gains or losses will reduce the extent to which an individual could utilize the capital gains exemption for dispositions of Small Business Corporation shares. Accordingly, *where possible, taxpayers should borrow for business purposes and use available cash to purchase investments.*

If the investment that was acquired with borrowed funds is sold and there are not sufficient funds to repay the loan, the continuing interest expense may continue to be deductible under certain circumstances. Also, if the proceeds of the sale are used to acquire other investments, the interest on the original loan may be deductible against the income from the new investment.

Appropriate records should be maintained to trace borrowed funds to the asset acquired.

Interest expense may be deducted on either the cash basis (when paid) or the accrual basis (when incurred) depending on the method normally followed by the taxpayer. The benefit to be obtained from a particular method depends on the taxpayer's circumstances.

Spousal and Child Support

On a marriage breakdown, one spouse often agrees to pay support to the other spouse for the maintenance of that other spouse and their children. Whether the payments are deductible to the spouse making the payments (and taxable to the recipient spouse) will often make a difference in the determination of the appropriate amounts. Although the individuals may not necessarily care whether payments are classified as spousal or child support, it is important to distinguish between the two, as the tax consequences are different. If an agreement or order does not specifically identify an amount paid or payable as spousal support, it is assumed to be in respect of child support. The rules are very specific with respect to the circumstances under which a payment is tax deductible/taxable, and it is not sufficient to simply agree between the spouses as to the tax consequences. Therefore, *it is important when structuring separation agreements or divorce settlements to consider the tax implications for both parties so as to avoid any unintended result.* Don't break up (your marriage) without your tax advisor by your side.

Spousal support payments (including payments to a common law partner, as discussed below) are generally taxable to the recipient and deductible by the payor, if two important criteria are met. Firstly, the payments must be made to, or received from, a spouse or former spouse pursuant to a court order or written agreement. Secondly, the payments must be of a periodic nature, as opposed to a lump sum payment. This, therefore, excludes transfers of property as a part of the settlement of marriage rights. The spouses must be living apart at the time of payment and throughout the remainder of the year.

Payments made as a result of a separation, but prior to a court order or written agreement are usually deductible if they are made in the same or in the preceding year that the agreement/order is in place. The agreement/order must specify that the payments are to be taxable to the recipient and deductible by the payor under the relevant provisions of the Income Tax Act.

In addition, certain amounts paid in respect of an "expense" can also be treated as alimony or maintenance payments. Amounts paid to third parties for items such as mortgage payments, medical

bills or tuition fees will be deductible and taxable as spousal support, if so stipulated in the court order or agreement.

The conditions noted above are very precise and must be met to ensure deductibility. Accordingly, caution should be exercised in determining the appropriate treatment for these items.

Common law partners of the same sex have had the same rights and obligations as married persons and common law partners of the opposite sex since 2001. Payments made under an order or agreement made prior to 2001 will neither be taxable to the recipient, nor deductible to the payor, unless the parties jointly elect to have the post 2000 rules apply to them.

Payments made for the maintenance of children under agreements made or varied after April 30, 1997 will not be taxable to the recipient. Correspondingly, the payor will not get a deduction for such payments. Child support payments made under agreements entered into prior to May 1, 1997 will continue to be deductible/taxable, but will lose this treatment if the agreement is altered or the separated parties both agree to abide by the rules in the new system by filing a form with the CRA.

Divorced and separated couples will likely pay more in combined taxes under this system since the payor is usually in a higher tax bracket than the recipient. Therefore, *it is important to consider these rules before making changes to an agreement in place before May 1, 1997.*

Child Care Expenses

A taxpayer is allowed to claim the cost of caring for children if the expenses have been incurred to enable the parent to earn income from employment or self-employment, or to allow the parent to attend school full-time or part-time. In order to qualify as "part-time", the program must last at least three consecutive weeks and involve twelve hours per month or more of course work.

Expenses can be claimed for the children of either spouse and for any other child that is dependent on the individual for support (as long as their 2011 income is less than \$10,527).

There are many rules regarding the type of expenses that may be claimed and there are limitations as to the amount of the claim. Expenses include the cost of babysitting, day care and camps. Payments to a boarding school or overnight camp are limited to \$175 per week for children under 7, \$100 per week for children of ages 7 to 16 and \$250 per week for disabled children. Day camps are not subject to the above restrictions. Payments made to relatives under the age of 18 or to the parent of the child are not deductible. Medical expenses, clothing, transportation, tuition and board and lodging costs are not eligible for this deduction.

The maximum deduction limit is \$7,000 for a child who is under the age of 7 at the end of the year, and \$10,000 for a child who is severely disabled (i.e. eligible for the disability tax credit).

The limit is \$4,000 for children from age 7 to 16 and for less severely disabled children of any age (i.e. infirm but not eligible for the disability tax credit). There is no overall family limitation. The amount allowable for one child may be spent on care for another child. Assume there are two children in a family, aged 3 and 7. The maximum deduction limit would be \$11,000 (\$7,000 for the 3 year old, and \$4,000 for the 7 year old). If the family spent \$11,000 on day care for the 3 year old, and no amount was spent on care for the 7 year old, the entire \$11,000 would nevertheless be deductible.

Some other restrictions exist when claiming this deduction. For example, the deduction is limited to two-thirds of the parent's income from employment or self-employment. Also, the parent with the lower income generally must claim this deduction (see exceptions below), sometimes resulting in virtually no tax benefit.

Single parents who are full-time students can deduct childcare expenses against all types of income, not just income from employment or self-employment. The maximum weekly deduction is \$175 for each child under 7, \$100 for children aged 7 to 16 and \$250 for disabled children, for each week of full time attendance at school, subject to a limitation of 2/3 of the parent's income from all sources. The higher income parent in a two-parent family may also claim the deduction as long as both parents are full time students.

A reduced childcare expense deduction is available to part-time students. For part-time students, the childcare expense claim is limited to \$175 per month for each child under 7, \$100 per month for each child aged 7 to 16 and \$250 per month for disabled children. In two-parent families, the higher income spouse may claim the childcare expense as a deduction, as long as both parents are either full time or part time students.

Separated parents sharing custody of a child can each claim childcare expenses relating to the period during which the child resided with that parent. Childcare expenses paid in respect of periods when the child resided with the other parent would not be deductible to the paying parent.

Childcare expenses remain one of the deductions that do not have to be substantiated by the filing of receipts with a personal tax return. However, it remains a favourite target of the CRA, especially in cases of tax returns that have been electronically filed. Receipts should, therefore, be kept to support the deduction in the event the taxpayer is audited. It is also prudent, when the caregiver is an individual, to verify the Social Insurance Number given. To deduct childcare costs in 2011, the expense must be paid in 2011 and must pertain to service for 2011. Therefore, prepaying in December does not provide a deduction a year earlier.

The CRA does not consider certain sports programs that have a significant educational or training component, particularly for older children, to qualify as childcare. The costs of these programs, if denied as childcare, may qualify for the Children's Fitness Tax Credit (see comments below).

Universal Child Care Benefit ("UCCB")

The UCCB is a benefit intended to subsidize childcare costs, although there is no requirement that families receiving the benefit actually incur any such costs. The benefit is a cash payment of \$100 per month per child under 6. If the family already receives the Canada Child Tax Benefit (see comments in that section) or received the UCCB payments in the prior year, the payments will be sent automatically. Otherwise, the family will need to complete the Canada Child Tax Benefit application form RC66 to apply for the benefit.

The amount received is taxable in the hands of the lower income spouse. Receipt of the UCCB does not have any impact on any income based tax credits.

A single parent has the option of including the UCCB in the income of the child. If the parent claims the child as an "eligible dependant", the UCCB may be included in the income of the child. If no "eligible dependant" amount has been claimed, the income may be included in the return of any child who is a qualified dependant under the UCCB Act.

Parents who share custody of a qualified dependant may split the benefit and each receive \$50 each month.

Moving Expenses

The cost of moving can often be substantial. In certain circumstances, a Canadian taxpayer will obtain some relief from these costs by deducting them in computing income.

In situations where a taxpayer starts a new job or a new business in Canada, and as a result moves to a home which is 40 kilometres closer to the new work location than the former home, certain moving expenses are deductible. Expenses incurred in moving from another country to Canada or from Canada to another country are generally not deductible for Canadian tax purposes. Deductible expenses include:

- cost of moving household items, including storage;
- reasonable travelling costs (including meals and lodging) in the course of the actual move;
- cost of meals and temporary lodging for up to 15 days;
- selling costs pertaining to the old house, such as legal fees and real estate commissions;
- where the former home is sold, the legal fees, land transfer tax and other tax, fee or duty (excluding GST/HST) relating to the purchase of the new home;
- mortgage interest, property taxes, insurance premiums and utilities at the vacant former residence to a maximum of the lesser of the actual costs and \$5,000, if the former home is being sold;
- lease cancellation costs, and
- costs of revising or replacing legal documents, driving license, vehicle permits, connecting and disconnecting utilities.

Any expenses reimbursed by an employer are obviously not deductible and, unless the reimbursement is in respect of certain expenses or the loss on the sale of the employee's former or new home, it would not be taxable to the employee.

The expenses may be deducted to the extent of income from the new business or employment and may be deducted in the year of the move or the subsequent year.

In addition, if a taxpayer moved to go to school in Canada or elsewhere, he may be able to claim a deduction for moving expenses against any taxable scholarships or grants.

In lieu of keeping track of actual vehicle and other expenses incurred during the move, a taxpayer has the option to claim a deduction based on a fixed per kilometre rate on the distance travelled. For a move, which originated in Ontario, the 2010 rate was 55 cents per kilometre. In addition, a person can claim \$17 per meal, for a maximum of \$51 per day for meal costs incurred during the move. The 2011 rate will be released early in 2012.

Disability Supports

A severely disabled person may deduct necessary costs to enable the person to attend school or to work. The maximum deduction is the person's income from employment or business, or if attending school, the lesser of \$15,000 and \$375 for each week during which the taxpayer attends school.

The expenses which can be claimed as a deduction include items such as sign language interpretation services, electronic voice synthesizers, note taking services, talking textbooks, reading services, deaf-blind intervening services, and the cost of a device or software that is designed to enable the person to read print. Assistance payments received will reduce the amount of eligible expenses. Expenses claimed under the disability supports deduction cannot also be claimed under the medical expense tax credit. In some cases, it may be more beneficial to claim these costs as a medical expense. The need for the item/service must be certified by a qualified medical practitioner.

Lump Sum Payments

Due to bureaucratic red tape, or the lengthiness of the judicial process, a person may receive a lump sum payment in a year, a portion of which relates to prior years. Examples include alimony, wage loss replacement payments, and pension benefits. If the entire payment is included in income in the year it is received, the tax payable on it may be higher than it would have been if the payment had been received and taxed over the prior years to which it relates.

The recipient may deduct from income, the amount (excluding interest component) received, which related to a prior year, as long as the deduction is \$3,000 or more. This amount is then taxed under a special formula, which takes into consideration the person's tax bracket in the year the payment related to, and a

notional interest amount. The taxpayer may request that the CRA determine if this special calculation is advantageous to him/her.

Pension Income Deduction

Pensioners are able to allocate up to 50% of their pension income to their spouses. Eligible pension income is any pension payments that qualify for the existing pension tax credit (see the Pension Income section for additional comments on the deduction).

The amount allocated will be deducted from the income of the transferor spouse, and included in income of the transferee. Both spouses must agree to the allocation in their tax returns for the year in question in a joint election on a prescribed form. The allocation must be made each year that the spouses wish to have the rules apply.

Miscellaneous Deductions

There are additional expenditures and deductions, which are available in arriving at taxable income. These include, but are not limited to, union or professional dues, investment counsel fees and certain legal fees. With respect to the latter, fees paid in connection with objections/appeals over tax matters, to collect unpaid wages, or to obtain a retiring allowance are some of the legal fees that are deductible. The legal fees relating to a retiring allowance must be deducted against such income in that year. If the income is deferred, the legal costs can be carried forward for up to seven years and claimed against this income in those later years. Accordingly, this rule should be factored into the determination of whether the eligible retiring allowance is transferred to an RRSP. The CRA will also allow the deduction of legal costs incurred to obtain an order for child support or to enforce existing rights to support.

In addition, certain carrying charges related to investments including safety deposit box charges can be deducted. These expenses must be paid in the year in order to be deductible in the same year. It is important to be aware of all available deductions and to consider the most appropriate timing of any deductible outlay.

Non-refundable Tax Credits

Personal tax credits are generally fully indexed. However, they remain, except where noted, non-refundable, i.e. if the credits exceed the amount of federal or provincial income tax otherwise payable, the excess will not be refunded. The federal tax credit is, unless indicated otherwise, calculated using the lowest tax rate, which is 15% in 2011. Please refer to Schedule 3 on page 33 for further details.

Ontario personal tax credits are also fully indexed. The Ontario personal tax credit is calculated using the lowest Ontario tax rate, which is 5.05% in 2011. Except where Ontario rules differ from the federal rules in respect to how the credits are to be

determined, the following comments will only refer to the federal amounts.

Pension Credit

The pension credit is a federal tax credit of 15% of the maximum eligible pension income of \$2,000, up to a maximum credit of \$300. As noted, this credit is non-refundable if it exceeds taxes otherwise payable. The \$2,000 amount is not subject to indexation. The amount eligible for the pension credit is indexed for Ontario purposes. Ontario will allow a pension credit on \$1,259 in 2011.

The definition of eligible pension income is dependent on several factors as outlined below.

If an individual is 65 years of age or older, qualifying pension income includes most periodic pension payments as well as annuity payments from a RRSP or DPSP and payments out of a RRIF. If under age 65, this credit is available only for payments from a superannuation or pension fund. The other amounts noted above will also qualify if a taxpayer under the age of 65 receives the amount as a consequence of his or her spouse's death. Lump sum payments from these types of plans do not qualify for this credit. In addition, qualifying pension income does not include benefits from the CPP or Old Age Security.

Taxpayers who turn 65 may wish to annuitize part of their RRSP before they are required to do so at age 71 in order to generate \$2,000 of pension income each year. Because the tax credit is

computed at the lowest marginal tax rate, higher-rate taxpayers will end up paying some income tax on the \$2,000 of pension income that is generated. The pre-payment of tax, however, is offset by the tax benefit of utilizing the \$300 federal credit.

If spouses share the pension income as permitted under the new rules, each spouse will be able to claim the pension tax credit, provided the income would otherwise be eligible pension income to the transferee spouse. For example, if the recipient spouse is under 65, but the transferor spouse is over 65, any RRIF or RRSP annuity payments would be eligible pension income to the transferor spouse, but not to the transferee spouse. As a result, only the transferor spouse would be entitled to claim the pension tax credit.

Medical Expenses

Individuals are entitled to a federal tax credit equivalent to 15% of their allowable medical expenses, over a stipulated threshold. The amount of allowable medical expenses will be reduced by the lesser of \$2,052 and 3% of net income, before application of the 15% credit. This limitation will allow certain high-rate taxpayers with large medical expenses (i.e. in excess of \$2,052) to take advantage of the credit.

Medical expenses for which reimbursements are received through a private health care plan or otherwise are not deductible. However, not all plans reimburse 100% of expenses, and the amount that is not reimbursed can be claimed as a medical expense.

| SCHEDULE 3 2011 TAX CREDITS Personal Tax Credits | | |
|---|---------------------------|---|
| | Federal Tax Credit | Combined Federal/Ontario Credit ¹ |
| Basic | 1,579 | 2,009 |
| Married | 1,579 ² | 1,969 |
| Equivalent-to-married | 1,579 ³ | 1,969 |
| Minor Child | 320 | 320 ⁴ |
| Infirm dependants over 18 | 642 ⁵ | 902 |
| Caregiver | 642 ⁶ | 902 |
| Age 65 and over | 981 ⁷ | 1,205 |
| Disability | 1,101 | 1,473 |

¹Calculated using the appropriate federal and Ontario tax rates, excluding surtaxes.
²Credit is reduced by 15% of net income
³Credit is reduced by 15% of net income
⁴Ontario does not allow a child tax credit.
⁵Credit is reduced by 15% of net income in excess of \$6,076.
⁶Credit is given to an individual who provides home care for an adult relative. No credit is available if the relative's income exceeds \$18,906.
⁷Credit is reduced by 15% of net income in excess of \$32,961.

The claim for medical expenses must be supported by receipts. The items that qualify as medical expenses are extensive and include fees paid to doctors and dentists, prescriptions and premiums for private health plans, institutional care (i.e. nursing home), prescription eye glasses and various medical devices. It is important to remember that self-employed individuals can deduct, as a business expense, the premiums paid for private health plans, subject to certain restrictions. This alternative provides greater tax savings for individuals with higher incomes.

For expenses incurred after March 4, 2010, cosmetic procedures will no longer qualify as medical expenses, unless they are necessary for medical or reconstructive purposes.

Medical expenses may be claimed for any 12-month period ending in the calendar year. As a result of this 12-month rule and the applicable threshold requirement, *there may be an opportunity to plan the timing of medical payments to maximize the ultimate claim.* A taxpayer should consider prepaying January expenses in December to get the credit one year earlier.

Medical expenses can be claimed for the taxpayer, his/her spouse and the taxpayer's other dependants. Other dependants include children, grandchildren, parents, grandparents, brothers, sisters, uncles, aunts, nieces and nephews, as long as they are dependent on the individual claiming the expenses for support. Other than children or grandchildren, all other dependants must reside in Canada.

Parents may claim medical expenses of their minor children without regard to the children's income. A person may claim other dependants' medical expenses, which exceed the lesser of 3% of the dependant's net income and \$2,052. The maximum eligible amount, which may be claimed in respect of each dependant was previously \$10,000. The \$10,000 limitation has been removed for 2011.

A decision as to which spouse should claim the medical expenses will depend upon the income level of each spouse. Because of the threshold limitation, all of a family's medical expenses should be claimed on one person's return. In some circumstances, it will be beneficial for the lower-income spouse to claim the expenses to maximize the amount of the credit.

A refundable medical tax credit can also be claimed by lower income taxpayers. In order to be eligible for this credit, the individual must not be eligible for the Child Tax Benefit and must have earned income of at least \$3,179. This amount of the claim is limited to the lesser of \$1,089 and 25% of allowable medical expenses (including expenses claimed under the disability supports deduction), and is reduced by 5% of the amount of income in excess of \$24,108. The maximum amount of the credit is subject to indexation. The claim of this refundable credit is in addition to the regular medical expense claim.

Charitable Donations

A two-tier federal tax credit has been established for charitable donations. A 15% federal tax credit will be provided for the first \$200 of donations. The balance of donations in excess of this limit will be eligible for a 29% credit. Ontario will allow a tax credit at 5.05% on donations up to \$200, and 11.16% on donations over \$200.

Since the 29% and 11.16% credit for donations in excess of \$200 is equivalent to the top federal and Ontario tax rates, the tax savings are comparable to a deduction for a top rate taxpayer. For lower bracket taxpayers, this credit is worth more than a deduction.

Rules were introduced (but not yet legislated) in late 2002 to eliminate some of the donation schemes being peddled in the marketplace. If an "advantage" other than the donation tax credit is made available to the donor, the value of the advantage may reduce the amount of the donation, which is eligible for the credit. An advantage may be any property, service or benefit the donor may receive either immediately or in the future. The full amount of the gift may still be eligible for the credit if the advantage does not exceed 80% of the fair market value of the gift. The donor will be required to apply to the government for a determination that the transfer was made with the intention to make a gift, and not merely to obtain a tax benefit. The charity is required to report on the receipts, the eligible amount of the gift received.

Additional rules were introduced to further attack certain "buy low", "donate-high" arrangements. The value of a donation is limited to the donor's cost, if the property is acquired in a gifting arrangement, or if the property is donated within three years of acquisition.

In order to obtain the credit in the 2011 taxation year, charitable donations must be made on or before December 31, 2011. The amount of charitable donations (including gifts to the government and related institutions) that may be claimed is limited to 75% of net income (see comments below re exceptions to the 75% limitation). Any donations that are unused or are in excess of the 75% maximum may be carried forward for five years, subject to the same limitation.

Donations to U.S. charities are eligible, but only to the extent of 75% of income from the U.S. Donations to a prescribed list of foreign universities are subject to the same rules as regular Canadian donations. Donations to non-U.S. foreign charities are generally not eligible for the credit.

The charitable donations limit is increased by 25% of the taxable capital gain that results from the donation of capital property. For gifts of capital property, an election can be filed to use a lower amount than the fair market value as proceeds of the donated property. If a lower amount is chosen, both the capital gain reported and the value of the donation will be lower. Any amount between cost and fair market value may be chosen,

however, it may not be less than the amount of any “advantage” (as described previously) that may be received. If the property is also a depreciable property, it is proposed that the donor can choose to value the donation at undepreciated capital cost, in order to reduce the amount of recapture that may result. In order to encourage donations of securities listed on prescribed stock exchanges, and ecologically sensitive land, the capital gains inclusion rate on such gifts is reduced to zero. *As a result of this rule, individuals should consider making donations of securities in lieu of cash to obtain more favourable tax savings.*

The donations of flow-through shares have proliferated in the last few years due to the exceedingly favourable tax treatment. Investors of these shares can deduct the cost of their investment in these shares in the form of renounced exploration or development expenses. Often, the investors are also able to claim federal and provincial mineral exploration tax credits on these expenses. If the shares are donated, the investors will also be entitled to claim a donation tax credit in respect of the value of the shares. The relief from capital gains tax on the entire value (the shares have a deemed cost of nil) can result in a virtual double deduction.

For flow-through share arrangements after March 22, 2011, the exemption from the capital gains tax will only be available to the extent it exceeds the original cost of the shares.

The following is an illustration of the tax implications of a donation of publicly listed shares other than flow-through shares.

Mr. Bachelor owns 100 shares of Bachelor Public Company with a fair market value of \$100,000 and a cost of \$40,000. If he sold the shares, and donated the after tax proceeds to a charity, he would realize a capital gain of \$60,000, 50% of which will be taxable. His tax on the capital gain (assuming a tax rate of 46%) would be approximately \$13,800. He would donate his after tax proceeds of \$86,200 to the charity, and receive a tax credit of approximately \$40,000. His net tax savings would be \$26,200 (\$40,000 - \$13,800).

If Mr. Bachelor donated the shares directly to the charity, and elected the proceeds to equal fair market value, he would realize a capital gain of the same \$60,000. However, the taxable capital gain would be zero. The \$100,000 donation would also give him a tax credit of \$46,400. This is a significantly more favourable result than the \$26,200 savings from donating the after-tax proceeds. In each case, Mr. Bachelor has donated shares valued at \$100,000. In some limited circumstances, the result may be more favourable if the donation is made through a corporation.

Donations of publicly traded securities to private foundations may also qualify for tax-free capital gains treatment under certain circumstances. Any capital gains realized on a conversion of exchangeable shares or partnership interests into publicly traded securities may be tax-free as well, provided that

the securities are donated within 30 days after the exchange.

Donations of property such as art, jewellery, household furniture and other personal items, will be subject to the proposed three year ownership rules noted earlier. Keep in mind, however, that this donation may result in a capital gain if the value of the property donated exceeds its cost. Taxpayers will only pay tax on capital gains on dispositions of personal use property to the extent that the sales price exceeds \$1,000. However, if the property donated was purchased after February 27, 2000, as a part of an arrangement in which the property is donated as a charitable gift, the \$1,000 threshold re personal use property will not apply.

Special rules exist for gifts of certified cultural property. In particular, such gifts are not subject to the 75% net income limitation noted above. A capital gain realized on gifts of cultural property will be exempt from tax.

It is also possible to obtain a charitable donation tax credit for gifts of life insurance policies. If a whole or universal life policy is donated to a charity during one’s lifetime, the value of the donation will be the policy’s cash surrender value plus any accumulated dividends or interest on the policy. This donation may result in income since the policy is treated as if it has been “cashed in”. Any future premiums paid by an individual under the policy will also be considered to be a charitable donation. A donation tax credit will be allowed to the deceased if a charity is designated as a beneficiary of a RRSP, RRIF or a life insurance policy.

Receipts must be filed with the tax return to support the donation claim. In the case of an electronically filed return the receipts should be kept handy in case they are required to support the claim at a later date. It is worth noting that, for administrative purposes, the CRA allows a taxpayer to claim donation receipts made out in the name of a spouse. In addition, a spouse can claim the other spouse’s unused donation carryforward amount. Therefore, *donation receipts made out to a husband or wife should be claimed by one spouse to ensure they obtain the favourable tax credit rate on donations over \$200.* In addition, *the donations should usually be claimed by the higher rate taxpayer since the credit is worth more to that individual because of the higher applicable surtaxes.* This approach is advisable as long as that individual has sufficient tax payable to absorb the credit. Since the credit is non-refundable, the sharing of donations may be advisable in certain cases.

Personal Tax Credits

The standard personal tax credits claimed by a taxpayer include the basic credit, the spouse credit and in some cases, the credit for dependent children. These credits are fully indexed.

The basic personal and spouse tax credit is 15% of \$10,527. The spouse amount is reduced by the spouse’s net income for the year.

Perhaps the most important other credit is the eligible dependant credit, which allows a taxpayer who is neither married nor in a common-law relationship (single, separated, etc.) to claim an amount equivalent to the spouse credit for the support of certain related individuals under certain circumstances. Taxpayers with common law partners will not be able to claim the credit for a child. In addition, the eligible dependant credit cannot be claimed if the parent receives support or is required to pay support to a separated or former spouse in respect of the child, even if the child support is not paid, or if paid, not claimed for tax purposes.

Eligible dependants for the purpose of this credit will be restricted to related minor dependants, the taxpayer's parents or grandparents, and any other infirm person related to the taxpayer.

Individuals age 65 or over by the end of the year may be eligible for a federal tax credit of up to 15% of \$6,537, known as the age credit. The available age credit is reduced by a formula that kicks in when the individual's income exceeds \$32,961. The credit is completely lost for individuals whose income exceeds \$76,541.

All of these personal tax credits are non-refundable in the event they exceed an individual's tax payable.

Schedules 3 and 4 on pages 33 and 37 outline the various credits that are available in 2011.

Beginning in 2012, a number of the personal tax credit amounts to be claimed in respect of infirm dependants will be enhanced by \$2,000.

The enhancement will apply to the spouse credit, eligible dependant credit, child credit, caregiver credit and the infirm dependant credit amounts.

The \$2,000 amount will be indexed beginning in 2013.

Child Tax Credit

A parent may claim a credit of 15% of \$2,131 for each child under 18 at the end of the year.

If the parents of the child are separated or divorced, the child tax credit may be claimed in addition to the eligible dependent tax credit. Similar to the eligible dependent tax credit, it cannot be claimed by a parent who is required to pay child support in respect of the child.

Previously, if two or more families share a home, only one individual of one family will be entitled to the child tax credit. Beginning in 2011, this rule will be repealed to allow each family to claim the credit in respect of its children.

Disability Tax Credit

If a taxpayer has a severe and prolonged mental or physical impairment, he/she may be entitled to a disability tax credit. In

order to claim the credit, the disability must cause the taxpayer's daily living activities to be markedly restricted and have lasted or be expected to last for a continuous period of at least 12 months. For these purposes, a basic activity of daily living includes feeding and dressing oneself. The disability tax credit is also available to those individuals who must undergo therapy several times a week, totalling at least 14 hours per week in order to sustain their vital functions.

The disability must be certified by a doctor on a prescribed government form (form T2201) that is filed with the return in the first year it is claimed. If the condition remains unchanged from year to year, the form need not be filed in subsequent years, unless specifically requested by the CRA. This credit may not be claimed if medical expenses for a full time attendant (unless the expenses do not exceed \$10,000) or for care in a nursing home are claimed for the same individual. Therefore, where such costs are incurred, a taxpayer has a choice between claiming such medical expenses or the disability credit.

The federal disability credit is 15% of \$7,341 in 2011.

Parents with infirm adult children are entitled to an infirm dependant credit of up to 15% of \$4,282 for each eligible child. A dependant credit may also be claimed for parents, grandparents, brothers, sisters and other relatives who depend on a taxpayer for support and are infirm. In order to qualify, these dependants must reside in Canada. The dependant credit is reduced if the dependant's income is in excess of \$6,076. If the dependant's income, including pension income, is over \$10,358, no amount can be claimed.

A disabled minor child is entitled to a supplementary disability amount. The amount, which can be claimed, is 15% of \$4,282. The supplement is reduced if the amount of childcare and attendant care expenses claimed in respect of the child exceeds \$2,508.

Unused disability amounts of a dependant may be transferred to the supporting person.

Caregiver Tax Credit

Many taxpayers look after elderly or infirm relatives at home. A tax credit may be claimed for parents or grandparents who are over 65 years old, and reside with the taxpayer. In addition, a taxpayer can also claim a tax credit for looking after a relative (a child, grandchild, sibling, aunt, uncle, niece or nephew) who is over 18 years old, who lives with the taxpayer and who is dependent on the taxpayer because of the relative's mental or physical infirmity. The credit is 15% of \$4,282, and is reduced if the dependant's income exceeds \$14,624. No credit is available if the dependant's income exceeds \$18,906. The caregiver credit cannot be claimed if the amount for infirm dependants age 18 or over is claimed for that individual.

Adoption Expense Credit

Eligible adoption expenses incurred, to a maximum of \$11,128 per adoption, may be claimed in the year an adoption order is issued or recognized by Canada. The maximum 15% federal credit may be divided between the adoptive parents. The credit can only be claimed in the year the adoption is finalized, but costs incurred in previous years can be claimed at that time.

Eligible expenses include adoption agency fees, court costs, reasonable and necessary travel and living expenses, document translation fees, and mandatory fees paid to a foreign institution.

Canada Employment Credit

Employees can claim a credit of 15% of the lesser of their employment income and \$1,065.

First Time Home Buyers' Credit

First time home buyers (using the same criteria as those applying to the Home Buyers' Plan) may claim a non-refundable tax credit of 15% of \$5,000 by purchasing a home. This credit is also available for a home purchased by or for the benefit of a disabled person.

To be eligible for this credit, the purchaser's interest in the home must be registered in accordance with the applicable land registration system.

Working Income Tax Benefit (WITB)

The WITB is a refundable tax credit which is available to low-income individuals who earn employment or business income. There are two components: a basic WITB, and a supplement available for disabled individuals. Both credits will be reduced if the individual's or family's income exceeds certain thresholds. The credits are indexed annually.

Public Transit Passes Credit

A person can claim the cost of eligible public transit passes for the use by the taxpayer, his or her spouse and children who have not reached 19 before the end of the year. Eligible public transit passes are for travel by bus, ferry, subway, train or trams, issued for a period of at least 28 days, and must be for commuter service (i.e. the passenger is reasonably expected to return daily to the place of departure). An eligible public transit pass can also include weekly passes as long as they aggregate at least 20 days in a 28-day period as well as electronic payment cards used by an individual for at least 32 one-way trips in a 31-day period.

Spousal (and Other) Transfers of Unused Credits

All taxpayers should attempt to maximize their use of all of the available tax credits. In certain instances, they can also utilize various credits available to their spouse or other dependants.

While these tax credits are non-refundable, they will remain transferable between certain individuals. *To the extent that the credits are not needed to reduce a transferee spouse's tax*

| <p align="center">SCHEDULE 4 Other 2011 Tax Credits Federal and Ontario Tax Credit</p> | |
|---|--|
| Pension income | 15% of eligible pension income; maximum \$300 unused credit transferable to spouse. Maximum Ontario tax credit is \$64. |
| Tuition fees | 15% credit for post-secondary tuition and ancillary fees; up to \$750 (combined with education credit) transferable to spouse or supporting parent or grandparent. Ontario maximum amount of credit transferable is \$318. |
| Education | \$60 credit per month for each month in full-time attendance and \$18 credit per month for part-time; transferable within \$750 combined limit. Ontario credit is \$25 for full-time and \$7 for part time. |
| Medical Expenses | Credit of 15% for uninsured medical expenses in excess of lesser of 3% of net income and \$2,052 |
| Charitable donations | Credit of 15% for first \$200 per year; 29% credit for remainder of contributions up to 75% of net income. Ontario credit is 5.05%, and 11.16% respectively. |
| CPP/QPP and UI premiums | Credit at 15% (federal) and 5.05% (Ontario). |

payable to nil, the following credits may be transferred to a supporting spouse: age credit, pension credit, disability credit and tuition/education credit. In addition, the latter two credits may be transferred to a supporting parent or grandparent, rather than a spouse. The disability tax credit may also be transferred to a supporting brother, sister, aunt, uncle, niece, nephew, child or grandchild. In each instance, the amount of credit transferable is reduced by the transferor's tax payable before deducting certain tax credits.

Political Contributions

Eligible political contributions are not deductible in arriving at taxable income, but instead generate tax credits, which reduce the actual amount of tax payable. Contributions to federal political parties will generate federal tax credits, while Ontario contributions will produce Ontario tax credits. Donations at a municipal level are not eligible for any deductions or tax credits. Official receipts are necessary to support a claim. The federal tax credit is calculated as the aggregate of:

75% of the first \$400, plus
50% of the next \$350, plus
33-1/3% of the next \$525, for a maximum credit of \$650

There is no credit for contributions above \$1,275.

In addition to contributions to the registered federal party and confirmed candidates in a federal election, contributions to registered electoral district associations qualify for the political credit.

Under proposed rules, the amount of contributions eligible for the political tax credit will also be reduced by the value of any "advantage" received by the donor, or someone related to the donor, for contributions after December 20, 2002.

Because the value of the credit per dollar of contribution drops as the amount of the contribution exceeds the \$400 and \$750 thresholds, *it may be beneficial in certain cases to split the contribution with a spouse or between different calendar years. The contribution must be made before 2012 to be eligible as a credit in 2011.*

Tuition Fees and Scholarships

A student may claim a tax credit for tuition fees paid in respect of courses taken in the year. Certain requirements must be met in order to claim tuition fees. Of particular note, the fees must be in excess of \$100 per institution. Additional charges by the institution to cover such things as lab costs, examination fees, diploma or certificate charges, and the cost of books included in the fees for correspondence courses, are also eligible. Fees paid to professional bodies or provincial ministries for exams required to obtain a professional status or to be licensed or certified will also qualify, beginning in 2011. Other requirements pertain to the duration of the course and the type of educational

institution that was attended. Only post-secondary level programs or job training courses certified by the Minister of Human Resources qualify for the tuition fee credit.

Fees paid to private schools for grade school or high school education are not eligible for the credit except for fees paid for courses that are eligible for credit at a post-secondary school level. However, some religious schools provide a tax receipt for a portion of tuition fees relating to the school's religious instruction, which is eligible as a charitable donation.

If the courses at the grade school or high school level were taken by adults to upgrade their job skills, it may be possible to claim a deduction for the amount of government tuition assistance received which is otherwise taxable. All scholarship amounts received in connection with a student's enrolment in a program eligible for the education tax credit are exempt from income. Scholarships received in connection with enrolment in an elementary or secondary school are also exempt. Scholarships provided directly by the school as free tuition fall within these rules.

Amounts received in respect of programs that consist principally of research, such as post-doctoral fellowships are not eligible for the full exemption, nor will the fees qualify for the education tax credit. Scholarships received for part time studies will only qualify for the exemption to the extent of the amount of the fees eligible for the tuition credit. Scholarships that do not relate to providing support for the period of study will not qualify. Scholarships that do not qualify for the full exemption will only be eligible for a \$500 exemption.

The tuition fee rules are more stringent if the student attends a foreign school. Canadians who commute to attend (either on a part-time or full-time basis) U.S. universities, colleges or other post-secondary institutions may claim the tuition fees paid to the U.S. school. The tax department requires the U.S. school to be within daily commute distance, and the student must in fact commute to the school on a regular basis. Otherwise, a student can claim fees paid to a foreign school only if the school is a university, and the student must be in full-time attendance in a course leading to a degree. Previously, the duration of the course must also be longer than 13 consecutive weeks. Beginning in 2011, the required duration has been reduced to 3 consecutive weeks.

Individuals who pay tuition fees will be eligible for a federal credit of 15% of tuition fees paid. In addition, an education tax credit of \$60 may be claimed for each month of full-time attendance in a qualified program. Part-time students will be eligible for an \$18 per month credit as long as the program is at least 3 weeks long and involves at least 12 hours per month. Students who receive tuition assistance for post-secondary education under certain job training legislation will be able to claim the education tax credit.

Students will also be eligible for a textbook credit in addition to

the education tax credit. The amount will be 15% of \$65 for each month the student qualifies for the full-time education tax credit, and 15% of \$20 for each month the student qualifies for the part-time education tax credit.

The rules allow for the transfer of the combined tuition, education and the textbook credit. *The tuition and education credit can be transferred (to a maximum of \$750 federally) to the extent it exceeds the amount required to reduce the student's tax payable to zero.* This credit may be transferred to the student's spouse (including common law) or a supporting person who is the student's parent or grandparent. The amount that may be transferred is the lesser of \$750 and the actual tuition/education/textbook tax credit, minus the tax payable by the student. The rule recognizes that tuition costs are frequently borne by the student's spouse or parent.

Instead of transferring the credit to a supporting person, any unused portions of the tuition and education credit can be carried forward indefinitely by the student. In this situation, only the student may make a claim for the unused amount carried forward.

A student can also claim a 15% federal non-refundable tax credit for interest paid in the year or any of the five preceding years on student loans made under the Canada Student Loans Act or equivalent provincial programs. While the credit cannot be transferred, it can be carried forward for up to five years.

It is possible to use funds inside a RRSP to fund all or a portion of tuition and other expenses. Please refer to the Tax Deferral Plans section for rules providing for the use of RRSPs to finance education costs.

Foreign Tax Credit

A non-refundable tax credit may be claimed for taxes paid to a foreign government on foreign income. The credit is equal to the lesser of the foreign taxes paid and Canadian tax payable on the foreign income. The foreign tax credit calculation is done on a country-by-country basis.

If foreign tax on investment income exceeds 15%, the difference is generally deductible in computing income. In addition, a provincial foreign tax credit may be claimed to the extent the foreign taxes were not eligible as a credit against federal taxes payable.

Unused foreign tax paid on business income may be carried back three taxation years, and carried forward ten years.

Children's Fitness Tax Credit

Parents may claim a tax credit on a maximum of \$500 per year of eligible fees paid. There is an additional \$500 amount per year allowed for a disabled child, provided at least \$100 has been claimed under the general fitness tax credit. Eligible fees

are for programs that are either at least eight weeks in duration with a minimum of one session per week or, in the case of children's camps, at least five consecutive days. The activities must include a significant amount of physical activity that contributes to cardio-respiratory endurance plus one or more of: muscular strength, muscular endurance, flexibility, or balance. Hockey, soccer, dance and gymnastics are examples of eligible programs. The child must be under 17 for the entire year, or under 19, if the child is disabled. The onus is on the organization providing the program to determine the amount of eligible fees.

Children's Art Tax Credit

A similar tax credit is available for programs of artistic, cultural, recreational or development activities, beginning in 2011. The maximum amount is \$500 per child. A disabled child is entitled to an additional \$500 amount when a minimum of \$100 is paid in eligible expenses. The child must be under 16 at the beginning of the year, or under 18, if the child is disabled.

The rules, other than the definition of eligible activities, concerning the parameters of an eligible program are similar to those that apply to the fitness tax credit.

Ontario Children's Activity Tax Credit

The Ontario government has a tax credit that combines both the federal fitness and arts tax credits, except the Ontario version is refundable. The credit is 10% on up to \$509 of qualifying expenditures. The credit will be \$100 for a disabled child under 18. The amount eligible for the credit is indexed annually.

Ontario Health Premium

The Ontario government levies a health premium, payable by all individuals who are residents in Ontario on December 31. The premium is withheld from employees' wages as part of their regular source deductions withholdings. Self employed and other individuals who remit their taxes through instalments are required to add the health premium to their regular instalments.

No health premium is payable if taxable income is under \$20,000. The health premium payable thereafter is calculated as follows:

| Taxable Income (TI) | |
|------------------------|----------------------------------|
| \$20,001 to \$25,000 | 6% of TI over \$20,000 |
| \$25,001 to \$36,000 | \$300 |
| \$36,001 to \$38,500 | \$300 + 6% of TI over \$36,000 |
| \$38,501 to \$48,000 | \$450 |
| \$48,001 to \$48,600 | \$450 + 25% of TI over \$48,000 |
| \$48,601 to \$72,000 | \$600 |
| \$72,001 to \$72,600 | \$600 + 25% of TI over \$72,000 |
| \$72,601 to \$200,000 | \$750 |
| \$200,001 to \$200,600 | \$750 + 25% of TI over \$200,000 |
| Over \$200,600 | \$900 |

Child Tax Benefit

The “Child Tax Benefit” system includes three components: the basic benefit, the supplementary benefit and a Child Disability Benefit. The Child Tax Benefit is paid monthly, generally payable to the mother. Each July, benefit payments will be changed to reflect the previous year’s tax information. Eligible families will receive a payment for each child until the child turns 18 or is no longer in their care. All three components are based on each family’s net income in the previous year, and the benefit may be reduced or eliminated once family income exceeds certain thresholds.

Unlike the UCCB, these payments are not taxable. However, if the previous year’s returns are reassessed and family net income is adjusted, the Child Tax Benefit basic, supplement and disability entitlements may be revised. Any resulting overpayment must be repaid. Beginning July 2011, the Child Tax Benefit may be split between separated or divorced spouses when custody of a child is shared.

SELF-EMPLOYED INDIVIDUALS

There is the perception on some fronts that being self-employed is the ultimate accomplishment. Just think about it; being your own boss; setting your own hours; having your independence; more time for family activities. It seems too good to be true. It is! Unfortunately, life is not necessarily all it’s cracked up to be on the self-employed front. With the requirements associated with HST and other assorted compliance matters, today’s owner/manger is overburdened with paperwork. In addition, a self-employed individual is not protected under the laws designed to protect the rights of employees in the work place, is not provided with employment benefits (such as vacation pay, sick leave, and health plans) and cannot collect employment insurance (“EI”) in the event the business fails. Sometimes the grass is not greener on the other side.

In this section, we will examine some of the tax aspects of self-employment (i.e. carrying on an unincorporated business). Please note that HST section covers some of the relevant HST issues that affect self-employed individuals.

Self-employed individuals generally have a greater ability to take advantage of tax planning opportunities than do employees. If an individual is self-employed, he can deduct any reasonable expenses incurred to earn business income. Employees, on the other hand, are restricted to a limited list of deductible expenses. Therefore, where possible, one should *consider whether it is prudent to provide services as an independent contractor, rather than as an employee*. It is advisable that both parties to the arrangement have a full understanding of the benefits and limitations of the relationship, so that there are no surprises.

While there may still be distinct tax advantages to being self

employed, it is essential to ensure that the facts support this position. The distinction between whether an individual is employed or self-employed is not always clear-cut, especially in cases where services are provided primarily to one organization. There is ample case law examining the issue of whether an individual is self-employed or an employee. The issue usually centres on the degree of control the individual has in carrying out his or her day-to-day activities. Other factors include whether the individual provides his/her own tools, whether he/she is entitled to various employee benefits and whether the opportunity for profit or risk of loss depends on the individual’s activities. Just because the contract says the relationship is that of an independent contractor doesn’t mean the government will agree. The facts must support that position.

Fiscal Year-End

Since 1995, all unincorporated businesses, whether a proprietorship or a partnership, that have any individuals as members, must adopt a December 31 year-end. Those in business in 1995 had the option of retaining their existing year-end or converting to a December 31st year-end. Most chose the December 31st option. Not everyone did. Those that didn’t must report their income based on a prescribed formula under the “alternative method”.

The following example illustrates how income is reported under the “alternative method”. Assume that Mr. Boss has a January 31, 2011 year-end. He would include in his 2011 income, the income for the fiscal period ending on January 31, 2011 (which includes the 2010 stub period, referred to below). He would include an additional 11/12 of the January 31, 2011 income in his 2011 income. Because he would have already included an estimated amount, (calculated as 11/12 of the January 31, 2010 income) in respect of the stub period February 1, 2010 through December 31, 2011 in his 2010 income, this amount may be deducted from his 2011 income.

Individuals who utilize the alternative method can switch to December 31 reporting at a later date, but once changed, cannot switch back to a non-calendar year-end. The choice of the appropriate method depends on a number of different factors, which may require professional advice.

Business Meals and Entertainment Expenses

Deductions for expenses incurred in connection with the consumption of food and beverages or the enjoyment of entertainment are restricted to 50% of their cost. Expenses caught by this measure include tickets for cultural or sporting events, meal allowances paid to employees and the cost of meals incurred while attending conventions or seminars. Adequate documentation, including the name of the individual who was taken out, should be kept to support the claim.

Only a limited number of exceptions have been provided to this restriction. These include circumstances where the meal and/or

entertainment activity is generally available to all employees of the business at a particular location, up to a maximum of six special events a year. This would seem to preclude functions that are offered only to smaller groups within an organization. The restriction will also not apply where the payment for such expenses is treated as a taxable benefit to employees or where the employer is reimbursed for his costs.

The cost of golf membership initiation, dues and green fees are not deductible. Meals consumed at a golf course are treated the same as any other meals. These expenses should be segregated from the golf fees in order to support the deduction.

Use of property that is a yacht, a camp or a lodge is also not deductible.

Office in Home

A large number of taxpayers claim expenses related to maintaining an office in a home. In an effort to prevent perceived abuses in this area, rules exist to limit the circumstances under which such expenses will be deductible for tax purposes. To qualify, the home office must be the taxpayer's principal place of business. Where this is not the case, the space must be used exclusively for business purposes and must be used on a regular basis for meeting customers, clients or patients. Even if a major customer provides a workplace to an individual, it does not prevent that individual from claiming an office in the home.

A related restriction will deny the deduction of home office expenses in excess of income from the business for which the office is used. Therefore, one cannot create a loss by claiming home office expenses. Any disallowed portion, however, will be carried forward indefinitely and will be eligible for deduction against self-employed income in a subsequent year.

It is important to note that the above restriction applies only to individuals who earn business income. Therefore, an individual who earns income from property or carries on business through a corporation will not be subject to these restrictions and may be able to claim such expenses, subject to supporting both the use of and need for the space.

Self-employed individuals who operate their office in the home can claim a portion of expenses such as property taxes, mortgage interest, insurance, maintenance and utilities or rent if the house is rented. The proportion claimed should be reasonable in relation to the space in the home that is used as an office. You can usually exclude common areas such as kitchens, hallways and bathrooms in this determination. *In most cases, depreciation on the home should not be claimed because of its negative impact on the principal residence exemption. If the home was acquired at the height of the market and therefore it is unlikely that the cost will be recovered, it may be advisable to claim depreciation on a portion of the home.*

Automobile Expenses

Only the first \$30,000 plus GST/HST and the applicable provincial sales tax (i.e. \$33,900 in Ontario in 2011) of the cost of an automobile will qualify for purposes of claiming capital cost allowance (CCA). Special rules apply to CCA claims for cars, which are subject to the above limits.

A similar provision exists to limit the deductibility of lease costs. The maximum deductible monthly lease cost in Ontario is \$904 (\$800 plus applicable taxes). However, even if the lease is structured so the monthly cost is less than the limits above, it may not be fully deductible if the car's list price is over the capital cost ceiling discussed in the previous paragraph.

Where money is borrowed to purchase a car, the maximum deduction for the related interest cost is limited to \$300/month. Accordingly, *taxpayers should attempt to structure their loan arrangements to ensure that interest charges on their car loans fall within these limits.*

The above limitations apply to most automobile purchases. However, there are exceptions to these rules. For example, a van or pick-up truck that is used at least 90% of the time for transporting goods or equipment in the course of business will not be subject to these cost/lease limitations.

The rules regarding the deductibility of operating expenses remain unchanged. Accordingly, all individuals who use their cars for business may deduct operating expenses such as gas, repairs, insurance, lease costs, and CCA in proportion to their percentage of business use based on distance travelled. Driving between different locations of the same business is considered a business purpose. However, travelling between home and place of business is considered to be personal driving.

Fines and Penalties

Any fine or penalty imposed under the laws of a government body (including foreign governments) are not deductible. Where the law doesn't indicate that the amount is a fine or penalty, the amount paid may be deductible if it was incurred to earn income.

Health and Dental Premiums

A self-employed individual can deduct premiums paid for private health and dental coverage, if the self-employment income is at least 50% of his/her total income during the year or in the preceding year. If the insurance coverage is comparable to that provided to arm's-length employees, and at least 50% of the employees/owners covered under the plan are arm's length employees, then there is no limit on the amount of premium that is deductible. If there are no employees, the maximum deduction is \$1,500 for each of the self-employed person and his/her spouse and \$750 for each child. If there are less than 50% arm's length employees, the amount deductible to the self-employed

is the lower of the \$1,500/\$750 limit previously referred to and the equivalent cost of coverage available to arm's length employees. Premiums in excess of the deductible amount are eligible for the medical expense credit.

There are special restrictions if the plan does not extend coverage to arm's length employees. In order for premiums to be deductible, the "insurer" must bear risk of loss. Premiums on a cost-plus plan which guarantees the insurer a return may not qualify for deduction.

Payroll Taxes

An employee does not have to bother with the administrative burdens associated with payroll taxes. Employment Insurance (EI) and Canada Pension Plan (CPP) contributions are withheld from his pay cheque.

Being self-employed is a mixed blessing. On the plus side, such individuals do not have to pay EI unless they opt to do so. This results in savings of \$1,888 in 2011 (taking into account both the employer and employee portion of EI). However, they also cannot claim EI benefits should their business fail. Nor can they collect maternal or paternal benefits and sickness and compassionate care benefits. Self-employed individuals have to pay both the employer and employee portion of CPP (this amounts to \$4,435 in 2011). The Employer Health Tax (EHT) is not applicable to self-employed earnings.

Self-employed individuals will be able to claim one-half of the CPP premiums as a deduction from income. This amount is claimed as an "other deduction" on the personal return and does not reduce business income. The other half of the premium is still eligible to be claimed as a non-refundable tax credit.

Employment Insurance

Under recent amendments to the Employment Insurance Act, self-employed individuals will have the option to be covered under EI and earn the right to collect EI benefits. Generally, EI benefits may be payable if the self-employed cannot work because of a prescribed illness, injury or quarantine, pregnancy, care of a newborn or newly adopted child or care of a dying family member. The self-employed individual must normally have been covered under EI for at least 12 months before making a claim.

Once a self-employed individual opts to be covered under EI, he/she will be required to add the amount of the premiums to the tax instalments required. The premiums are equivalent to what an employee would have to pay. An annual return will be required and the return will be subject to assessment, late filing penalties and the interest rules that apply to income tax. Once an individual opts to pay EI premiums, he/she cannot elect out of the program while he/she remains self-employed.

Income and Expense Recognition

Individuals in business may have opportunities, which allow them to select the year in which to include certain income or to deduct certain items. Capital cost allowance (CCA), which is tax depreciation, is a prime example of a discretionary deduction. A taxpayer can claim CCA on assets used in a business at any amount up to the maximum allowed. For example, it may be prudent not to claim CCA in low-income years if it is expected that income will be significantly higher in future years. Lower CCA may also be claimed in order to utilize losses or other credits that might otherwise expire. Generally, capital assets should be acquired before the year-end. Even though a taxpayer gets one-half the normal CCA in the year of acquisition, no further restrictions apply even if the asset is purchased on the last day of the year-end. The timing of both income and expense recognition can affect a taxpayer's ultimate tax liability.

Another area where timing plays an important role is the deduction and payment of accrued bonuses. While the rules in this area have been tightened over the years, a deferral opportunity still exists. The bonus accrued must be paid within 179 days of the fiscal year-end in order to obtain the deduction. Otherwise, the deduction will only be permitted in the fiscal year the bonus is paid. Accordingly, the deduction and the related tax savings can be obtained prior to the payment of tax on the bonus. This type of planning may be available for the spouse of the proprietor but not for the proprietor, as salary to a proprietor or partner in an unincorporated business is considered an allocation of profit.

Proprietors who dispose of capital property should be aware that the timing of the reporting of these gains differs from that of regular business income. Capital gains are reported in the calendar year in which the property is disposed. For example, a taxpayer who has retained a July 31, 2011 year-end and who disposes of capital property in August 2011 will have to report the gain on his 2011 tax return even though the disposition occurs during his 2012 fiscal year. It is interesting to note that this rule does not apply to gains realized through partnerships. This particular point may have less relevance as a result of unincorporated businesses being forced to adopt December year ends, as discussed earlier.

Losses

If a self-employed individual incurred expenses in excess of revenues, the resulting loss may be deducted against other sources of income, as long as the business is being carried on in a business-like manner, and is undertaken in the pursuit of profit. Otherwise, expenses will only be deductible to the extent of revenue earned. The application of losses is discussed in the "Losses" section of this publication.

Construction Contract Payment Reporting

As part of the effort to combat the underground economy, contractors are required to maintain a record of payments made to subcontractors for construction services. Goods-only payments are exempted. Mixed payments will have to be reported if there is a service component of at least \$500 per year. Payments to employees and contractors providing other types of services do not have to be reported. The information to be reported includes the name, the amount paid, and the Social Insurance Number or Business Number of the subcontractors. Although the address of the subcontractor is not mandatory, the contractor is encouraged to provide the address whenever possible. The due date for reporting this information on Form T5018 is six months after the end of either the fiscal year or calendar year.

INCORPORATION - IS IT THE ANSWER?

You are about to start a new business. You've got lots of questions. Perhaps one of the most frequent questions posed to a financial advisor at this stage is: Should I incorporate? The answer to that question has many facets and the correct response depends on the facts of each situation. In this section, we will look at some of the factors that should be examined before taking the steps to incorporate and some of the pros and cons once you get there.

The tax advantages of incorporation are not available if it is in fact an incorporated employee. Such a corporation is considered to be carrying on a "personal services business" and not entitled to the reduced tax rate (see Taxation of Corporations below for more details). In addition to paying tax at 28% instead of 15.5%, such a corporation will only be able to deduct salaries to the shareholder and limited other expenses. The difference will be greater for corporate taxation years that begin after Oct 31, 2011 as a result of proposed changes to tax rates applicable to personal services business income. The federal tax rate will increase by 13% (slightly lower if part of the taxation year falls within 2011), which may result in an overall corporate tax rate of about 40%. It is important, therefore, to keep these rules in mind before deciding to incorporate.

Limited Liability

As with most business decisions, the commercial considerations should take precedence over the tax issues. Unlike a sole proprietorship or unincorporated partnership, a corporation is a separate legal entity from its owners, the shareholders. In general terms, incorporation of a business should protect the personal assets of the owners from the commercial risks associated with the business activities of the corporation. A major exception would be professional corporations, discussed below. These risks could include potential litigation that could result from any

actions taken by the corporation or liability to third party creditors. If any of these risks are likely, the business should be incorporated from day one, irrespective of any tax considerations.

The protection of the corporate veil is lost, however, to the extent that the obligations of the corporation are personally guaranteed by the shareholders. The shareholders may also be held personally liable for their actions as directors of the corporation. These actions include failure to withhold or remit amounts payable under the Income or Excise Tax Acts.

Taxation of Corporations

Since a corporation is a separate legal entity, it must file a tax return and pay taxes, separate from its owners. The corporation calculates its income and deductions in much the same manner as an individual. However, the introduction of a corporation opens up a new set of complications, but it also comes with opportunities.

There are essentially two ways to distribute income earned by a corporation to its owner/manager: as a salary or as a dividend. Any salaries paid to an owner/manager are deductible by the corporation and taxable to the recipient. If all of a corporation's profit is distributed by way of salary, the owner/manger would essentially be in the same tax position as if the corporation did not exist. A corporation may also pay tax on its income, and distribute its after-tax earnings as dividends to its shareholder. The dividend paid is not deductible from the corporation's income.

A Canadian controlled private corporation (a defined term, see the Capital Transactions section for details) carrying on an active business (i.e. not earning investment income) in Ontario pays tax at a flat small business rate of 15.5% on its first \$500,000 of net income in 2011. When the corporation distributes its after-tax earnings to its shareholder in the form of a dividend, the individual will pay an additional tax of approximately 32.6% (at the top Ontario rate) on the actual amount of the dividend paid from income subject to the low rate of tax. The total corporate and personal tax incurred by using the corporation to earn the income would be slightly lower than the tax payable by the individual earning the income directly.

The major tax benefit is the ability to defer tax on income retained in the corporation. The corporate 15.5% rate is roughly 31% lower than the tax rate applicable to a top rate individual taxpayer in Ontario. Furthermore, this tax rate is less than the lowest applicable marginal tax rate of an individual in Ontario who has more than approximately \$13,000 of income (see Schedule 1). As long as the earnings of a company are not paid to shareholders (by way of salary or dividend), the corporation has the opportunity to accumulate additional earnings/cash that can be used to assist in future growth. A top rate taxpayer pays approximately \$46 of every \$100 he earns, to the government. A corporation subject to the low rate of tax pays only \$15.5.

Simple arithmetic illustrates that this advantage is sizeable and allows a corporation to retain additional cash flow that can be reinvested in the corporate business.

The above assumes that the shareholder does not require the corporation to pay the shareholder from its first \$500,000 of income in order to meet the shareholder's personal needs. Should the shareholder need to withdraw the amounts from the corporation, the tax-deferral benefit referred to in the previous paragraph will generally be lost.

If the corporation pays dividends from its income that has been subject to a regular rate of tax (i.e. not eligible for the small business tax rate, nor investment income subject to refundable tax treatment), the dividends will be subject to the Large Corporation dividend tax rate of 28% in 2011 (see Investment Income section for more details). There will be a tax cost of approximately 2% to leave income to be taxed at the regular rate in the corporation in 2011, after taking in account the personal tax on dividend distributions.

If the corporation is subject to the regular rate of tax, there is still a potential tax deferral benefit. The regular corporate tax of 28% is scheduled to reduce to 25% by 2014 which after factoring in the personal tax on a dividend compares favourably with the personal tax rate of 46%.

A corporation can deduct any salary or bonus set up at year-end even though it is paid after year-end. Any salary or bonus that is deducted by the corporation must be paid no later than 179 days after the year-end date. If not, the bonus can only be deducted in the year it is paid. If the corporation's year-end date is less than 179 days prior to December 31, the company has the opportunity of deducting the income in the current fiscal year while the bonus can be recognized as personal income for tax purposes in the following calendar year. For example, a corporation with a year-end of July 31 or later in 2011 can defer payment of its bonuses to 2012.

Salary/dividend planning should be done annually to determine the most appropriate owner/manager remuneration mix. The increase in the Large Corporation dividend tax rate will result in the tax cost of leaving income to be taxed in a corporation to be about 1% by 2013. Although these changes appear to make the dividend/bonus decision irrelevant, the analysis is not quite that simple. Therefore, it continues to be necessary to make this determination annually.

Issues such as CPP contributions, effect on RRSP limits, and EHT on salary, among others, should be considered in this decision.

However, it may be beneficial in some cases to defer the personal tax component on the income, if the shareholder does not require the additional bonus. The benefit of the tax deferral may compensate for the eventual additional tax cost. This decision should be made with your tax advisor.

If amounts have been advanced to a corporation by way of a loan or by acquiring shares from the company, the amount advanced to the company can be returned to the shareholder without tax consequences. Oftentimes, this loan arises from payments made personally by the shareholder on behalf of the corporation. Interest can be charged on any loans to the company and taxed in a comparable manner as salary in the hands of the shareholder. The advantage of interest payments is that they are not subject to EHT or other related payroll costs. Taxpayers should ensure the requirement to pay interest is properly documented to ensure interest deductibility.

The corporation can usually return the capital contributed at the time the shares were acquired from the company without tax consequences. This can be done through a legal procedure known as a "paid up capital" reduction. It is important that this transaction be properly documented to avoid any unintended result.

In summary, when you combine the commercial benefits of limited liability with the potential for a large tax deferral, the advantages of incorporation are difficult to ignore.

Professional Corporations

In recent years, Ontario has taken steps that permit certain professionals to incorporate. Members of the following professions are able to incorporate their practices: Chartered Accountants, Certified General Accountants, lawyers, medical personnel regulated under the Regulated Health Professions Act (such as chiropractors, nurses, opticians, dentists and doctors), social workers and veterinarians. The governing bodies of these professions are responsible for the certification or licensing of professional corporations under their jurisdiction, and have issued the necessary regulations or by-laws. These regulations and by-laws determine the degree of flexibility each profession will have in the ownership of these corporations.

Due to the disadvantages of the personal services business rules referred to previously, a professional who is an employee should not use a professional corporation to render services to his or her employer.

In most cases, all issued and outstanding shares of the corporation must be legally and beneficially owned, directly or indirectly, by members of the same profession. Family members of a doctor or dentist may own non-voting shares of a professional corporation. Family trusts for the benefit of minor children (but not for the benefit of a spouse or other adults) will also be permitted as shareholders. Subject to the regulations and by-laws of the relevant profession, the professional corporation might be owned by a holding company, as long as all of the shareholders of the holding company are professionals. All officers and directors of the professional corporation are required to be shareholders of the corporation.

Professional liability will not be limited. So why bother incorporating? A fiscally prudent professional can take advantage

of the tax deferral opportunity of earning income through a corporation eligible for the small business deduction. There may also be the opportunity to take advantage of the capital gains exemption on a sale of shares in the professional corporation. Although professional liability is not limited, liability to other creditors may be limited. A holding company may be used to facilitate creditor proofing, as discussed in the following section. Of course, other factors, such as whether the professional already owns a corporation which is claiming the maximum small business deduction, will affect the decision to incorporate.

The tax benefits associated with incorporating professional income are restricted when the business is carried on through a partnership in that the amount subject to the lower tax rate must be shared by the partner corporations. Planning steps may be available that would alleviate this restricted benefit. Professional corporations that are members of partnerships must use a December 31 year end. Professional assistance should be sought before incorporating a partnership.

Some Other Pros and Cons

So now you've decided to incorporate. You must be wondering what you have got yourself into.

There are additional costs associated with incorporation. Firstly, there are the start-up costs of incorporating. Also, preparation of annual corporate minutes and federal and possibly provincial tax returns are just a few of the additional requirements and costs that result from incorporation.

Although the federal and the Ontario capital tax have been eliminated, the taxable capital calculation may still be relevant as the small business deduction, for example, may be reduced for corporations with taxable capital in excess of \$10 million.

Losses of the business will no longer be deductible on the shareholder's tax return against other sources of income.

On the plus side, the corporation may provide additional flexibility in personal tax planning. Dividend income from a corporation may solve a CNIL (cumulative net investment loss) problem when trying to maximize use of the capital gains exemption. A corporation can also choose a non calendar year end which can provide additional tax planning flexibility.

In order to avail oneself of the enhanced capital gains exemption, and the allowable business investment loss rules, the shares must be that of a qualifying small business corporation. Obviously, in order to take advantage of these provisions, the business must be incorporated. Sole proprietorships or partnerships do not qualify. It is possible, however, to incorporate the business immediately prior to a sale to qualify for the capital gains exemption.

Corporations can be used in certain circumstances to implement various income splitting arrangements with various family

members. *If salaries cannot be paid to a spouse and adult children because they do not work in the business, they can still be shareholders of the corporation (subject to the comments on ownership of professional corporations) and receive dividends which will be taxed in their hands.* There are a number of traps and pitfalls to avoid when working in this area (see our comments in the Income Splitting section) and careful planning is essential before proceeding.

Many owner/managers simply withdraw funds from their corporations without any thought to the consequences. Many find out the consequences too late. Any amounts, other than bona fide loans, withdrawn from the corporation may be taxable to the owner/manager immediately, without the corporation being able to claim a deduction for the amount. There is, in effect, double taxation. Amounts can be loaned from a corporation to a shareholder under certain extremely restricted circumstances. In many cases, the entire amount of the loan may be included in the shareholder's income if it is not repaid within a certain period of time. A deemed interest benefit may arise on the loan. If the proceeds of the loan are used for investment purposes, the deemed interest benefit may be deductible by the shareholder as interest expense. There are some exceptions to these provisions. Owner-managers should think twice before withdrawing significant monies from a corporation in such a manner.

Incorporating investment income may also help mitigate the impact of the Old Age Security "Clawback" for seniors and perhaps help avoid U.S. Estate tax on U.S. investment assets. However, investments should not be transferred into a corporation that carries on an active business. This move may impair the ability to utilize the enhanced capital gains exemption (see our commentary on the Capital Gains Deduction) on a disposition of the shares of that corporation. Also, those investments may be at risk to creditors of the active business.

If a corporation carries on business through or invests in a partnership, it was previously possible to defer recognition of the income from the partnership by selecting a corporate year end that is earlier than the partnership's year end. For corporate year ends after March 22, 2011, rules similar to the "alternative method" (described in the Self Employed Individuals section) will be applicable to require certain corporate partners to recognize stub-period income. This rule applies if a corporate partner and related parties together own more than a 10% interest in any partnership.

In many cases it may make sense to interpose a holding company between the shareholders and an operating company. The undistributed surplus accumulated in the operating company can usually be paid to the holding company without incurring tax. If the surplus is required in the operating company, it can be loaned from the holding company with appropriate security put in place. This is just one example of a simple "creditor protection" mechanism that can be implemented using a holding company structure.

Accumulating surplus funds in a holding company may also have a negative impact on the availability of the \$750,000 capital gains exemption. Special care must be taken in this regard. (See Capital Transactions section.)

We have only provided a brief overview of the ins and outs of incorporation. As illustrated, there are many complex issues involved in the decision to incorporate. It's important that all of these significant issues are carefully examined before the ink dries on the "INC".

LOSSES

The Beatles sang "I'm a loser, but I'm not what I appear to be". As this section describes, the Canadian tax system offers some significant relieving provisions in connection with losses and the ability to utilize them. Sometimes a loss can be turned into a "win".

The main categories of losses are non-capital losses (which may be losses from business, or losses from investment property such as a rental property), capital losses (which are losses from the disposition of capital property), limited partnership losses and farm losses. There is also a category known as an allowable business investment loss (ABIL), which is discussed in the Capital Transactions section.

For some taxpayers, the first decision may be whether to trigger a loss, whatever the type, in order to reduce income for the current year. There are a number of rules, commonly referred to as "stop-loss" rules which will prevent a taxpayer from recognizing inherent losses until the source of the loss has been transferred to unrelated parties. It is not possible, for example, to claim a loss that is realized through the sale of property to a spouse, or a controlled corporation until the spouse or controlled corporation sells the property to an unrelated party.

If a debt has been settled in the current year or in the past for less than the full principal and interest owing, the debt forgiveness rules may apply and reduce the loss available to be claimed.

In order to claim a loss from any source, the venture, which generated the loss, may be required to have a "reasonable expectation of profit". This is a weapon frequently threatened by the CRA whenever a loss is being applied. This standard has been unequivocally rejected by a Supreme Court decision, in dealing with purely commercial ventures. If there is a personal element in the venture, there is still an onus to prove that the venture was undertaken with the intention of earning a profit, and there must be businesslike behaviour to support that intention. The "reasonable expectation of profit" test may be applied under these circumstances. For example, a higher standard may be required by a taxpayer who owns a yacht, which is used in a charter business, and it can be demonstrated that the owner uses the yacht for personal pleasure at least some of the time.

Although the government has apparently abandoned the effort to legislate a "reasonable expectation of profit" test, it does not mean that CRA will not try to apply some form of the test in assessing a taxpayer's return.

Non-capital losses can be applied against income from any source, virtually without restriction. Keep in mind that a business loss must first be offset against other types of income, such as from investments and employment, in the same year, before it is available to be carried forward or back to another taxation year. Losses derived from taxation years ending on or before December 31, 2005 may be carried forward for ten years. The non-capital loss carry-forward period has been extended to twenty years for losses incurred in 2006 and subsequent taxation years. ABILs can only be carried forward for ten years as non-capital losses, after which they convert back to capital losses.

As noted earlier, capital losses can only be applied against capital gains. Unused capital losses can be carried back three years or forward indefinitely, but only applied against capital gains. If the capital gains exemption has been claimed in any year, a capital loss cannot be carried back or forward to that year against the same capital gain.

Limited partnership losses are losses available to limited partners which could not be deducted due to the operation of the "at risk" rules (see further comments in the Tax-Sheltered Investments section). These can be carried forward indefinitely, and deducted when the limited partner increases his capital in the same partnership either through additional contributions or income allocated from the partnership.

Special rules apply for farm losses, which include losses from horse racing operations. Farm losses are categorized as business farm losses and restricted farm losses. The difference lies in the extent to which the losses can be deducted from other sources of income. Individuals whose chief source of income is from farming can deduct losses in full in the year in which the losses are incurred. Taxpayers whose chief source of income is not from farming will need to demonstrate that the farming is not merely a hobby or a lifestyle choice. One of the factors which will be considered will be whether the operations have a reasonable expectation of profit (there's that term again). If an individual's activities do not show a profit over many years, it may be difficult to support that there was a reasonable expectation of profit. Any losses incurred may not be deductible. "Part-time" farmers who have a reasonable expectation of profit can only deduct a restricted amount (up to \$8,750) of losses against non-farming income. The remainder of the loss can be carried back three years and forward twenty years, but can only be deducted against farming income.

The utilization of any of these loss carryovers is fully discretionary; that is, both the quantum and order of utilization of these losses is at the discretion of the taxpayer. However, older losses must be claimed before losses of a more recent year may be claimed. *In most cases, it would be advantageous to*

carry back current losses to the earliest year possible to maximize the flexibility of utilizing future years' losses.

Great care should be taken, however, when determining the amount of loss carryover to claim against prior years' or future years' income. The first rule in this regard is that *one should never use loss carryovers to reduce taxable income below the level when no tax would be payable.* For example, because of the basic personal tax credit, individuals should not utilize losses to bring their income below \$10,527 in 2011. This threshold would increase to the extent that other credits are available. In addition, it may make sense to *allow some income to be taxed at a low rate in order to utilize losses against income in the foreseeable future that would be taxed at the higher marginal tax rates.*

TAX-SHELTERED INVESTMENTS

Tax shelters are business or investment arrangements that offer tax savings through various write-offs and deductions, in addition to the often-remote possibility of a return on the amount invested. Previously, tax shelter investments were often sanctioned as a result of the government's desire to stimulate economic activity in a specific area (e.g. Canadian films, rental housing, or research and development). Tax shelters have taken more than their fair share of the federal government's relentless assault in the past number of years because of its perception that the tax benefits provided to investors are unwarranted, and the tax shelters have taken advantage of unintended loopholes in the tax legislation. Tax shelters, which have applied for, and received favourable income tax rulings from the government, have also been subject to attack by the CRA. A potential investor must keep in mind the adage: "Buyer Beware", when considering a tax-shelter investment.

Gone are the days when tax shelters were offered in abundance late in the year, accompanied by those wonderful tax write-offs. In a large majority of tax shelters, investors will not see a return on their investments, and end up settling for the tax benefits that are provided. Often, when they receive a reassessment from the CRA reversing the tax shelter write-offs, the tax savings have been spent, and they will still be holding the debt that was used to acquire the tax shelter. These investors would probably like to forget they ever made the investment in the first place.

The tax benefits from the acquisition of a tax shelter reduce the amount of the investment that is at risk. With rules successively introduced to curtail the utilization of deductions provided by shelters, the amount "at risk" on these investments continues to increase. *Great care should be exercised before making these types of investments. Prior to investing, it is imperative to examine the shelter's investment and business merits, of which the tax benefits should only play a part,*

A number of tax changes made over the years have reduced the impact of the deductions available from specific tax shelters. The AMT, matchable expenditure rules, CNIL rules, at-risk rules for limited partnerships and capital cost allowance (CCA) restrictions are representative of the bombardment of rules designed to reduce the attractiveness of tax shelters. In addition, the holders of certain partnership interests where the tax cost of the interest becomes negative as a result of significant write-offs, are treated as having realized a capital gain. Some rules only affect individuals, therefore where appropriate, taxpayers might *consider investing in those types of shelters through their corporations.*

In addition to the specific rules, which restrict the amount of the write-offs available, the CRA has also attacked the tax shelters on the basis that the investors generally have no reasonable expectation of profit from these arrangements other than the tax deductions. As well, CRA may challenge the valuation of assets, the legal effectiveness of the arrangement, the reasonableness of expenses incurred and other issues. The CRA may still continue to consider whether an investor has a reasonable expectation of profit if the venture has a personal element.

The reporting rules for tax shelters have been broadened. In particular, investors who acquire tax shelter investments should *ensure that the shelter is registered with the CRA and has a "tax shelter identification number". The deduction or claim made must also be reported on form T5004, otherwise the expected write-offs may not be allowed. Keep in mind, the fact that a tax shelter is registered does not mean it has received the CRA's blessing.*

Recently, the government has introduced proposals that would require an investor, among others, to report certain types of transactions beginning in 2011. These are transactions that involve any of the following elements:

- Fees are charged by anyone involved that are either based on the amount of the tax benefit or contingent on obtaining the tax benefit;
- There is confidentiality protection with respect to the details or the structure of the transaction;
- There is contractual protection such as insurance, indemnity, compensation or undertaking with respect to failure of the transaction, or costs that may be incurred in a dispute relating to the tax benefit.

The reporting will not be required for tax shelter investments or flow-through shares due to the separate reporting required for these investments.

Generally the transactions involved are aggressive tax planning structures that fall outside of the tax shelter rules. The investor, the promoter of the transaction, and anyone involved with giving advice on the transaction must file an information return. The CRA may impose joint or several penalties on every person who failed to report any reportable transaction. The required reporting will be detailed and generally self-incriminating. The logical result of these rules should be that investors would

demand that these types of structures be registered as tax shelters to move the reporting burden from the investors and the accountants back to the promoters.

The remainder of this section examines some of the more common types of tax shelter arrangements.

Charitable Donation Arrangements

A number of years ago, certain taxpayers were successful in defending themselves in court in circumstances where art was acquired at a low cost, and donated at a higher value. Since that time, a number of donation arrangements have been packaged and sold to “investors”. There are a number of variations on these arrangements and they operate under the same general guiding principle: the “investor” will receive a donation receipt in excess of his/her actual cost. The charities generally will receive only a fraction of the value of the receipt.

The government has introduced a number of legislative amendments to make life difficult for the promoters of these shelters in the last few years. The most recent (still proposed) amendments appear to have shut down most of the arrangements. In addition, the CRA has aggressively challenged previous donation arrangements, and has revoked the charitable registrations for a number of charities participating in the arrangements. Taxpayers who are interested in the remaining arrangements should be aware that the CRA would likely try to attack them using its available arsenal.

Limited Partnerships

The limited partnership structure has long been a favourite tax shelter vehicle as it can be used in a variety of arrangements. This structure was often advantageous in start-up situations, where the business expected losses in its formative years. Not only did it provide the investor with limited liability, but it also allowed for the flow-through of partnership losses and tax credits to the individual investor, whereas losses and tax credits of a business carried on through a corporation are generally trapped at the corporate level.

A limited partner’s claim of investment tax credits (ITCs) and business losses of the partnership is restricted to the extent of the amount of his investment in the partnership that is “at risk”. This “at risk” amount includes the partner’s actual cost of investment plus his/her share of partnership income and certain other adjustments. The at-risk amount will also include any “real” debt for which an investor is liable. Any loss in excess of the “at risk” amount is not deductible in the year and may be carried forward indefinitely to be applied against income from the **same** limited partnership. Any unclaimed losses may be added to the cost base of the partnership interest when that interest is sold.

The losses generated reduce the cost base of the partnership, and often result in it becoming negative. Various rules provide that

a negative cost base of limited or certain other passive partners will trigger a capital gain at the year-end of the partnership. Some limited partnership interests held since February 22, 1994, which are still in business, are exempt from these rules.

In many of these arrangements, the limited partner may finance his/her investment outside the partnership rather than have the partnership borrow to acquire the property in question. Accordingly, the interest costs do not form part of the partnership loss and is thereby not subject to the at-risk rules. It also may allow for the deduction of CCA within the partnership, where applicable. It should be noted that the “reasonable expectation of profit” test referred to previously, may allow the CRA to attack this structure.

The limited partnership structure is often used even for mature businesses. Prior to 2006, this structure was preferred over investment in corporations because it was more tax efficient (i.e. tax paid only once by the investor on profits of the partnership, at a maximum tax rate of 46% for a resident in Ontario). This was favourable to a combined personal and corporate tax rate of approximately 56% in Ontario if the business is not carried on by a CCPC. The federal government was concerned that the proliferation of the publicly traded limited partnership and the business income trust structures (see the Income Trusts section) was having a significant negative impact on tax revenues. Its solution: improve the integration of the personal and corporate income tax systems for non-CCPCs. This was achieved by reducing corporate tax rates and reducing the rate individuals pay on any dividends received. The combined tax payable by the corporation and its shareholder has been reduced significantly from the pre-2006 56% to 48.5% in 2011, and will be 47% by 2014. By 2014, an investor should be indifferent as to whether the business is carried on through a corporation or through a limited partnership structure. The tax on dividends paid out of high-rate corporate income (“Large Corporation” dividends) has narrowed the gap between individual tax rates on dividends and capital gain to around 5% from the pre-2006 high of 8%, but will increase to 6.3% by 2012. An investor will continue to prefer realizing capital gains over receiving dividends.

The rules referred to below concerning the distribution tax will also apply to public partnership distributions.

Income Trusts

Income trusts are an investment vehicle for certain assets or businesses and typically raise funds by selling units in the trust to public investors (i.e. unitholders). The unitholders are the beneficiaries of the trust, and their units represent their right to participate in the income and capital of the trust. Income trusts generally invest funds in assets that provide a return to the trust and its beneficiaries based on the cash flow of an underlying business. This return is often achieved through the acquisition by the trust of equity and debt instruments, royalty interests or real properties. There are three primary types of income trusts: business income trusts, energy trusts and real estate investment

trusts (REITs). Business income trusts are a more recent development in Canada than energy trusts and REITs, which have existed since the 1980s.

Income trusts are not a tax shelter in the traditional sense, because losses cannot be flowed through to the investors. The structure increases the cash flow or investment yield to the investor due to the elimination of corporate level taxation. In addition, the structure allows the investors to receive distributions from the trust as a return of capital. The return of capital reduces the investors' cost of the units, and on a subsequent sale of the units, a larger capital gain may result. Business income trusts are generally used to own assets of a mature business which can generate sufficient cash flow to meet the investors' expected rate of return.

The government has eliminated the tax advantage of Income Trusts through a two-pronged approach. The first measure involved the reduction of personal tax rates applicable to dividends from publicly traded corporations. As indicated on Schedule 1 and in the discussion concerning limited partnerships, the changes to the personal tax rate on Large Corporation dividends do not completely eliminate the tax benefit of investing in income trusts. The second measure is a distribution tax applicable on distributions from income trusts and publicly traded partnerships from business income earned through these existing vehicles, beginning in 2011. The distribution tax for any income trust conversions that were not completed until after October 31, 2006 would apply immediately. Certain REITs, but not energy trusts, have been exempted from these rules. The distribution tax is levied at the income trust/public-traded partnership level. The investors will be taxed on the distributions as if they have received Large Corporation dividends. Generally, the investment yield from these vehicles should decrease once these rules are in place. The income trusts' ability to return capital to their investors may still be attractive due to the deferral of tax on the cash received.

A number of income trusts have been restructured into stapled units which combined shares of a public corporation with high yield debt of the same issuer. These are designed to preserve the ability of the former income trust to distribute pre-tax income to the investor. The government has proposed rules which will eliminate this advantage.

Investment Trusts

A recent variation of the Mutual Fund Trust has surfaced in the marketplace. Under these arrangements, the Trust will make regular distributions to the investors, but the distributions will be characterized as return of capital, to the extent they exceeded income of the Trust. The Trust is structured so that it will realize and allocate capital gains to the investors. In effect, although the underlying investments will generate ordinary investment income, the investor will be taxed at capital gains rates. Time will tell if the CRA will decide to challenge these types of investment structures.

Real Estate Investments

Capital cost allowance (tax depreciation) on the building portion of rental real estate can shelter the rental income from the property, but cannot create a loss that may be applied against income from other sources. Mortgage interest expense, property taxes and other maintenance costs can be deducted against rental income, and may create a loss in certain cases. However, most costs related to the construction period of a project must be capitalized to the building rather than deducted in computing income. The capital appreciation on such investments may be taxed as capital gains at preferential rates. Here, perhaps more than any other type of investment, the merits of the business investment must override other considerations.

Over the last few years, a popular way of investing in real estate has been in units of a REIT (see comments above under Income Trusts). An investor's risks and benefits are spread over a pool of rental properties. However, REITs are not tax shelters because the REIT cannot allocate any losses to the investor.

REITs that own real estate as investment instead of business assets may be exempted from the distribution tax referred to previously, as long as certain conditions are met. A REIT that qualifies for the exemption must meet certain annual criteria with respect to revenues and asset values.

Resource Properties

The deductions available to taxpayers from a resource property remain a source of confusion for most taxpayers. Thankfully, most resource shelters provide detailed instructions at year-end for use in completing a personal tax return. Resource tax shelters generally use a limited partnership arrangement or corporate "flow-through shares" which allow the corporation to forego certain tax write-offs or credits and pass them through to their shareholders. The federal and Ontario governments will give investors tax credits (15% federal and 5% Ontario) for investments in eligible junior mining companies. These tax credits will be taxable in the following year. The federal tax credits were recently extended to include flow through agreements entered into by March 31, 2012.

Resource partnerships or resource trusts are subject to the distribution tax affecting income trusts beginning in 2011.

Labour-Sponsored Venture Capital Corporations (LSVCC)

The federal government and a number of provinces, including Ontario, provide tax incentives to promote equity investments in developing businesses. One such incentive is a tax credit given to individuals who invest in shares of venture capital corporations designed to provide alternative sources of capital to small and medium-sized Ontario businesses. These are known as Labour-Sponsored Venture Capital Corporations ("LSVCC")

or Labour Sponsored Investment Funds (“LSIF”) in Ontario. The federal government provides a tax credit of 15% on an investment up to \$5,000 for a total credit of \$750. The deadline for a purchase to make a claim in the 2011 tax year is February 29, 2012. The maximum credit available in Ontario is \$375 reached on an investment of \$7,500. If the *LSIF* qualifies as a Research Oriented Investment Fund (ROIF), investors receive an additional five per cent non-refundable tax credit. The credits will no longer be available after the 2011 taxation year.

Although the LSVCC provides an attractive tax result, especially if purchased through an RRSP, *be aware of the redemption restrictions and investment aspects of the LSVCCs*. Investments must be held for at least 8 years. *If the holding periods are breached, the previous tax savings must be repaid*. However, LSVCC redemptions in February and on March 1 will be deemed to be made 30 days later.

These equity investments may also be purchased in an individual’s RRSP. In this case, an RRSP tax deduction will be available in addition to the tax credits noted above. Accordingly, the after-tax cost of an investment structured in this manner can be reduced significantly.

Life Insurance

Life insurance products have become more prominent as tax shelter vehicles. Although the premiums paid for the life insurance may generally not be deductible, the proceeds the beneficiary receives on the death of the life insured are not taxable. Many policies, in addition to pure insurance, have investment components. These policies and arrangements can be used to provide retirement income through tax-sheltered earnings in addition to life insurance coverage. The income earned in the policy is generally sheltered from tax. Creative ownership arrangements have also been developed that may reduce the costs associated with owning life insurance. *The merits of life insurance as a form of tax-sheltered investment should be given consideration*. However, the CRA is reviewing certain leveraged life insurance products, and anyone interested in this type of planning should consider them only with the appropriate professional advice.

ALTERNATIVE MINIMUM TAX (“AMT”)

The AMT was introduced as a response to the perception that high-income taxpayers pay little or no personal income tax through the use of so-called tax preferences (shelters). The tax applies primarily to taxpayers with large capital gains and minimal other income, or those with significant interests in tax shelters. While the majority of taxpayers do not pay AMT, *possible minimum tax implications should be considered when investing in a tax shelter, or realizing large capital gains*.

AMT introduces a separate computation of income and tax, applicable to all individuals and trusts (other than certain trusts, such as mutual fund trusts). The individual’s tax payable for the year will be the greater of his/her tax payable under AMT and under the regular system, including any Kiddie Tax payable (see the Income Splitting section for a description of Kiddie Tax).

The AMT system differs in two major ways from the regular system used to calculate tax payable. These are as follows:

1. Various tax preference items are added to regular taxable income when computing AMT taxable income.
2. The federal tax rate applied to AMT taxable income is a flat 15% in 2011. The taxpayer must pay the higher of the federal tax otherwise determined and the AMT. The applicable provincial rate is then added. The combined 2011 federal-Ontario AMT rate is approximately 21%, including all surtaxes. Only certain tax credits are deducted in computing the AMT liability. Dividend tax credits and investment tax credits are examples of some of the credits not allowed in computing AMT. A taxpayer must claim the same amount of those tax credits (which are allowed for AMT purposes), in calculating regular tax and AMT.

Tax preference items are added to regular taxable income to determine the taxable income subject to AMT. These include:

- Tax shelter losses
- Losses from partnerships if you are a limited partner or a passive partner
- Certain resource related deductions, including renounced resource expenditures from investment in flow-through shares or partnerships
- Carrying charges related to the above-noted types of investments, to the extent the carrying charges exceeded income from the investments
- Employee home relocation deduction
- 60% of amounts claimed under the employee stock option deduction
- 60% of the untaxed one-half of capital gains

Because interest paid on loans not used to purchase tax shelters, and ordinary business losses are not added to taxable income subject to AMT, *where possible, investments in these assets should be financed, and tax shelters should be purchased with the taxpayer’s own funds*.

The following are deducted from taxable income subject to AMT:

- The grossed-up portion (i.e. the 25% gross-up on ordinary dividends or the 41% gross-up on Large Corporation dividends) of dividends received
- \$40,000 basic exemption available to individuals and to trusts resulting from the death of individuals

The \$40,000 basic exemption is shared by multiple trusts arising as a result of the death of a single individual by filing a prescribed form.

AMT is not applicable in the year of death. Since significant capital gains can arise on death through the operation of the deemed disposition rules, this exception is welcome news.

The rules provide for a seven-year carry forward of the excess of both the federal and Ontario AMT over the tax that would otherwise be payable under the regular system in a taxation year. The maximum carryover that can be deducted in a given year will be equal to the excess of the federal and Ontario tax under the regular tax system over the AMT for that same year. However, minimum tax carryover cannot be claimed against the Kiddie Tax. Since AMT is potentially refundable in future years, the only real cost associated with this tax may be of a financing nature. *Planning should be instituted to ensure the AMT is either not payable or recovered as soon as possible after it arises.*

TAX INSTALMENTS, PENALTIES AND RELATED MATTERS

Tax Instalments and Interest

Paper. The government loves to send you paper. Some months it seems that a day doesn't go by without receiving some form or notice from our friends in Ottawa. Some of this paper flow is purportedly designed to simplify a taxpayer's life and help him/her comply with the multitude of tax payment deadlines inherent in the system. This is especially true in respect of quarterly personal tax instalments.

One thing is certain: under the current regime, more and more taxpayers will find themselves drawn into the tax instalment web, much to their dismay. Sometimes increased paper flow also means improved government cash flow.

The starting point is to determine whether instalment payments are required. Tax is withheld at source from such items as employment income, RRSP withdrawals and certain pension benefits. Individuals are required to make quarterly instalments if the difference between tax payable and amounts withheld at source is greater than \$3,000 in both the current year (i.e. 2011) and either of the two preceding years (i.e. 2009 and 2010). Therefore, a taxpayer may technically have been required to pay instalments during a year if he/she realized a large but unanticipated capital gain late in the year.

Since the instalment rules are based on net tax payable, employed individuals who do not have sufficient tax deducted from their wages may be in for a surprise when they receive their

first instalment request from the CRA. Taxpayers who have control over the amounts they have deducted at source (i.e. owner/managers) can more easily plan their affairs to stay out of the quarterly instalment system.

Instalments are due on the 15th of March, June, September and December. The final balance is due on April 30 of the following year regardless of when the tax return is due. These dates are extremely important because of the interest and penalties that can be assessed when these dates are ignored or inadvertently missed.

Once the requirement to pay instalments has been determined, the question remains as to the amount that must be paid. There are three methods to calculate the quarterly instalments.

Instalments can be based on either the estimated tax liability for the current year or the previous year's tax liability, whichever is less. In this situation, tax liability means the amount of tax owing on the return after deducting amounts withheld at source. Under these two methods the instalments are made in four equal payments that total the prior year's liability or the current year estimate, depending on the method chosen. If you are expecting lower income in the current year, it may be advantageous to make instalments based on current year's estimated tax liability. The income estimate should be as close as possible to actual liability to avoid a deficiency in instalment payments and the resultant instalment interest.

Instalments may also be made under a third option:

- (1) the March and June instalments are based on one quarter of the taxpayer's tax liability from two years ago (i.e. the first two 2011 instalments are based on 2009's tax liability); and
- (2) the September and December instalments are based on the prior year's tax liability less the amount determined in (1) (i.e. the last two 2011 instalments are based on 2010's liability, with an adjustment to ensure total instalments end up equalling 2010's tax liability).

The CRA sends out notices informing taxpayers of their instalment requirements, generally based on the third method. If the CRA's instalment notices are adhered to and the amounts are paid on time, instalment interest and penalties will not be charged, even if the CRA's notices miscalculated the required instalments. This third option is typically advantageous to first time remitters or those individuals whose tax payable increases each year. However, this system does not always produce the best result for other taxpayers. Therefore, taxpayers relying on the CRA's notices to determine their instalments should be careful to ensure they are remitting the correct amounts.

Self-employed individuals with rising incomes and corresponding increasing instalment requirements may wish to opt for the later June 15 filing deadline (see below) for their tax

returns. As noted, the CRA's notices base the last two instalments in a calendar year on the previous year's tax liability. If the tax return is filed at the later filing deadline, the CRA may not assess the previous year's return in time to adjust the last two instalments. Accordingly, the last two instalments may be based on the second prior year's tax liability. *Therefore, self employed taxpayers with increasing tax liabilities should consider filing by June 15.* This approach may improve a taxpayer's cash flow, but will also result in a higher outstanding balance the following April.

Taxpayers will be subject to non-deductible interest charges on deficient instalments and on any unpaid balance of tax after April 30. The interest is computed using the government's prescribed rate, which is roughly equal to 4% above the Bank of Canada rate, compounded daily. Thankfully, the interest calculation will be based on the instalment method that results in the lowest amount payable. Instalment interest under \$25 will not be assessed. *Taxpayers should make instalments whenever required, in part to avoid instalment interest, but perhaps more importantly to ensure that they do not find themselves facing a large tax bill at the end of the year.*

Not surprisingly, the government will not pay taxpayers interest if the instalments are paid earlier or are greater than required. They will, however, credit an account for such early or excess payments to the extent that they have otherwise generated non-deductible interest charges in the year. *Taxpayers who have made late or deficient instalments may wish to consider paying their final balance prior to April 30 to take advantage of this offset. In addition, they can make an earlier instalment payment or overpay a subsequent instalment to achieve the same result.* It is vital that instalments are not overpaid, unless they are made to correct a deficiency. Despite rumours to the contrary, there is no advantage to financing the government in advance. This juggling act to pay the correct instalments could be mitigated if the CRA decided to pay interest on overpaid accounts. Unfortunately, this is unlikely to happen.

The CRA does pay interest on tax refunds to individuals. The interest clock will start 30 days after the later of April 30 and the day on which the return was actually filed. The interest rate earned is 2% less than the rate that the CRA will charge on any amounts owing to the CRA. To add insult to injury, the interest paid by the CRA is taxable. *If a refund is expected, the tax return should be filed as soon as possible.*

Penalties and Interest

There seems to be a movement by the government to introduce a wide variety of penalty and interest provisions to ensure compliance by taxpayers with filing their returns and paying their taxes. These rules seem to grow and expand each year. Taxpayers should be aware of all of these provisions and ensure that they stay outside of these rules whenever possible. It can save time and money.

The government may impose penalties for late or deficient

instalments. In addition to charging instalment interest (discussed in the previous section), a penalty comes into play when instalment interest exceeds \$1,000 in the year. This penalty can approach 50% on any interest over \$1,000. Neither the interest nor the penalty are deductible for tax purposes.

The impact of these rules is best understood by examining some numbers. Assume that the prescribed rate is 5%. When the effect of daily compounding is factored in, the effective rate is approximately 5.1%. After factoring in the above noted penalty and the fact that the interest is not deductible, this rate equates to a pre-tax interest rate of approximately 14% (at the top rate of tax in Ontario). If this does not send a clear signal that paying instalments is vital, what would? *Paying your instalments on time can be your best investment.*

The Canadian tax system currently imposes a penalty for late-filed returns, equal to 5% of the unpaid tax at the required due date, plus an additional 1% per month of default (up to a maximum of 17%). Interest at prescribed rates is payable on the unpaid tax and late filing penalty. The penalty is as high as 50% of the unpaid tax if a person files late twice in any four year period. Therefore, even if a taxpayer cannot pay the liability owing at April 30, *the return should still be filed on time to avoid the penalty.* Conversely, if for some reason the return cannot be completed in time, *an estimate of the tax owing should be paid by April 30 to minimize the application of the penalty.* Taxpayers who have until June 15 to file their return should ensure that the amount of tax owing is paid by April 30 to avoid interest charges.

There are a number of other more punitive penalties to be considered. If a taxpayer inadvertently fails to report an item of income, he may be subject to a penalty equal to 10% of the amount not reported, if he had failed to report any amount of income in any of the three preceding taxation years. The CRA need not provide proof that the omissions are intentional, just that the omissions occurred. Taking the attitude that "Let the CRA find it" may prove to be expensive.

If the CRA is able to prove that the failure to report was due to gross negligence, which is a much higher standard, the penalty may be as high as 50% of the tax payable on the unreported income. The CRA routinely threatens to assess such a penalty on a taxpayer whenever certain adjustments are made on audit, even if the taxpayer does not meet the standard of gross negligence. A taxpayer may face criminal prosecution for more serious offences.

Waiver of Interest and Penalty Charges

The government has enacted a taxpayer relief package to deal with, among other things, the potential cancellation of interest and penalty charges. There are a variety of circumstances in which the CRA will consider waiving these charges, including serious illness or accidents, and errors and delays caused by the CRA. Any taxpayers with significant interest charges and penalties should consider whether the provisions of the taxpayer relief package may be applicable.

Tax Return Filing

The personal tax return is due on April 30th. However, individuals with self-employment income and their spouses have until June 15th to file their returns. The return must be postmarked or filed electronically by the due date. The interest clock, however, starts ticking after April 30 on any unpaid balance of tax. If there is no tax payable for the year, no return is required unless CRA requests one to be filed. A return is also required in situations where no tax is payable but a capital gain/loss has been realized.

Quebec is the only province that currently requires a separate return. Quebec residents and taxpayers with business income in Quebec are required to file a Quebec tax return. Members of partnerships that have offices in Quebec must also file a Quebec return.

As an alternative to filing a paper return, tax returns can be filed electronically, referred to as "EFILE". Under the EFILE system, returns are electronically transmitted without any "paper" filed with the CRA. However, all documentation that supports the return must be retained for six years to enable any subsequent review by the CRA. The main advantage of this system is that returns are processed by the CRA in very quick order and accordingly, so are the tax refunds. Because the return is assessed earlier, the three-year period in which the CRA can examine a return also gets an earlier start.

The CRA may selectively verify the information reported on returns that have been EFILE'd. This process is routine. The CRA may issue a written request to examine the supporting documentation for items such as childcare expenses, RRSP and charitable contributions.

Taxpayers will also have the option to file their tax returns via the Internet. This is referred to as NETFILE. The CRA will send each taxpayer a personal access code in his/her annual tax package. In order to NETFILE, the return must be prepared using a commercial tax preparation package or a certified Web application.

Some taxpayers with simple information may also be eligible to file by telephone. The CRA will send each eligible taxpayer an access code, which will allow access to this service.

There are also a number of information returns, which must be filed by sending in hard copies of the forms, and penalties may be assessed if these are late or delinquent. These include returns to report payments to non-residents, payments of dividends or interest to Canadians, and payments to construction contractors.

DEATH OF A TAXPAYER AND ESTATE PLANNING

Death and Taxes. They have commonly been referred to as the

two "certainties" that are faced in life. While there is no question that death will eventually result, there are a variety of planning steps that can be taken to ensure that taxes that would otherwise arise on death are minimized. In this section of our commentary, we'll focus briefly on a variety of what are commonly referred to as "estate planning" techniques.

Some Basic Rules - The "Terminal" Return

When an individual dies, a terminal tax return is required to be filed to report income earned from January 1 to the date of death. In computing income on that return, a number of special rules apply.

Normally, an individual pays tax only on income which has been received. On death, amounts earned, whether or not they have been received, must be included in income. For example, if Mrs. Mort died on June 1, 2011, and at the time of her death, she owned a GIC which she bought on March 1, 2011 with a maturity date of September 1, 2011, the interest earned on the GIC from March 1 to June 1 will need to be calculated, and included on the terminal return.

The deceased individual is deemed to dispose of all the capital property he or she owns, at their fair market value, at the date of death. This results in the realization of all accrued capital gains and losses on such assets. In addition, death may trigger either recapture of depreciation claimed previously or a terminal loss on depreciable assets such as buildings. There are exceptions to this general rule when the property is left to a spouse or a spouse trust (more about that later). There is presently no estate or inheritance tax in Canada, except for probate fees charged by the courts in each province (except Quebec) to grant approval for the executor to assume control over the deceased's property. In Ontario, the probate fee is known as the Estates Administration Tax, referred to at the end of this section.

Any capital losses triggered on death, to the extent that they exceed capital gains in the same year, can be deducted in the year of death or be carried back to the immediately preceding year to reduce any type of income (not just capital gains). This loss utilization can only be used to the extent the deceased has not previously claimed the capital gains exemption. As well, any capital losses carried forward from previous years can be used against all other income in the year of death or the preceding year, except to the extent the exemption was claimed.

As noted in our AMT section, minimum tax does not apply in the year of death. Therefore, large capital gains triggered as a result of this deemed disposition on death will not create AMT.

Charitable donations made in the year of death, if they cannot be used in the terminal return, can be carried back to the year prior to death. The charitable donation limit in the year of death and the immediately preceding year is 100% of net income (instead of the normal restriction of 75% of net income). Any donations made pursuant to a will, or by direct designation of a charity as a

beneficiary under a life insurance policy, a RRSP or a RRIF, are treated as if made in the year of death and can be claimed in that year or the previous year. The transfer must be made within 36 months after death. The Executors may apply for an extension of the 36-month period. There are a number of additional conditions which have to be met if a life insurance policy is donated.

Medical expenses can be claimed for amounts paid during any 24-month period that includes the date of death (instead of the normal 12-month period ending in the year). This includes medical expenses paid after the date of death.

The deceased's employer can pay death benefits of up to \$10,000 to the surviving spouse or in some cases to other family members or the estate without attracting tax. This is especially relevant in situations where the deceased was an employee of a closely-held family corporation. The death benefit is included in the return of the recipient (i.e. the estate or the beneficiaries), not in the terminal return.

If the deceased has a surviving spouse, a RRSP contribution may be able to be made to a spousal RRSP as long as it is made within 60 days after the end of the year of death.

The requirement to pay instalments ends when the taxpayer dies. The only instalments required are those that were due before the date of death. The terminal return for the deceased (and the resultant tax) is due by the later of the normal April 30 filing deadline or six months after death. A similar extension is allowed for the tax return for the year before the year of death, if the individual dies before the usual due date of that return. The tax on certain types of income, such as recapture of capital cost allowance and capital gains on deemed dispositions may be payable over 10 years. The deceased's legal representative must file an election form in order to obtain these extended payment terms. Adequate security must be provided to the CRA and the unpaid balance is subject to interest.

Additional Returns

There are opportunities to file additional separate tax returns for a deceased individual. For example, certain income that was earned prior to death but not received can be reported on a separate tax return. One example of such income (known as a "right or a thing") includes a salary or bonus relating to pay periods ending prior to the date of death that was owing to the deceased but was not paid by the date of death. The advantage of filing a separate tax return on death stems from the fact that the second return is eligible for a new set of marginal tax rates (i.e. the same rate as those applicable on the original terminal return) and is entitled to many of the same personal tax credits (i.e. basic, age, etc.) claimed on the terminal return. There are other circumstances where other separate returns can be filed on death. Professional advice should be sought in that regard.

If the deceased owned property in a foreign country at the time of death, there may be foreign estate, inheritance or succession

taxes applicable. A foreign tax or other return may also be required.

The Estate Return

Any income earned after the date of death is taxable to the estate of the deceased. In cases where the deceased's will does not provide for an ongoing estate, *the estate can typically be run for one year from the date of death (or longer if it takes longer to wind up the affairs of the estate).* This approach may be advantageous when the beneficiaries of the estate have income in their own right. The income earned by the estate can be taxed in the estate at the marginal tax rates available to other individuals thereby taking advantage of the lower personal tax rates on the first \$42,000. The estate does not get the basic personal tax credit.

RRSP/RRIF/TFSA on Death

On death, the deceased is usually taxed on the full amount in his RRSP/RRIF. The exception to this occurs when the RRSP/RRIF is left to a surviving spouse who receives the RRSP/RRIF either as the direct beneficiary of the plan or through the estate. In those cases, the RRSP/RRIF is taxable to the surviving spouse. The spouse can defer the tax to the extent that he or she transfers the funds to his or her own RRSP/RRIF or purchases an annuity. If there is no surviving spouse and the plan's funds are left to a financially dependent child or grandchild, the amounts can be taxed in the dependant's hands or an annuity can be purchased for a term that will last until the child reaches age 18. Funds can also be transferred to other dependant's RRSP/RRIF/RDSP or used to purchase a life annuity, if the dependency resulted from physical or mental infirmity. Under proposed rules, a trust, under the terms of which the infirm dependant is the sole beneficiary during his/her lifetime, may be named as the annuitant under the annuity. For an annuity purchased after 2005, the dependant who is the beneficiary of such a trust must be mentally infirm.

It is possible to transfer funds from an RRSP/RRIF to a financially dependent child even where there is a surviving spouse. The dependant has until 60 days after the calendar year to transfer the funds from the deceased's RRSP/RRIF to a permissible tax deferral vehicle.

If the funds of the RRSP/RRIF are taxed on the deceased's final return, any increase in the value of the plans between the date of death and the date the funds are distributed to the beneficiaries is taxable on the beneficiaries' returns.

If the plan value has fallen in the intervening period, a deduction of the decrease in value may be claimed on the deceased's final return, as long as the distribution is made by the end of the year following the year of death.

If the deceased had borrowed funds from his/her RRSP under either the Home Buyer's Plan or the Lifelong Learning Plan (see Tax Deferred Plans section for more detail), any amount not yet

repaid by the time of death must be included in income, unless an election is made to have the surviving spouse assume the liability.

The value of a TFSA at the time of death is not taxable to the deceased, but any investment income earned post death may no longer be exempt from tax. An exception to this rule is if the TFSA is designated to be left to a surviving spouse, the TFSA continues without any current tax implications.

Transfers to Spouse on Death

As previously noted, the sole exception to the deemed disposition rules on death occur when capital property is left to a spouse, or spouse trust (i.e. a trust where all of the income must be paid, and capital can only be paid to the surviving spouse while he or she is alive).

In the case of transfers to a spouse/spouse trust, the property moves to the spouse at the deceased's tax cost at death, so no gain/loss arises. This transfer happens automatically (i.e. no election is required) and any future gain/loss is measured from the deceased's cost when the surviving spouse sells the asset or on his or her death. *The executor of the deceased's estate can elect out of this automatic transfer at the deceased's cost.* If the executor chooses to do so, the asset will be deemed to be disposed of at fair market value. This election can be done on an asset-by-asset basis. *This approach may be useful in order to trigger gains to which unused capital loss carryforwards could be applied or perhaps trigger gains eligible for the enhanced capital gains exemption.* Alternatively, this approach can be used to trigger capital losses on death that can be applied to reduce income in the year of death or the immediately preceding year.

There are several potential advantages of utilizing a spouse trust in lieu of transferring assets directly to a spouse on death. Firstly, the use of a trust enables the deceased to plan for the ultimate disposition of his/her assets upon the death of the surviving spouse. Without the trust, the distribution of those assets would be governed by the surviving spouse's will. Secondly, the spouse trust will have a separate marginal tax bracket from that of the surviving spouse. This alone can result in significant tax savings as income can continue to be split between two taxpayers even after death. This planning, however, will involve some very specific filing requirements.

The Will

"Where there's a Will, there's a way". There is a lot of truth in this old familiar saying, especially when a will is viewed in the context of estate planning. The will provides for the orderly distribution of an estate's assets and is the only way to ensure that the deceased's assets are distributed in accordance with his or her wishes. Without a will, the government is forced to get involved, and assets are distributed in accordance with a prescribed set of rules and formulas. The threat of government involvement should

provide enough incentive for all individuals to rush out and prepare or update their wills.

It is very important to choose the right executor(s) for the estate. The executor plays the key role in the distribution of assets, dealing with the estate property after death, and taking care of all other administrative matters including the filing of tax returns. In most cases, the will should name an alternate executor in case the original executor dies before the testator, chooses not to act as executor or is a non-resident. The choice of executor is a decision which should not be made lightly.

It is important that the will is structured to provide flexibility to executors to take various steps to mitigate the tax bite on death. As well, the will should be reviewed on a regular basis to ensure that it is consistent with the prevailing tax and family law, as well as to ensure it mirrors existing desires concerning the distribution of property. In particular, family law legislation in Ontario can overrule the provisions in a will and should be considered when making a will.

It is important to keep in mind that an estate is generally considered to be resident where the majority of the executor(s) reside, or, in accordance with some recent court decisions, where the decisions of the estate are made. The administration of the estate can be vastly more complicated should an executor reside outside of Canada as the estate may be required to comply with laws and regulations of more than one country. It may be advisable to include wording for a change in executor (s) to ensure that the majority will be Canadian residents.

In addition to a will, a power of attorney should be completed to address situations where an individual is unable to act by reason of a physical or mental incapacity. A power of attorney should be prepared for decisions related to finances and personal care.

Estate Freeze

We touched on the concept of an estate freeze in the Capital Transactions section of our commentary. An estate freeze involves fixing the value of the assets currently owned by an individual and allowing the future growth of the assets to accrue to others, likely the individual's children, so that the increase is not taxed on the original owner's death. Estate freezes are quite common when businesses are operated through corporate entities.

The mechanics of an estate freeze can be best illustrated in an example. Consider a corporation currently owned 100% by Dad that is valued at \$750,000. Dad could implement an estate freeze by converting his existing equity shares into fixed value preference shares worth \$750,000. These shares can be voting and redeemable at Dad's option to ensure that Dad retains control of the company and is able to redeem them at his option. New common shares would be issued to other family members (e.g. children) and these members would share in the future growth in the company over the \$750,000 value. The decisions involved in implementing an estate freeze are endless and must

be considered very carefully. This is especially true in situations where some children are not involved in the family business. In many cases, it makes sense to issue the growth shares to a family trust as opposed to directly to the children. This postpones the decision as to who will ultimately receive the shares and maintains this discretion in the hands of the trustees of the trust. It may also provide protection against family law legislation.

Life insurance often plays a key role in an estate plan. It can, among other things, fund the tax liability that arises from the capital gain created on death, or assist in the funding required for an orderly business succession in a family run operation. In any estate plan, the pros and cons of insurance should be reviewed as part of the process.

There are many advantages associated with an estate freeze. These include the following:

- (1) Reducing the tax cost on death by fixing the value of assets held by the older generation. This may be even more beneficial when the enhanced capital gains exemption is utilized as part of the “freeze” to bump up the cost base of the frozen shares;
- (2) Multiplication of the enhanced capital gains exemption by placing shares in the other family members’ hands; and
- (3) Income splitting by directing dividends into the hands of new shareholders.

These are just some of the benefits associated with an estate freeze. The options and choices available in structuring an estate plan are multifaceted and complex. However, the benefits to be derived from this planning are often too great to ignore.

Trusts - Why Use One?

There are three principal players in a trust arrangement. The settlor is the individual who creates the trust by transferring property into the trust. The trustees are the people who hold legal title to the property and make all the decisions regarding administration of the trust property. The beneficiaries will benefit from the property held by the trust. The choices of settlor, trustees and beneficiaries may have an impact on the taxation of the trust. Professional advice is warranted in this regard to avoid the many traps, such as the potential application of the attribution rules noted in our Income Splitting section.

Trusts can either be set up while the settlor is alive (inter-vivos) or on his/her death (testamentary) through the provisions in a will.

A trust is treated as a separate taxpayer for tax purposes. A separate tax return must be filed for each trust. The trust return is due 90 days from the year-end of the trust. In the case of an inter-vivos trust (which must have a December 31 year-end) the due date is usually March 31. A trust is taxed comparably to an individual

except that it is not eligible for the basic personal and similar tax credits. Testamentary trusts are eligible for the same progressive marginal tax rates as individuals; however, inter-vivos trusts are subject to tax at the top rate of tax. The trust is entitled to a deduction for amounts paid or payable to beneficiaries, thereby shifting the income so that it is taxed into the hands of the beneficiaries. Certain types of income such as capital gains, dividends and income subject to the Kiddie Tax (see Income Splitting section) retain their character when they are flowed out to beneficiaries. Losses cannot be allocated to the beneficiaries of a trust.

As noted previously, a trust is considered to be resident where the majority of the trustees reside and where decisions of the trust are made. *Under the right circumstances, it may be possible to have the trust income taxed in a lower rate province*, such as Alberta, through the judicious selection of a majority of Alberta resident trustees who will ordinarily and regularly exercise their powers to control the trust from Alberta. This strategy may be appropriate, for example, if the beneficiaries are paying tax at greater than the top rate of 39% payable by an Alberta trust. The other provinces are conscious of the potential erosion of their tax base. Also as noted elsewhere, the CRA does not look kindly at this type of arrangement. This strategy should not be undertaken without careful consideration.

A trust is deemed to dispose of all of its property every 21 years. Accordingly, any accrued gains would be recognized at the time. Plans should be put in place prior to the 21-year anniversary of a trust to avoid the tax on the deemed disposition of property. This usually involves winding up the trust and distributing property to the beneficiaries. Proper tax (and family law) planning is required in this regard.

A trust can be used for a wide variety of tax planning purposes. For example, a will can set up a separate testamentary trust for each beneficiary. In this case, each trust will be treated as a separate taxpayer eligible for its own set of graduated marginal tax rates. Trusts can also play an important role in the context of an estate freeze, as noted earlier.

Trust planning, however, does not have to be used solely in the event of death. Many trusts are set up while an individual is alive. Such trusts may have a number of benefits, including reducing probate fees on assets in the trust or income splitting, while at the same time allowing an individual to maintain control over the assets through a position as trustee. Tax planning in the trust area requires extreme care; don't go it alone without proper advice.

Probate Fees or Estates Administration Tax (“EAT”)

In all provinces except Quebec, EAT is levied on the total value of an estate (without any deduction for debts other than debt on real estate) in order to confirm that the deceased's will is valid, and that the executor has the authority to administer the estate. Institutions

such as banks often require proof of probate before they will release assets to the executor.

EAT in Ontario is charged at 0.5% of the first \$50,000 of value and 1.5% of the value in excess of this amount. The amount of EAT assessable on a large estate may be substantial. Prudent planning should be considered to minimize the EAT, where appropriate.

Property that is owned by the deceased jointly with the right of survivorship with another person is generally not subject to probate if the deceased intended to give the joint-owner the property on death. Assets that are held jointly do not form part of the decedent's estate, and pass to the surviving joint owner outside of the will. Accordingly, *where appropriate, assets and bank accounts should be owned jointly*. Legal counsel should be consulted if assets are placed in joint names solely for convenience, and no gift has been intended. Any planning in this regard should also take into account the relevant income tax implications. Care must be taken to ensure that the other beneficiaries are fairly treated under the will, taking into consideration the value of the assets that have been removed from the estate in this manner.

Where possible, the beneficiary should be named directly in life insurance policies so that these assets do not become part of the estate. Similar planning is applicable to RRSPs.

In some cases, assets may be distributed to beneficiaries without probate. The location of the assets may also be changed to a jurisdiction with a low or fixed EAT. *A separate or multiple wills dealing with these assets may be appropriate*. In these circumstances, the EAT can be avoided or significantly reduced. Professional advice is required in this regard.

It is also possible to *set up an inter-vivos alter ego trust* (for the exclusive benefit of the individual during his/her lifetime) *or joint partner trust* (for the joint benefit of the individual and his/her spouse during their lifetimes) *which may avoid the EAT*. A taxpayer who is at least 65 years of age may transfer property into such a trust. On his/her death (in the case of an alter ego trust) or on the death of the surviving spouse (in the case of a joint partner trust), there will be a deemed disposition of the property at fair market value. However, the property in the trust may be distributed to the contingent beneficiaries as set out in the trust document without requiring probate.

Income tax does not arise on transfers of property to these types of trusts. Since both of these trusts are inter-vivos trusts, they are subject to tax at the highest marginal tax rate and do not benefit from the graduated marginal rates of tax.

EMIGRATION FROM CANADA

When a person is considering becoming a non-resident of Canada (see our commentary in the Taxation of Non-Residents section on

the issue of residency), he or she must, in addition to taking steps to sever Canadian residency ties, factor into the decision the tax cost of leaving. Canada is one of the few countries in the world that imposes a "departure tax". Essentially, an individual ceasing to be a resident of Canada is deemed to dispose of most of his or her assets at their fair market value ("FMV") on the date of departure. If this FMV is greater than the cost, a capital gain could arise. A person may elect to treat assets, which would otherwise be exempt from the deemed disposition rules as having been sold. This is beneficial if the elected assets have an inherent loss, which can offset the gains from other assets. The loss triggered under this election can only offset the gain from the deemed disposition rules.

Since non-residents cannot claim the \$750,000 capital gains exemption, it is important that the exemption is utilized on qualifying shares before emigration from Canada. Therefore ensuring that the shares of private companies are SBC shares prior to departure is of utmost importance (see Capital Gains section).

Short-term residents of Canada benefit from a significant exemption from the departure tax. If a person has been resident in Canada for 60 months or less in the 10 years before he emigrates from Canada, property owned at the time he last became resident in Canada, and also any property which he inherited since that time, will be exempt from the departure tax. This is a significant concession to foreign executives who may be transferred to Canada for short-term assignments.

It is not possible to avoid the departure tax by becoming a dual resident. Canada will consider an individual to have ceased Canadian residency if under provisions of an income tax treaty, that individual is considered to be a resident of a foreign country.

An emigrant with reportable assets worth over \$25,000 will be required to file, by April 30 (or June 15, if self-employed) of the following year, a prescribed form (Form T1161) listing these assets. Reportable assets include most property owned by the emigrant, with limited exceptions for items such as cash in the bank and RRSP/RRIF.

There are certain specific exemptions from this tax, primarily for property which will be subject to either Canadian income tax or withholding tax when ultimately disposed or realized. Real estate and assets of a business carried on in Canada are examples of these types of property. Please see the Taxation of Non-residents section concerning rules applicable when such assets are sold. Rights under certain employer-sponsored or legislated plans or arrangements, such as RPPs, RRSPs, salary deferral arrangements, and U.S. Individual Retirement Accounts, are also exempted. As well, rights under employee stock option plans are exempt.

Since RRSPs are not subject to the deemed disposition rules when leaving Canada, *it may be prudent to wait after becoming non-resident before withdrawing RRSP funds*. Such withdrawals will be subject to a 25% withholding tax, which in many cases would be lower than the taxpayer's tax rate as a Canadian resident. This strategy should be considered only after

determining whether any foreign tax may be payable on the withdrawal.

If the emigrant has withdrawn funds from his or her RRSP under either the Home Buyers' Plan or the Lifelong Learning Plan, any unpaid balance must be reported as income on the return in the year of departure, unless it is repaid within 60 days of becoming non-resident.

Due to the significant hardship imposed on emigrants as a result of imposing tax on generally illiquid assets, the government has also introduced complex "relieving" rules.

A Canadian resident contemplating emigration has the option of electing to provide security to the CRA in order to defer payment of the tax until the asset is sold. The emigrant must contact the local tax office of the CRA by April 30 of the year after emigration to make arrangements for posting security. The CRA may, in extreme hardship cases, accept modest security. Acceptable security may include a letter of credit, a mortgage or a bank guarantee. The CRA may also ask for additional security if the original security is subsequently determined to be inadequate. If security is accepted, interest and penalties do not apply until such time as the amount becomes unsecured. Further, security is not required on the tax (calculated at the top bracket) on up to \$100,000 of capital gains. Once the asset is sold, the departure tax will be due on April 30 of the following year. Interest and penalties will begin to accrue from that day forward.

The departure tax may result in significant double taxation for some individuals. Most countries do not provide a step up in the cost of an asset when the owner immigrates to that country. Therefore, an asset's original cost will be utilized in determining its gain upon its ultimate disposition. Any departure tax paid, even if creditable in the foreign country, may be lost if no gain is recognized in the foreign country in the same year. The following may alleviate this problem under certain circumstances.

It may be possible to step up the cost base of the property in the foreign country by a transfer of the property at fair market value to a spouse immediately prior to leaving Canada. In addition, Canada and the U.S. have recently amended the Treaty between the two countries to allow an emigrant to the U.S. to elect to step up the tax cost of assets subject to the Canadian departure tax. Canada has recently renegotiated existing income tax treaties with some countries and entered into new treaties with other countries so that these countries will recognize the stepped up cost base on an eventual sale. In addition, a portion of any foreign taxes arising on the sale of assets subject to Canadian departure tax will be allowed as a credit against this tax, as long as the emigrant is a resident in that foreign country at that time, and the country has a treaty with Canada. Only foreign taxes paid on the portion of gain which accrued while the person was resident in Canada will be eligible for the credit. Foreign tax payable on gains on real property situated in a foreign country will be creditable regardless of whether the emigrant is a resident

of that foreign country, and whether the country has a treaty with Canada.

Anyone who ceased to be a resident in Canada, and then became resident once again may choose to unwind the deemed disposition on departure. This option is available regardless of how long the returning former resident has been away. This option may not always be beneficial. The decision will depend on the value of the assets when the person resumes residency.

Similar rules may apply to the distribution of property by a trust to a non-resident beneficiary.

As a result of the departure tax, becoming a non-resident is no longer a matter of making sure residency ties have been properly severed. Timing of the move may be critical. If emigration is a possibility, do not leave until you have planned it with your tax advisor.

FOREIGN REPORTING

The Canadian government has demonstrated an ever-increasing appetite for information relating to offshore holdings of, and transactions by, Canadian taxpayers. Canadians are required to file annual information returns to report such interests and transactions, and may incur higher costs to comply with these rules. Although onerous penalties have been introduced in connection with all of the foreign reporting forms, it remains to be seen whether an individual who had not properly reported income from offshore assets prior to these rules, will report the existence of these assets to the CRA.

The following information returns each require the disclosure of significant and detailed information, which often must be obtained from offshore parties. These returns fall into five categories.

- i) transfers or loans to foreign trusts (Form T1141);
- ii) interests in foreign affiliates (Form T1134 A, T1134 B);
- iii) distributions or loans from foreign trusts (Form T1142);
- iv) interests in specified foreign property, where the cost of such property exceeds \$100,000 (Form T1135), and
- v) business transactions with related foreign entities, if total of such transactions exceed \$1 million in value (Form T106).

There are certain exceptions to the foreign property reporting under iv), including personal use property such as foreign residences and vacation properties and property held in a RRIF or RRSP. Form T1135 is due at the same time as the filing date for the personal tax return.

Information reported on these returns will be entered into a national database. These returns may form the basis for a future audit. In addition, information contained on the forms may be forwarded to foreign governments with which Canada has

agreed to exchange information. The completion of these returns should not be attempted without your professional tax advisor.

In addition to the above, Canadians who have business transactions with related foreign entities have to document that the prices charged for goods and services are substantially equivalent to those charged to third parties. Otherwise, the CRA may adjust the Canadian's income by including additional amounts into income, or denying deductions claimed. A penalty of 10% of the negative tax adjustments may also be applied if the adjustments exceed the lesser of 10% of the Canadian's gross revenue and \$5,000,000. Although these requirements and penalties will principally apply to corporations, they are also applicable to individuals. The penalty may be avoided if the taxpayer prepares and maintains extensive documentation to support the reasonableness of the transfer pricing method used. The documentation required is extremely detailed and is required to be on hand by the tax return due date. In addition, it must be submitted within 3 months of receiving a written request from the CRA. The CRA's current policy is to request such documentation at the commencement of an audit if it is aware of transactions with non-arm's length non-residents. It is therefore advisable to assemble the necessary documentation as early as possible and to update it on a periodic basis.

TAXATION OF NON-RESIDENTS

The Canadian income tax system determines an individual's liability for tax based on residency. If an individual is a resident of Canada, he/she is subject to tax in Canada on his/her worldwide income. Accordingly, all of the rules discussed elsewhere are applicable.

Just because an individual is not a resident of Canada does not mean that he/she escapes the Canadian tax net. Non-residents in certain circumstances, as discussed below, will be subject to tax in Canada on income from Canadian sources.

To avoid potential double taxation, Canada has entered into a variety of tax treaties with other countries, which govern the rights of each country in mutual tax matters.

What is Residency?

Factual Residents

As already noted, the key to establishing liability for tax in Canada is the individual's country of residence. Determining residence involves the application of a number of general principles established over the years by the courts.

Generally, an individual is resident in Canada if he/she lives primarily in Canada. If an individual does not live in Canada,

he/she may still be deemed to be resident in Canada. In certain situations, a person who would otherwise be considered to be resident in Canada may still be deemed not to be resident in Canada.

There are a number of factors that must be considered in making a determination of residency, the principal of which is the individual's residential ties with Canada. The residential ties that the CRA considers the most significant are the location of the individual's home or homes, the location of his or her spouse or common-law partner, and the location of dependants. For obvious reasons, it is far more difficult to convince the CRA that a Canadian resident has ceased residency in Canada than to have them accept that a non-resident has assumed Canadian residency.

Other factors which the CRA will take into consideration include: the location of other family members; personal property (such as furniture, clothing, automobiles and recreational vehicles); social ties (e.g. club memberships, membership in religious organizations); financial ties (e.g. bank accounts, Canadian employer, credit cards, investment accounts, Canadian businesses); coverage by provincial health plans; immigration status; and Canadian drivers' license. Generally, a person is not considered to have ceased Canadian residency unless he/she has severed all or most of these residential ties with Canada.

The CRA may presume that an individual maintains his/her Canadian resident status if he/she is away from the country temporarily. The CRA takes the position that there is no particular length of stay abroad that necessarily results in an individual becoming a non-resident. The residency ties maintained while abroad will be determinative, as well as factors such as evidence of the individual's intention to permanently sever residential ties with Canada, the regularity and length of visits to Canada and residential ties outside Canada. If the individual has clearly severed all of his/her residential ties with Canada, he/she will be considered to be a non-resident, even if his/her return to Canada was foreseen at the time of departure.

Deemed Residents

An individual who is physically present in Canada for 183 days or more in any year is deemed to be a resident of Canada for the entire year. This individual is commonly referred to as a sojourner. A person who commutes to Canada for his/her employment, and returns each night to his/her normal place of residence outside of Canada is not considered to be sojourning in Canada.

Other individuals, such as members of the Canadian military, Canadian diplomats, and their dependants, are also deemed to be Canadian residents.

Deemed residents will generally not be considered to be residents of a province. As a result, he/she will pay a federal

surtax of 48% in lieu of provincial tax, and will not be entitled to any provincial tax credits or provincial benefits.

Deemed Non-Residents

It is possible for an individual to be considered resident in more than one country, either because residency ties have not been completely severed, or under the sojourner rules. The applicable tax treaty may contain a “tie breaker” system to determine which country is the country of residence for tax purposes. Canada will consider a person who is determined to be resident in a foreign country under a tax treaty to have ceased residency in Canada, and the person will be subject to the departure tax discussed in the Emigration section.

If an individual is considering taking up residence in Canada or leaving Canada, there are a number of tax planning opportunities and pitfalls that should be addressed. Anyone entering or leaving Canada should obtain the appropriate professional advice to avoid unwelcome surprises.

The remainder of our comments in this section assume that an individual is a non-resident of Canada.

Who is Taxable?

A non-resident of Canada may be subject to Canadian tax if the individual:

- (1) was employed in Canada;
- (2) carried on business in Canada;
- (3) disposed of property known as “taxable Canadian property”; or
- (4) received certain passive income from Canada, including dividends, interest, rents and pensions.

Employment and Business Income

There are special rules that will deem former Canadian residents who continue to receive employment or scholarship income from Canadian sources as employed in Canada in the year, and taxable under (1) above.

Income tax treaties between Canada and the resident countries may limit or eliminate the Canadian tax payable by the non-residents by restricting Canada’s right to tax to specific situations.

As noted in the section U.S. Tax Issues For Canadians, U.S. employees may become taxable in Canada under category (1) only if they are physically present in Canada for more than 183 days in any 12 month period that either commenced or ended in the year. U.S. persons may be considered to be carrying on business in Canada, and taxable in Canada under category (2) if

similar criteria are met.

Any non-resident who falls into categories (1) and (2) above and is not exempt from Canadian tax by virtue of a treaty must file a personal tax return in Canada and report the Canadian source income from such activities. These individuals will generally be subject to the same graduated tax rates as Canadian residents, but will usually be limited to certain types of deductions in computing taxable income.

Disposition of Taxable Canadian Property

Special reporting rules exist when a non-resident disposes of most types of taxable Canadian property, except if the exceptions referred to below apply. A purchaser of taxable Canadian property from a non-resident is required to withhold 25% of the purchase price and remit it to the CRA. The purchaser is exempt from this requirement if the non-resident provides him/her with a certificate of compliance, or the property is a treaty-protected property.

In order to apply for a certificate of compliance, a non-resident is required to report the disposition no later than 10 days after closing, and pay a tax of (or provide adequate security for) 25% of the estimated gain (instead of the proceeds). Any tax withheld pursuant to the above mechanism is credited against the ultimate tax liability reported on the non-resident’s Canadian tax return. A 50% withholding tax is applicable on certain types of property, such as life insurance policies, or real estate inventory. The tax department will then issue a certificate of compliance that exempts the purchaser from withholding tax on the proceeds. If the certificate cannot be issued before the purchaser is required to remit the withholding tax, the tax department will generally issue a comfort letter allowing the purchaser to delay the remittance. The additional requirement that non-resident individuals must obtain an Individual Tax Number (ITN) may further delay the receipt of the certificate of compliance.

Taxable Canadian property is a defined term which includes real estate situated in Canada, property used in a business in Canada, shares of certain private corporations resident in Canada, shares of certain non-resident corporations, certain partnership interests, certain capital interest in trusts, and certain public company shares. Shares of a public corporation will be included if at any time in the 5 years preceding disposition, the non-resident and related parties owned 25% or more of the corporation’s capital stock. Accordingly, shares of most widely held public companies will not be subject to tax in Canada when disposed of by a non-resident.

Recent proposed amendments have simplified these rules under certain circumstances by changing the definition of Taxable Canadian Property. Interest in private corporations, partnerships and capital interest in trusts are only subject to these rules if at any time in the preceding 60 months, more than 50% of the fair market value of the interest was derived from Canadian real property or resource property. This eliminated the need for a

certificate of compliance for common non-taxable transactions such as capital distributions to non-resident beneficiaries or exchanges of shares of one Canadian private corporation for shares of another Canadian private corporation. The purchaser may still insist on withholding tax in order to protect itself if it cannot be satisfied that the purchased asset is outside of the 60 month look back window.

Even if a property is a Taxable Canadian Property, the transaction may still be exempt from Canadian income tax either because there is no gain or because there is a tax treaty that exempts the seller from any Canadian tax on the resultant gain. A purchaser is exempted from withholding tax on the amount paid for property purchased from a non-resident if the purchaser concludes after reasonable inquiry that the seller is resident in a treaty country, and that the property is treaty-protected property to the seller. The purchaser will be required to send a notice to the CRA setting out details of the transaction. The seller will not be required to file a tax return under these circumstances.

The procedure may not resolve the problem for arm's length transactions. Although the purchaser is not required to withhold tax if the above conditions are met, the purchaser must be satisfied that the property is treaty-protected property which is not usually something that an arm's length purchaser can determine. There is no reasonable inquiry defence on this issue. A purchaser will likely continue to withhold in order to minimize any exposure to the penalties associated with a failure to withhold the proper amount of tax.

Non-residents are generally subject to the same capital gains rules as Canadians, with certain exceptions. They are not entitled to claim a reserve in respect of proceeds not due until after the end of the year, nor can they claim the capital gains exemption.

Passive Income

Non-residents who receive category (4) income are not required to file a Canadian income tax return, unless they elect to do so under the Special Elections Rules.

Withholding Tax

A non-resident individual who works in Canada, whether as an employee or as a self-employed person, is subject to Canadian withholding tax on remuneration received for the service. This rule applies whether the amount is received from a Canadian resident or a non-resident, even if the individual is exempt from Canadian tax under an income tax treaty. The withholding tax can be avoided or reduced only if the individual applies to the CRA for a reduction or waiver of the withholding tax by reason of the treaty, and the CRA approves the application.

For an employee, the amount of the deductions at source (including income tax, CPP and EI premiums) will depend on the individual's marginal tax rate. A self-employed person will

be subject to a flat 15% withholding tax. The tax withheld can be claimed on the Canadian personal tax return as taxes paid.

Non-residents in receipt of the types of income in category (4) will generally only be subject to withholding taxes at source. Interest payments to arm's length non-residents are exempt from withholding tax.

The general withholding rate on passive income is 25%. However, the various tax treaties between Canada and other countries often reduce this rate. The applicable rate is dependent on the country and the type of income involved.

Special Election Rules

Non-residents subject to withholding tax on category (4) income may in some circumstances file an election to obtain a reduction in the tax otherwise payable on such income.

A primary example is a non-resident receiving rent from a property in Canada. Withholding tax is imposed in Canada at 25% of the gross amount of rents paid or credited to a non-resident, subject to treaty relief. This result could be extremely onerous in situations where the property is generating net rental losses or minimal net rental income.

Accordingly, an alternative method of reporting may be utilized. The non-resident may, within two years after the end of the year, elect to file a regular personal tax return and report net rental income (i.e. after related expenses and tax depreciation) from Canadian property on that return. Tax is computed on this net income as if the non-resident were a regular Canadian taxpayer. If the property is generating losses, no tax will be payable. Instead of paying provincial income tax on any net rental income, the non-resident will pay a federal surtax of 48%. The personal and other tax credits noted elsewhere in the release are not applicable in this calculation.

It is important to note that filing this return does not exempt the non-resident from the 25% withholding tax. It only allows him/her to obtain a refund where the withholding exceeds the tax liability on the return. However, if the individual has a Canadian agent receiving rents on his/her behalf and he/she files an NR6 form before January 1 of the year in question, some relief from withholding can be obtained. In that case, 25% of estimated net rental income (excluding depreciation and foreign expenses) will have to be withheld. If an NR6 is filed, the tax return is due 6 months after the end of the taxation year. The CRA is generally very unforgiving about imposing withholding tax on taxpayers who file the return late. It will give a non-resident only one opportunity to late-file a return without the imposition of withholding tax and related penalties and interest. This exemption is not available if the non-resident has previously been advised of his/her withholding tax responsibilities, or the CRA has initiated enforcement action against the non-resident. *Non-residents who have chosen this alternative should ensure the filing deadline is met.*

A non-resident receiving pension benefits and RRSP/RRIF/DPSP payments which are subject to withholding has the option of filing a similar election. By filing the appropriate election, such items of income must be reported in a personal tax return along with other Canadian source income (e.g. income from employment or business, and capital gains on dispositions of taxable Canadian property). This return must be filed within 6 months after the end of the calendar year. The benefit of this election has been substantially eroded, and has merit only in very limited circumstances. Personal tax credits are only partially available unless greater than 90% of the non resident's income for the year is taxable in Canada. Further, the non-resident will pay tax on the Canadian source income at a tax rate which reflects his/her world wide level of income. For example if a non-resident has worldwide income of \$105,000, he/she will have to determine the notional federal tax (including federal surtax) on that income as if all of the income is taxable in Canada. The 2011 effective rate is approximately 30%. If \$5,000 of the \$105,000 came from his/her RRSP he/she will pay Canadian tax of about \$1,432 on the RRSP withdrawal by making this election and \$1,250 if no election is made.

U.S. TAX ISSUES FOR CANADIANS

In recent years, the price of U.S. real estate has been exceedingly attractive and consequently, many Canadians have purchased U.S. real estate for investment purposes or as winter getaways. The U.S. tax consequences of such decisions may not have been fully considered. In addition, Canadians often travel to the U.S. in the course of business, employment or pleasure. It is often a surprise for the frequent traveller to find out that these trips may have caused him/her to fall into the U.S. tax net, and be subject to a myriad of U.S. compliance rules.

Although there are many U.S. issues that may affect the taxation of Canadians, the following comments are directed towards three specific concerns for Canadians who vacation or live in the U.S. for extended periods of time, or for those who own property in the United States. These comments only address federal U.S. tax issues. There may be additional consequences at the state and sometimes county or city levels that may have a bearing on the ultimate tax result.

U.S. Filing Requirements

As discussed in the section on Taxation of Non-Residents, an individual is subject to tax on his or her world income if he/she is resident in Canada. The same rules essentially apply in the United States. U.S. citizens are also taxed in the U.S. on worldwide income (with limited exceptions), regardless of where they are resident. The balance of the commentary will deal with U.S. considerations for Canadians who are not U.S. citizens.

Canadians (and other non-resident aliens) who vacation or are otherwise present in the United States for extended periods may

be considered to be U.S. residents for tax purposes, and may be required to file a U.S. tax return or other tax forms.

There are five sets of circumstances that may require attention.

- a) An individual who holds a U.S. "green card" is considered a resident of the United States, regardless of his actual presence in that country.
- b) An individual who is physically present in the U.S. for 183 days or more in a calendar year is deemed to be a U.S. resident.

Under the circumstance in a) and b) above, an individual is required to file a U.S. tax return and will be taxable on his or her world income. However, the Canada-U.S. Tax Treaty "tie breaker" rules may apply to determine which country has primary taxation authority. These tie-breaker rules, in the following order, look at which country an individual has: a "permanent home"; closer "personal and economic relations"; or a "habitual abode"; and the citizenship of the individual. If the preceding rules do not "break the tie", the issue will be resolved by the agreement of both governments. A person who meets the a) or b) circumstances above, but is found to be a Canadian resident under the "tie-breaker" rules, will still be required to file a form (Form 8833) with the IRS within certain time limits to claim the treaty relief. Form 8854 may also be required for long-term green card holders who are dual residents of Canada and the U.S., and claim that they are tax residents of Canada under the Treaty. If these forms are not filed, the IRS may deny treaty relief and assess U.S. tax on worldwide income. A person who is considered to be a Canadian resident under the "tie-breaker" rules will still be considered a U.S. resident under U.S. domestic law. As such he or she will be subject to other U.S. reporting rules including reporting ownership of non-U.S. corporations, transfers to and distributions from non-U.S. trusts, and receipts of non-U.S. gifts and bequests.

It should be noted that US green card holders may be subject to a U.S. expatriation tax if they filed Form 8833 and Form 8854 declaring that they were no longer tax residents of the U.S. The expatriation tax may also be eligible if a green card holder voluntarily abandons his/her green card by filing Department of Homeland Security Form I-407. The expatriation rules are intended to apply to taxpayers with substantial assets and income, but can apply to those who have not complied with U.S. tax obligations in the 5 years before expatriation. U.S. tax advice should be obtained before signing these forms to ensure that the signature does not trigger the U.S. expatriation rules.

- c) An individual who is present in the U.S. for 31 days or more, but less than 183 days in a calendar year, may also be considered to be resident in the U.S., if the individual meets a substantial presence test.

The substantial presence test is met, if the total of:

- all the days present in the current year (2011), plus

- 1/3 of the days present in the 1st preceding year (2010), plus
- 1/6 of the days present in the 2nd preceding year (2009)

equals 183 days or more.

The preceding calculation would result in 183 days if the individual spends at least 122 days (or essentially four months) each year in the U.S.

An individual may not be considered to be a U.S. resident in any year under the substantial presence test if the individual has a closer connection to Canada and files a “Closer Connection” statement (Form 8840) with the IRS. In order to make this claim, the person must be present in the U.S. on fewer than 183 days during the current year, had a tax home in a foreign country during the same year, and had a closer connection to that foreign country than to the U.S. during that year. The individual must meet all three criteria in order to make a “Closer Connection” claim. The IRS will look at factors similar to the personal and economic relations test under the Treaty in order to determine whether an individual has a closer connection to Canada.

A green card holder should consider his/her immigration status (and the potential of being subject to the expatriation tax) before making the “Closer Connection” claim.

- d) The individual carries on business or earns employment income in the U.S.

If an individual carries on business in the U.S. (either directly or through a partnership), or earns employment income in the U.S., he or she may be required to file a U.S. tax return. This is the case, even if his business or employment activities are exempt from U.S. tax under a provision of the Canada-U.S. Tax Treaty. Under the recent amendment to the Canada-U.S. Tax Treaty, Canadians who work in the U.S. will find themselves taxable in the U.S. if they are physically in the U.S. for more than 183 days in any twelve-month period. It is often difficult to know whether a person is on-side with respect to this rule in any year since the twelve-month period may fall in two calendar years. If the individual sold U.S. real property interests (whether or not they are capital assets), or elected to treat U.S. real property rental income as effectively connected to a U.S. business (thereby avoiding U.S. withholding tax on the gross rental income), the individual will be required to file a U.S. tax return. The election to treat U.S. rental income as effectively connected income is permanent and can only be revoked in limited circumstances.

If the income is exempt from U.S. tax under the Canada-U.S. Tax Treaty, a U.S. tax return and form 8833 must be filed in order to claim treaty relief. U.S. state tax, however, may still be payable.

- e) Former permanent residents (i.e. green-card holders) or citizens of the U.S. may continue to have an obligation to file in the U.S. and report world-wide income if they returned to the U.S. for a minimal amount of time during any of the 10 subsequent calendar years. The income may be exempted from U.S. tax under the Treaty and the procedures detailed above must be followed to claim the Treaty exemption.

If an individual is not caught by a), b), c), d) or e), no filings are required. On the other hand, if a tax return or closer connection statement is required, it should be filed by June 15 of the following year. If a return is not filed by 16 months after the end of the year, the IRS may deny all deductions and tax credits, which may otherwise be applicable.

Even if an individual is not subject to U.S. filing requirements because he or she is not considered a U.S. resident or did not earn income subject to U.S. tax, certain types of income are subject to U.S. withholding taxes. The rate of withholdings may vary, but is generally reduced by the Canada-U.S. Tax Treaty. The U.S. payor will generally request the Canadian recipient provide a W-8Ben form to certify that he/she is eligible for the reduced withholding tax rate. Such income would also be reportable in Canada, in Canadian dollars, and the withholding taxes should be available, with certain restrictions, as foreign tax credits against taxes payable in Canada.

The U.S. has introduced tax return filing requirements for certain recipients of income eligible for reduced withholding tax under the Treaty. Generally a tax return, and Form 8833 may be required if there is significant related party payments of such income, or if special conditions needed to be satisfied in order to qualify for treaty benefits.

Clearly if one feels he or she may be subject to these U.S. requirements, professional assistance should be sought.

U.S. Estate Taxes

The United States imposes an estate tax on the value of assets owned by an individual at the time of death. The estate tax rate has been gradually reduced and the exemption threshold has been increased over the last number of years. Under previous legislation, the estate tax was to have been eliminated for 2010. The federal estate tax was reinstated from 2010, but at a reduced maximum tax rate and increased exemption threshold. The maximum rate of 35% and \$5 million threshold will apply for deaths occurring in 2010 to the end of 2012. Without further legislation, a 55% rate and the exemption of \$1 million will apply beginning in 2013.

Executors have the option of electing out of the tax for deaths that occurred in 2010. If this option is chosen, the assets will pass through to the beneficiaries at the decedent's cost. However, the executors may elect to step-up the cost of the assets by up to U.S. \$1.3 million plus another U.S. \$3 million for assets inherited by a surviving spouse. If the election is not made, the estate tax will apply but the assets will have a full step up to fair market value on death. The IRS has announced that the election must be filed by November 15, 2011 on Form 8939. The U.S. estate tax is also applicable to non-residents who own U.S. property such as real estate (including vacation property), shares of U.S. corporations (including shares owned through RRSPs and RRIFs), as well as certain debt obligations owed by U.S. persons. Although shares of a U.S. company are included in an individual's U.S. estate (including shares of a U.S. company purchased through a Canadian stock exchange) for purposes of the U.S. estate tax, shares of a non-U.S. company owning U.S. assets, including real estate, are generally not subject to this tax.

In determining the value of an estate for U.S. tax purposes, certain deductions are allowed from the gross value of the deceased's assets. These deductions include property left to a deceased's spouse who is a U.S. citizen, property left to a "qualified domestic trust", a non-recourse mortgage on U.S. property, and certain liabilities at the time of death.

Once the value of an estate for U.S. estate tax purposes has been established, a tax exemption of U.S. \$13,000, effectively equal to U.S. \$60,000 of value, is provided for all non-residents under U.S. domestic law. After this threshold, the tax rates may become very onerous.

The following table summarizes the current status of the U.S. estate tax.

| Year | Estate Tax Exemption Threshold U.S. \$ | Maximum Estate Tax Rate % |
|---------------|---|---|
| 2010 | \$5 million (unless election made not to have estate tax apply) | 35% (unless election made not to have estate tax apply) |
| 2011 and 2012 | \$5 million | 35% |
| 2013 Onwards | \$1 million | 55% |

The Canada-U.S. Tax Treaty contains a number of provisions which will help mitigate some of the problems in connection with the U.S. estate taxes.

The following example illustrates how the estate tax credit will be calculated in 2011. Assume at the time of his/her death, a

Canadian resident owned assets with a total value of U.S. \$5,000,000, of which U.S. \$250,000 were investments in U.S. property. His/her U.S. estate tax (before the tax credit) on the U.S. \$250,000 of U.S. assets would be \$70,800. Under U.S. domestic rules, his/her estate would only be able to claim a credit of U.S. \$13,000, and the net U.S. estate tax would be U.S. \$57,800. The credit available to U.S. residents on the \$5 million exemption would be \$1,730,800. The Canada-U.S. Tax Treaty would increase the amount of the credit as follows:

$$\frac{\text{Total Value of U.S. assets}}{\text{Total Value of all assets}} \times \text{U.S. } \$1,730,800$$

$$\frac{\text{U.S. } \$250,000}{\text{U.S. } \$5,000,000} \times \text{U.S. } \$1,730,800 = \text{U.S. } \$86,540$$

Since the available credit is greater than the actual U.S. estate tax of \$70,800, there will be no U.S. estate tax payable as a result.

The Canada-U.S. Tax Treaty provides some additional relief for Canadian residents with worldwide estates valued at less than U.S. \$1.2 million. Under these relieving provisions, only U.S. real estate and certain business property will be subject to U.S. estate tax. Keep in mind, however, that there are a number of differences between Canadian and U.S. rules concerning the determination of the value of an estate. For example, the value of a life insurance policy on the deceased's life is includable in the gross value of an estate for U.S. purposes. These differences may result in a higher value of the worldwide estate for U.S. purposes, and cause the estate to exceed the \$1.2 million threshold.

An executor must file a U.S. estate tax return for the deceased if the total U.S. property has a value exceeding U.S. \$60,000, even if no tax is payable. It is not clear as to the filings that are required for a death which occurred in 2010. The U.S. estate tax return will require disclosure of all of the deceased's worldwide assets, not only U.S. based assets. The estate tax return is normally due within 9 months after death.

Estate taxes are taxes on the value of a property, not on the gain related to ownership. Such a gain may be subject to income tax in Canada as a capital gain (see our commentary regarding Death of a Taxpayer). U.S. estate tax is not considered an income tax and would not be creditable as a foreign tax credit in Canada against the tax associated with the gain on the same property except for the specific relief provided under the Treaty. The Treaty provides that both Canada and the U.S. will allow a credit for tax arising in the other country as a consequence of death. This may in some cases resolve the potential double taxation.

Property which is transferred to a surviving spouse may escape U.S. estate tax or Canadian capital gains tax on death under certain circumstances.

For those Canadians with significant estates, the existing problems have not been solved and the current somewhat unsatisfactory solutions must still be considered. There have

been a number of planning techniques developed to address this potential problem, including the use of a Canadian corporation to hold U.S. property. Each solution unfortunately has related shortcomings or other problems.

These (partial) solutions may include:

- 1) *Acquire property jointly with a spouse or perhaps children. Each individual must use his or her own funds.* Simply taking title in two names or giving the second individual the funds for the purchase will not avoid estate taxes. It is generally not advisable to hold the interest in joint ownership with right of survivorship as U.S. estate tax may be payable on each death.
- 2) *Attach non-recourse financing to the U.S. asset, either upon acquisition or at some later date, to reduce the net amount subject to tax.* Non-recourse financing is debt on which a lender may seize only the secured property and not otherwise recover from the debtor. Although available, this type of debt may be more difficult or expensive to obtain.
- 3) *Obtain life insurance specifically to fund the estate tax liability created on death.* The life insurance should not be underwritten by a U.S. insurance company, for the death benefit may also be subject to U.S. estate tax. In addition, the foreign insurance policy may be subject to the FIE rules discussed in the Investment section.
- 4) *Sell the asset, perhaps to a family member, during lifetime. Payment should be in the form of asset(s), which may include a promissory note, held outside the United States.* Consideration must be given to any tax consequences, Canadian and U.S., resulting from the sale (e.g. capital gains tax or gift tax). In addition, U.S. estate tax may be payable on the death of the family member.
- 5) *Acquire or perhaps transfer U.S. assets, other than personal-use assets, to a Canadian corporation.* This should remove the asset from the U.S. estate tax net, as the deceased would own shares of a Canadian corporation, not the U.S. asset directly. Extreme care must be taken with this type of planning as the IRS may attempt to “look-through” the corporate ownership. One additional U.S. disadvantage to owning a residence in a corporation is the fact that on the sale of the residence, the corporation is not eligible for the U.S. low long term capital gains tax rate available to individuals. In addition, the CRA would no longer grant administrative relief and exempt a shareholder from being assessed a taxable benefit with respect to personal use of corporate assets. Administrative relief remains available with respect to arrangements in place on June 23, 2004, until the property, or the corporation

holding the property, is sold.

- 6) *Set up a spousal trust which qualifies for rollover treatment under both U.S. estate tax law and Canadian tax law.*
- 7) *Use a Canadian partnership to hold the U.S. asset.* The partnership may elect to be treated as a corporation for U.S. tax purposes.
- 8) *Use a trust to hold the U.S. asset.*

U.S. estate tax may be avoided under either 7) or 8). These strategies may, however, result in a number of potential income tax issues, and this type of planning should not be undertaken without careful consideration. Clearly, professional advice is warranted in this complex area.

U.S. Taxes on Sale of U.S. Real Estate

The gain from the sale of U.S. real estate is subject to tax in the United States. This includes the gain on sale of shares of U.S. real estate companies. All of the gain (subject to treaty relief discussed below) is taxable in the U.S. However, the maximum U.S. federal tax rate on gains for assets held for more than 12 months is 15% in 2010 - 2012, and 20% in 2013. State tax may also be payable on the gain. The same gain in the hands of a Canadian resident is also subject to tax in Canada. The maximum combined federal and provincial tax rate in Ontario is 23% in 2011. Any U.S. taxes on the gain should be available as a foreign tax credit against Canadian taxes on the property.

If the U.S. property has been owned since September 27, 1980, only the gain since January 1, 1985 will be subject to U.S. tax. The gain can be calculated based on a value of the property at January 1, 1985 or alternatively based on a proration of the gain over the period of ownership. Form 8833 will need to be filed in order to benefit from the treaty relief. The treaty may not reduce state income tax, as not all U.S. states grant relief in accordance with the treaty.

The Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”) provides for a withholding of 10% of the total selling price, even if some of the proceeds may not be due at the time of closing (i.e. an instalment sale for U.S. purposes). The withholding can be refunded if the ultimate tax is less than that withheld, but a return must be filed. An exemption from, or reduction of withholding is available by applying to the IRS for a “withholding certificate” before the sale. This exemption process is vital, particularly on instalment sales. An exemption from FIRPTA withholding is also available if the sale price is less than U.S. \$300,000 and the purchaser will occupy the property as a residence.

Certain states also have state withholding tax on sale of real property located in the state, and should not be forgotten.

EMPLOYEE STOCK OPTIONS

The taxation of employee stock options is relatively complex. The rules, however, are worth careful scrutiny because the results might be significant and the relieving provisions could be substantial.

Taxable Benefit

In addition to a good salary, employees fight hard to achieve the ultimate recognition: job perks. It used to be that a prized employee was rewarded with company cars, club memberships, big offices and important sounding job titles. Since the dot.com boom of the late 1900's and the early 2000's, employee stock options had been the most talked about and most demanded prize. The tax rules concerning stock options give employees tax consequences that are generally more favourable than other forms of benefits. However, with the recent volatility of the stock market, some employees may prefer the more traditional forms of compensation. The recent government proposals will likely further dampen the enthusiasm for this type of compensation.

There are many variations of stock based compensation plans, each offering the employee the opportunity to share in an increase in the value of the employer. Generally, when a stock option is granted to an employee, the employee has the right, either immediately or in the future, to buy shares of the employer, or a corporation related to the employer, at a fixed price. Restricted stock units plans, on the other hand, allow employees the right to purchase or receive shares once certain restrictions, such as working a certain number of years or achieving certain performance targets, are met. Employee stock purchase plans usually provide employees the right to purchase company shares at a discount. There are also plans such as phantom stock plans which pay future cash bonuses equal to the value of a certain number of shares. With the exception of the phantom stock plan under which no shares are to be issued, the tax benefits of the other plans are measured under stock option rules.

Assume that a corporation, Employerco, a Canadian Controlled Private Corporation ("CCPC"), granted its employee James Worker an option to purchase 1,000 common shares of Employerco at \$10 per share, and the options vested immediately. At the time the option was granted, the shares of Employerco were worth \$5 per share. If James exercised the option at a time when the share value was \$10 a share, there would be no immediate tax consequence to James.

If the value of the Employerco shares remains below \$10, Employerco may exchange the stock option held by James for new stock options with a lower exercise price. As long as the exchange does not result in an increase of the net benefit associated with the stock option, the exchange of stock options

will not result in an immediate tax liability to James. For example, when James received the original stock options, there was no net benefit to him because the exercise price exceeded the fair market value of the shares. If the stock option exercise price were dropped to \$8 per share at a time when the Employerco shares were worth \$8 per share, there would still be no net benefit to James. The exchange, therefore, would not result in any immediate tax benefit to James. Under proposed rules, when enacted will have retroactive effect to 1999, the same result may be achieved with a reduction of the exercise price under the existing stock option plan.

Assume the stock option exchange did not take place. James decides to exercise the stock option when the shares are worth \$18 per share. Once James buys the 1,000 shares under the stock option plan, he will realize a taxable benefit of \$8,000 which is equal to the difference between the fair market value of the shares (i.e. \$18,000) on the day the shares are purchased and the option exercise price of \$10 per share (i.e. \$10,000). Since Employerco is a CCPC at the time the options were granted to James, James would not be taxed on the benefit until he actually sold the shares. That would be true even if Employerco were no longer a CCPC when James purchased the stock option shares. In the year of sale, if certain conditions (described in the section concerning stock option deductions) are met, he will be able to claim a deduction to partially offset the amount of the taxable benefit. The net amount taxable (as the example in the "Sale of Stock Option Shares" section in this commentary illustrates) should be equivalent to the capital gains inclusion rate.

Employees who receive shares of private corporations, other than CCPC shares, will not benefit from these rules.

If Employerco were a publicly listed corporation, James would be taxed on the benefit when he exercised the option and purchased the shares. The ability to defer the taxable benefit resulting from the exercise of a public company stock option has been eliminated for options exercised after March 4, 2010.

If James owned other shares of Employerco (that he had purchased from a third party, for example) in addition to shares purchased under a stock option plan, there are complicated rules that will govern the timing of the recognition of any taxable benefit. Generally, shares that are held for the longest period are considered to be sold before other shares the employee owns in the same corporation, i.e. on a first-in, first-out basis. Shares which have been purchased outside of a stock option plan, however, will be deemed to have been purchased before shares acquired from a stock option plan, i.e. they will be considered to be sold first. There is an exception to the above ordering rules. An individual may make an election to designate stock option shares purchased 30 days before a sale to be the shares that are sold.

Sale of Stock Option Shares

If stock option shares are sold immediately after they are

acquired, the employee will be taxed on the difference between the fair market value and the exercise price as an employment benefit. The entire amount of the taxable benefit, without regard to the stock option deduction and the additional deduction referred to in the following paragraphs, will be added to the cost of the shares. Generally, no capital gain or loss will result.

If the shares are held for a period after the stock options are exercised, any increase in the value of the shares will be taxable as a capital gain. Alternatively, the employee may find that the share value has eroded. If he/she then sells the shares, he/she will realize a capital loss, which cannot be used to reduce the employment benefit previously realized. The capital loss can only be utilized against capital gains (not employment income). Therefore, even though the rules may permit a deferral of the taxable benefit if the shares are not sold, it may still be advisable to sell the shares at the same time the stock option is exercised, particularly if the share price is volatile.

The following example illustrates James' tax consequences assuming Employerco is a CCPC.

| | |
|--|------------|
| FMV of shares when stock option exercised (\$18 x 1,000) | \$18,000 |
| Stock option exercise price (\$10 x 1,000) | (\$10,000) |
| Taxable benefit | \$8,000 |
| Stock option deduction (½ of taxable benefit) | (\$4,000) |
| Net amount taxable | \$4,000 |
| If the shares were sold for \$15 per share: | |
| Sale price (\$15 x 1,000) | \$15,000 |
| Cost of shares (\$10,000 + \$8,000) | (\$18,000) |
| Capital loss | (\$3,000) |
| If the shares were sold for \$20 per share: | |
| Sale price (\$20 x 1,000) | \$20,000 |
| Cost of shares | (\$18,000) |
| Capital Gain | \$2,000 |

Sales of Underwater Shares

As noted previously, employees who have exercised stock options of publicly traded companies before March 4, 2010 were able to elect to defer the recognition of the taxable benefit associated with the exercise. They may face significant tax liability with no ability to meet their obligation if they sell the shares when the share values have dropped significantly since their purchase.

These individuals may elect to undo the effect of the election if the optioned shares are sold before 2015. If this election is made in the year of sale, the employee may claim a deduction equal to the full amount of the stock option benefit that is required to be recognized in the year of sale. To counter the effect of the capital loss that will be realized in the year of sale, the employee must also recognize a capital gain equal to the lesser of the stock

option benefit and the capital loss from the optioned shares. The employee must also pay the amount received as proceeds as a special tax.

The impact of these rules can be illustrated by modifying James's tax consequences as previously summarized.

| | |
|---|------------|
| FMV of shares when stock option exercised (\$18 x 1,000) | \$18,000 |
| Stock option exercise price (\$10 x 1,000) | (\$10,000) |
| Deferred Taxable Benefit – taxable in year of sale | \$8,000 |
| Stock option deduction in year of sale | (\$8,000) |
| Net amount taxable | \$0 |
| If the shares were sold for \$15 per share: | |
| Sale price (\$15 x 1,000) | \$15,000 |
| Cost of shares (\$10,000 + \$8,000) | (\$18,000) |
| Capital loss | (\$3,000) |
| Deemed capital gain (lesser of stock option deduction & capital loss) | (\$3,000) |
| Net capital gain | \$0 |
| Special Tax payable=Sales price | \$15,000 |

This election can also be made in respect of sales that occurred in prior years as the tax department will consider the election to be an application under the Taxpayers' Relief provisions, under which the tax department may make adjustments for up to 10 years.

Whether the election is a good idea will depend on whether the employee can otherwise utilize the capital loss, and the quantum of the special tax in comparison to the tax payable on the taxable benefit. For example, without the election, James would have a taxable benefit of \$4,000, and a capital loss of \$3,000. The tax payable on the taxable benefit, even if James cannot utilize the capital loss, is minor in comparison to the special tax payable of \$15,000.

Stock Option Deduction

James will be able to claim a deduction to partially offset the amount of the taxable benefit if he held the Employerco stock option shares for two years before selling. Alternatively, since James received ordinary common shares under the stock option plan, and the exercise price of \$10 per share was greater than the fair market value of Employerco shares on the date the option was granted to him, James would be able to claim a stock option deduction even if he held the shares for less than two years. The ½ deduction results in net taxable amounts that are comparable to capital gains.

If Employerco shares were publicly listed, James would be eligible to claim a similar deduction in the year the option shares were exercised or sold, depending on whether the shares qualified for the deferral.

If James had exercised his stock options in a publicly listed Employerco on June 1, 2007 (and was eligible to defer the taxable benefit under the rules discussed previously), and he sold the shares on January 1, 2011, he would be taxed on the \$8,000 taxable benefit in 2011. The result would be as illustrated in the example under the “Sale of Stock Option Shares” section. He would be able to claim a deduction equal to ½ of the \$8,000 taxable benefit. The net amount taxable to him in 2011 as an employment benefit would be \$4,000.

In the example, James also realized a capital gain or loss as a result of a fluctuation in the share price of Employerco after the exercise date. In determining the cost of the stock option shares, the taxable benefit is added to the actual cost to the employee. The stock option deduction does not reduce the cost of the shares.

Due to the plunge in stock prices a few years ago, many corporations had adjusted the exercise prices of existing stock options downward. If the new exercise price were less than the fair market value of the shares when the options were initially granted, the employee would not be able to claim the deduction. The government proposed rules, which are retroactive to price reductions that occurred after 1998, to consider new rights to have been issued at the time of the price reduction. As long as the new exercise price was the fair market value of the shares at the time of the price reduction, the employee would be able to claim the stock option deduction.

The stock option deduction is increased to 100% of the stock option benefit if the election in respect of underwater shares is made (see that section for more detail).

Some employees are permitted under the stock option plan to receive cash in lieu of shares. If an employee receives cash or in kind payment, the employee will not be eligible for the stock option deduction. The employee is eligible to claim the deduction if the employer makes an election that neither the employer nor any non-arm’s length parties will deduct any amount in respect of the payment, other than any payments to third parties to manage the financial risk of stock option plans. The employer election must be filed with the tax department, and the employee must be provided evidence in writing of the election, which must be filed with the employee’s tax return.

Donation of Publicly - Listed Shares Received Under A Stock Option

In order to encourage charitable giving, the federal government allows an additional deduction if an employee who exercises a stock option chooses to benefit a charity. He/she may either donate the stock option shares within 30 days of acquiring the shares, or direct the administrator of the stock option to sell the shares within 30 days and donate all or part of the proceeds to a qualifying charity.

The amount of the deduction will be 1/2 of the taxable benefit. The deduction of ½ of the taxable benefit in effect exempts the entire

benefit from tax. This parallels the changes made to the capital gains inclusion rate for other donated property.

If the shares decrease in value between the time they are acquired and the time of the donation, the amount of the additional deduction will be based on the lower value. Therefore, *employees who are interested in donating stock option shares should do so immediately after exercising their stock options.*

THE HARMONIZED SALES TAX (HST)

The Goods and Services Tax (GST) has been a fixture in the Canadian tax system for over 20 years. Since July 1, 2010, Ontario and BC joined the existing participating provinces of Nova Scotia, New Brunswick and Newfoundland in harmonizing their provincial sales taxes with the federal GST. The combined tax is the HST. BC’s voters have since voted for a return to the old PST system, and the transition back is expected to be completed by March 2013. Quebec administers its own sales tax system (QST), which combines the collection of GST with the QST. The First Nations Goods and Services Tax (FNGST) is an equivalent tax on goods and services on certain First Nations lands. Other First Nations impose the First Nations Tax (FNT), which applies only to alcohol, fuel and tobacco products. GST is applicable in the rest of the country. The CRA administers the GST, HST, FNGST and the FNT, which operate under similar rules. The following will generally only address the HST as it applies in Ontario.

The GST rate in non-participating provinces (i.e. one that HST does not apply) is currently 5%. Previously, the provincial portion of all of the HST provinces was 8%, or a combined HST rate of 13%. With the advent of HST in Ontario and BC, the provinces are now free to vary the provincial portion of the HST rates by giving the federal government 120 days notice. Nova Scotia has increased its HST to 15%, effective July 1, 2010. The BC HST rate will remain at the 12% rate until the PST is re-implemented.

Quebec was ahead of the alarming trend of increasing provincial sales tax rate. It had increased the QST from 7.5% to 8.5% effective January 1, 2011, and will further increase to 9.5% effective January 1, 2012. Since the QST is imposed on the sales price including the GST, the effective combined QST/GST is 13.92% in 2011 and 14.97% in 2012.

With the exception of transitional rules, and the continuation of certain exceptions under the former provincial sales tax (RST), the HST in Ontario will operate essentially the same way as the GST.

The following are a few comments on specific HST issues that may affect individual taxpayers.

Employees

Employment income and benefits

Wages and salaries are not subject to HST.

The amount of fringe benefits to be included in the employee's income is to be determined inclusive of any GST /HST or PST paid by the employer for the property or service which gives rise to the benefit even if sales tax is not actually payable because of the status of the employer (e.g. municipality), or the use of the property (e.g. fixture to real property).

Employee Rebate

Employees may, in certain circumstances, file for a rebate of the HST they have paid on certain expenses and on capital cost allowance ("CCA") relating to an automobile. An employee may be able to claim a HST rebate on certain expenses, provided several conditions are satisfied, including that the employee is entitled to claim a deduction for the amount under the Income Tax Act and

the employer is registered under the HST. Further, if the employee receives mileage reimbursement from his/her employer, he would be entitled to a HST rebate only if the employer certifies that the reimbursement is unreasonable, and that the employer would not be claiming a HST credit with respect to the notional HST on the amount of the reimbursement. As a result, this rebate is not available to all employees.

The amount of the rebate will depend on whether GST or HST has been paid on the purchase. The rate is 5/105 if only GST was paid, and the relevant HST rate (i.e. 13/113 if HST was paid in Ontario) of the expense being deducted or of the CCA being claimed. The rebate rate on CCA will depend on whether GST or HST was paid on the purchase of the car. In Schedule 5, the example shows how this would be calculated. GST/ HST must have been paid before the rebate is available. Many expenses include HST such as gasoline, parking expenses, airline tickets, meals, hotels, and so on. Others do not, such as interest, and insurance.

The rebate is the good news. The bad news is that a rebate received in the year must be included in income in the year received or reduce the capital cost of the asset on which the

**SCHEDULE 5
GST/HST REBATE TO EMPLOYEE - EXAMPLE**

| | 2011 Expenses \$ | 2011 Income Inclusion \$ |
|--|---------------------|--------------------------------|
| Automotive Costs (actual total costs) | | |
| Oil and gas | 1,070 | |
| Insurance | 720 | |
| Interest on bank loan | 780 | |
| Repairs and maintenance | <u>650</u> | |
| | 3,220 | |
| Capital cost allowance (car purchased in 2009) | 3,000 | |
| | 6,220 | |
| Less personal portion - say 25% | (1,555) | |
| | <u>4,665</u> | |
| GST/HST Rebate | | |
| Costs on which 5% GST was paid | | |
| Capital cost allowance | <u>3,000</u> | |
| | <u>3,000</u> | |
| Deductible for income tax - say 75% | <u>2,250</u> | |
| Rebate 5/105 x \$3,540 | <u>107</u> | |
| Costs on which 13% HST was paid | | |
| Oil and gas | <u>1,500</u> | |
| Deductible for income tax - say 75% | <u>1,125</u> | |
| Rebate 13/113 x \$1,125 | <u>129</u> | |
| Total rebate claimed | <u>237</u> | |
| Impact of GST/HST rebate, filed for 2010, received in 2011 | | |
| Income inclusion - \$ 1,500 x 75% x 13/113 | | 129 |
| Deduction from capital cost - \$ 3,000 x 75% x 5/105 | | <u>107</u> |
| | | <u>237</u> |

rebate was calculated. Schedule 5 illustrates the effect of the rebate on the income of the taxpayer.

An employee has four years from the end of the year in which the amount was claimed as a deduction to apply for the rebate. Application for the rebate is usually made in the personal income tax return for the appropriate year, by filing a special rebate form (Form GST 370) with the return. The rebate can reduce an individual's regular tax payable or increase a refund for the year of the claim.

Self-employed Individuals

As is the case under income tax laws, the HST rules affecting a self-employed individual are different from those affecting an employee. A self-employed individual may be able to claim a refund of all of the HST paid relating to his or her commercial activities, provided that person is registered.

Registration under the HST is required for self-employed individuals who carry on HST taxable activities that generate more than \$30,000 of gross revenue in a fiscal year. Registration is optional to those with gross taxable revenues under \$30,000 per year. For those self-employed individuals who carry on exempt activities, registration is not required. These include doctors and dentists. Accordingly, these individuals cannot recover the HST on their expenses. If these individuals also carry on taxable activities over the \$30,000 threshold, they will be required to register and charge HST (and recover HST on a portion of their expenses) on the taxable activities.

An individual who is registered will be required to charge the HST to his or her customers/clients on whatever taxable goods and services are provided. The individual should be able to claim input tax credits. Where the individual is entitled to claim full input tax credits, the HST should ultimately not be a cost of doing business. In fact, the business should achieve a cost savings since PST previously imbedded in the individual's costs will now be recoverable as HST paid.

Where an individual is not required to be registered (e.g. those in exempt activities or gross revenues under \$30,000), HST would not be charged on sales. However, input tax credits would not be available. Some relief is provided though, as the HST paid on expenses of the business would be deductible for income tax purposes.

For small businesses, a simplified method of accounting known as the "Quick Method" may be used. Many businesses with annual taxable sales of \$200,000 or less (including GST or HST) can use this method. As the \$200,000 threshold includes HST, fewer businesses will be able to utilize the "Quick Method" since Ontario adopted HST. Accountants, lawyers or financial consultants cannot use this method.

Under the Quick Method, instead of remitting the net of GST/HST collected and GST/HST paid, a fixed percentage of

sales is remitted. The percentage varies depending on whether the business operates through a permanent establishment in a HST or non-HST province, and whether the sale is made in a HST or non-HST province. The following chart summarizes the remittance rates for a business that operates through a permanent establishment in Ontario.

| | Sales of Services | Sales of Goods |
|---|-------------------|-------------------------|
| Supplies made in Non-HST province | 1.8% | 0% (and 2.8% credit) |
| Supplies made in BC | 8% | 3.6% |
| Supplies made in NS | 10.4% | 6.1% |
| Supplies made in any other HST province | 8.8% | 4.4% |

These rates are lowered by 1% for the first \$30,000 of tax-included sales. Input tax credits are not available under this method, except on capital purchases. Businesses with few taxable expenses should consider using this method.

As an alternative to the Quick Method, a streamlined accounting method for claiming input tax credits is available for businesses with annual sales not exceeding \$500,000, and taxable purchases of less than \$2 million. Under this method, businesses would total purchases and separate those purchases that are subject to only GST from purchases that are subject to HST. The business will claim 5/105ths of the total GST paid purchases as input tax credit. It may also claim input tax credit at the relevant rate, depending on the province, if HST was paid on the purchases. Under this method, purchases include GST/HST, provincial sales tax, late payment penalties, interest charges on late payments and tips. This method should result in a larger claim for input tax credits than the actual amount of GST/HST that was paid.

Partners

Partners may be able to claim a rebate similar to that claimed by an employee, as discussed earlier. There are, however, two main differences between these rebates. The partnership in which the partner is a member must be registered under the HST. In addition, the partnership must have been entitled to claim an input tax credit if it (the partnership) had incurred the expense rather than the partner.

Where these criteria are satisfied and the partner is entitled to deduct the amount for income tax purposes, the partner would be entitled to claim a HST rebate relating to the expenses incurred, including CCA. As with employees, the rebate must be included in income or reduce the capital cost of an asset on which the rebate was calculated, in the subsequent year.

Other Matters

HST Credit

The purpose of this credit is to provide some financial assistance to families with low or modest income. The credit is supposed to offset all or part of the HST paid by these families. However, the amount of the credit does not bear any relation to the actual HST paid. Rather, it is based on family income. The credit is tax free and is usually paid in quarterly instalments.

For those entitled to the credit, the CRA mails cheques in July, October, January and April. A single payment in July is made for those eligible for less than \$100 in HST credit.

Ontario Sales Tax Transition Benefit (OSTTB)

To ease the transition from the Ontario retail sales tax to the HST, there is a temporary relief available. The relief is in the form of three tax-free payments, the last of which was payable in June 2011. In order to receive the June 2011 payment, the 2010 income tax return must be filed no later than April 30, 2012.

The maximum benefit available to a single person is \$300 (\$100 per payment). The benefit is reduced by 5% of income in excess of \$80,000, and will be phased out if income exceeds \$82,000. The maximum benefit available to single parents or couples is \$1,000, with payments of \$330, \$335 and \$335. The phase out range is between \$160,000 and \$166,700 of net income.

Purchase of a New House

The purchase of a newly constructed home in Canada is a HST taxable event. That is, the HST (based on the purchase price) is added to the cost of a home. Now, not only will the purchase of the family dwelling be the largest single expenditure for many Canadian families, but it may very well be the largest single outlay of HST that a family may make.

HST New Housing Rebate

The HST new housing rebate may be available to the purchaser of a new house. The rebate is only available provided certain conditions are satisfied. The key condition is that the purchaser (or a relative) intends to use the house as a primary place of residence. The rebate is not available to speculators or to those who intend to rent the property.

Provided this and other conditions are satisfied, the HST rebate is available. The federal and provincial portions of the HST rebate are calculated separately.

The maximum rebate of the federal portion of the HST is \$6,300. If the purchase and sale agreement was entered into prior to the GST rate change to 5%, the maximum rebate would be different. The maximum rebate is available when the purchase price is

\$350,000. Where the price is less than \$350,000, the rebate is equal to 36% of the federal portion of the HST paid. If the purchase price is more than \$350,000, then the rebate is reduced, such that at a price of \$450,000, no rebate is available.

The rebate form must be filed within two years after ownership has been transferred. It is possible to have the builder credit the rebate against the HST payable so that the purchaser pays the net HST after deducting the rebate.

The Ontario portion of the HST rebate is 75% of the provincial portion of the HST up to a maximum rebate of \$24,000. This in effect will mean that the Ontario portion of the sales tax will be applied at 2% on the first \$400,000 of the purchase price, and 8% on the balance. Unlike the federal portion of the rebate, the Ontario rebate is not eliminated on higher-priced homes.

Ontario Transitional Housing Rebate

There is often a time lag between the time the sales agreement is signed and the actual completion and transfer of the ownership of the home. The two events may straddle the implementation of the HST in Ontario.

The HST will not apply to the sale of a new or substantially renovated home if either ownership or possession of the home was transferred before July 1, 2010. If both ownership and possession were transferred on or after July 1, 2010, the HST will apply unless the transitional rules apply.

These transitional rules are very complicated and may require a PhD in both math and literature. Here they are anyway.

Sales of new homes under agreements entered into on or before June 18, 2009 will not be subject to the provincial portion of the HST even if ownership and possession of the home are transferred on or after July 1, 2010. The builder must, however, pay an amount to account for tax that would otherwise have been embedded in the new homes under the pre-July 1, 2010 system but not paid because part of the cost was incurred under the new system. The tax adjustment is not required if the home was 90% or more completed on July 1, 2010. The builder of a new condominium unit or building must pay a tax adjustment of 2% of the purchase price, but will be entitled to claim the transitional rebate described below.

If the new home is subject to the HST, but the construction was completed in full or in part prior to July 1, 2010, there was in effect a doubling up of the Ontario portion of the sales tax. The builder would have paid sales tax on the cost of the home, and the home-buyer would pay it again in the form of HST. A transitional housing rebate is available to the buyer to offset the embedded sales tax. The rebate may be applied directly with the CRA or through the builder by assigning the rebate to the builder, similar to the HST Rebate system. The builder, not the

purchaser, will be entitled to the rebate in the case of a residential condominium.

The rebate will be calculated using one of two methods. It will be based on estimated RST content calculated at a prescribed amount per square metre of floor space, or 2% of the selling price. A portion of the resulting estimated RST content may be claimed as a rebate, based on the percentage of completion of the property on July 1, 2010. No rebate is available if the home was less than 10% completed on that date.

The application for the transitional rebate must be filed before July 1, 2014.

Purchase/Sale of a Used House

The sale of used (previously owned) housing is exempt from HST. Plain and simple. The purchaser does not pay any HST on the transaction. As a result, the HST new housing rebate does not apply. If HST is not paid, then the purchaser should not be entitled to a rebate.

It should be noted though, that HST will apply to legal fees, moving costs, real estate agents' commissions and other costs associated with purchasing or selling a house (new and resale).

Rental Properties

If you own residential real estate which is rented out, no HST will apply to the rent. Accordingly, one will not be able to recover HST paid on expenses related to the property.

If you have built, renovated or converted property into residential rental units you will be allowed a rebate equal to the new housing rebate on the HST paid or self-assessed. The full rebate will be available for rental units valued up to \$350,000. A reduced rebate is available for units between \$350,000 and \$450,000 in value. The equivalent thresholds for land leased for residential purposes are \$87,500 and \$112,500.

Rental of commercial real estate is subject to HST and one is able to recover HST on expenses paid. If rental income is less than \$30,000 one can choose whether

to register for HST. The owner may wish to register and collect the HST if the property is rented to a business that supplies taxable goods or services. The tenant in this case will be able to claim an input tax credit on the rent, while the landlord will be able to claim input tax credits for HST paid on expenses.

Ontario New Rental Housing Rebate

The Ontario portion of sales tax on new rental housing will also be eligible for the maximum \$24,000 rebate, similar to the rebate on new homes.

Trade In of a Used Vehicle

HST is payable on the differential between the new car that is being purchased and the used car that is being traded in. If you are a HST registrant and you use your vehicle primarily for your business, you are required to collect the HST from the dealer and remit the amount to the CRA when you trade in your vehicle.





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