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WHO WANTS TO BE A TAX BILLIONAIRE

Game shows have been a part of our culture from the beginning of time. Jeopardy, The Price is Right, Wheel of Fortune, The Hollywood Squares, Let's Make a Deal, The Match Game, To Tell the Truth, What's My Line, The $100,000 Pyramid; these are just a few of the many game shows that have spanned the airwaves over the past half-century and have become ingrained as part of our every day lives. You would have to look high and low to find an individual who has not spent time in front of their T.V. set, glued to a game show at some point in their life. Geez, they even have a television network whose entire programming is devoted to game shows, both old and new.

What is it about game shows that grabs our attention? While every game show comes with its own twists and wrinkles, certain basic concepts are germane to every game show. At its core, the game show is a contest between two or more combatants, matching wits and using their consummate skill to win those fabulous prizes at the end of the show. While the contestants, might initially appear friendly, there is no doubt that as the tension mounts and they get closer to the big prize, the gloves are bound to come off. That's when the games begin.

Today, we're going to invite you to a game show that you probably didn't even know was a show. It is a battle that's contested every year between two able-bodied contestants: the government and the taxpayer, supported by his trusted tax advisor. It has all the elements of your classic game show; two fiercely competitive combatants fighting over the same prize—the "almighty tax dollar". What better prize could there be?

What you are about to experience is a fictional game show. Any resemblance to any of the "historic" or current game shows is purely coincidental. One might say that this game show is a blend of some of the great game shows of all time. So hold on to your hats. It's SHOWTIME !!!

THE GAME SHOW

Don For-Dough [Announcer] (in a deep baritone voice) These people, dressed as they are, come from all over Canada to save tax. Here in the marketplace of Canada, WHO WANTS TO BE A TAX BILLIONAIRE. And here is Canada's top taxman, TV's big dealer, Rich S. Cashbin.

Rich S. Cashbin: Thank you Don For-Dough. Thank you my friend. And welcome to another exciting edition of Who Wants to be a Tax Billionaire, Canada's number one-rated game show of all time. I'll be your host for the next hour ... Canada's most electrifying hour of television.

In a few moments we will select a lucky member from our studio audience to come on stage to match wits with the dreaded "TAXMAN" to try to score some of these precious tax dollars from his coffers. Since nobody should face the Taxman alone, each week we invite a celebrity tax advisor to help our contestant weave their way through the treacherous maze of rules to procure that tax money. Here he is, the master of the tax game, everybody's favourite tax advisor, TEDDY TAXPERT. [ROUSING APPLAUSE FROM THE STUDIO AUDIENCE]

Teddy Taxpert: Thank you thank you. What a pleasure being back on Who Wants to be a Tax Billionaire. To tell the truth, I love going head to head with the Taxman to fight for those tax bucks. We're really going to break the bank today Rich S.

Rich S. Cashbin: Okay Teddy. Let's bring on the competition. Here's everybody's favourite bad guy, The man who puts the "whammy" on every poor taxpayer; Every high roller's worst nightmare... THE TAXMAN.
Dramatically sinister music followed by large hissing from the studio audience.

The Taxman: I love it. They hate me. They really hate me. This tax game is bound to be a dog eat dog battle today, Mr. Cashbin. Teddy’s going to have to be on his toes to get the jackpot today. He’s going to require supreme concentration, because I’m at the top of my game. There can only be one survivor. This is no trivial pursuit.

Rich S. Cashbin: Ok, the lines have been drawn. It’s win lose or draw. There’s no love connection here. Don For-Dough it’s time to start the game.

Don For-Dough: Ok Rich S. Here it comes, televisons most exciting hour of fantastic prizes, the fabulous 60 minute “Who Wants to be a Tax Billionaire”. [Pause] Average Joe Taxpayer, come on down. You are the first contestant on Who Wants to be a Tax Billionaire!

Rich S. Cashbin: Welcome to the show Average Joe. Hey that rhymes. You’ve seen the show before and you know what the Taxman can do to the Average Joe taxpayer. Does any fear factor into your appearance today?

Average Joe: No way Rich S.. I’m willing to run the full gambit with this game. Teddy Taxpert and I are going to be true American gladiators. I’m ready to spin my wheel of fortune and go after those precious tax dollars.

Rich S. Cashbin: Ok we’re ready for the amazing race for some tax money. Every dollar counts so let’s play Who Wants to be a Tax Billionaire. Teddy Taxpert, are you ready to press your luck.

Teddy Taxpert: Let’s go Rich S.. We’ll take income-splitting plans for $10,000.

The Taxman: You don’t say. Build move Taxpert. You know how I love to squish income-splitting schemes. You’re showing your greed now Teddy, why not start living something easier like RRSP’s. You’re like child’s play in my hands.

Teddy Taxpert: You’ll never see anything like my income-splitting plans. I’m ready to match games with you, Taxman. You are like the rest of those card sharks, always ready to change the rules as we go along.

Rich S. Cashbin: This is no regular family feud. And this isn’t the dating game. These boys mean business. It’s your play Average Joe.

Average Joe: I’ll take my chances with miscellaneous tax deductions and credits, Rich S. Let’s make a deal. We’ll start with some child care expense deductions and follow that up with a few charitable donation credits.

Teddy Taxpert: That sounds like the sale of the century. What’s my line? Oh, yeah, now I remember. Good tax planning must be carried out throughout the year, otherwise your results could be in jeopardy. You shouldn’t do all your planning just at year end. If the price is right, prudent planning throughout the year will save you enough to go to Hollywood with three Squares a day.

The Taxman: Whoa...Taxpert! I’m the one that names that tune. The tax buck stops here. You can’t reach for the top of the $100,000 pyramid without going through me. I set the rules and I can change the rules. You can’t handle the truth or consequences of your actions. I’ve got the password to all the problems.

Teddy Taxpert: Look the joker’s wild. I’ve got the answer to the $64,000 question. There are two basic tax planning strategies in any game show. The first involves plans to reduce taxes and save those tax dollars. Maximizing your deductions or splitting income with other family members are sure-fire ways to hit the bullseye.

The second and equally important tax game show planning tool involves deferring taxes to a future year. You’ve got to beat the clock and put those taxes off to another day. If you follow these two tips, you’ll find your tax dollar savings as simple as tic, tac, dough.

Most of our tax tips are designed for the 2004 T.V. schedule, however, some tips may be helpful for the 2003 season. So take a split second to review our tips and win some of that tax dollar prize money, Taxman, this is the gong show and you’re out of here. Three’s a crowd.
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)

Anyone who has watched the longest running game show Jeopardy knows that one of the topics that appear from time to time is “Popular Acronyms”. For $14,500, the answer is “Canada’s favourite tax saving tool for retirement, and what no Canadian should be without”. The question, Alex, is - “What is an RRSP”.

When Canadians turn their thoughts to retirement and the tax system, perhaps the first thing they think about is the RRSP. Then again, it could also be the size of their refund (or lack thereof) in April. But that aside, RRSPs have long become a fixture in Canadian society. Vast sums of money are currently invested in RRSPs and the amount of contributions made on an ongoing basis continues to increase.

RRSPs continue to be one of the most widely known and best-used tax deferral vehicles. Prior to every budget, there is always concern that the government will make dramatic changes to the RRSP system that will lessen its benefits. However, recent changes have been favourable as RRSP limits are finally scheduled to increase over the next several years.

Despite the changes made to RRSPs over the years, the basics remain the same. 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 an RRSP are too favourable to pass up. Hence, an RRSP may serve as an excellent planning tool to defer the recognition of income for tax purposes, as well as act as a vehicle to accumulate retirement savings.

Contribution Limits & More

The $13,500 contribution limit, which has been in place since 1996, has finally increased to $14,500 in 2003. The maximum amount that may be contributed annually to an RRSP for a particular taxation year is based on the earned income of the previous year. For example, 2003 contributions are based on 2002’s earned income. Because of this, individuals can determine their maximum RRSP contribution early in the year.

The following chart sets out the applicable RRSP contribution limits for the years 2003 to 2006 and the amount of earned income required in the previous year to permit the maximum contribution.

<table>
<thead>
<tr>
<th>Year</th>
<th>RRSP Annual Contribution Limit</th>
<th>Earned Income required in previous year for maximum contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>14,500</td>
<td>80,556</td>
</tr>
<tr>
<td>2004</td>
<td>15,500</td>
<td>86,111</td>
</tr>
<tr>
<td>2005</td>
<td>16,500</td>
<td>91,667</td>
</tr>
<tr>
<td>2006</td>
<td>18,000</td>
<td>100,000</td>
</tr>
</tbody>
</table>

Where an individual does not participate in an employer-sponsored pension plan, his or her deductible contribution to an RRSP will be limited to the lesser of 18% of the preceding year’s earned income and the annual contribution limit (i.e. $14,500 for 2003). As noted, 18% of 2002 earned income serves as the basis for the 2003 contribution limit. Earned income of $80,556 in 2002 will allow a taxpayer to make the maximum contribution in 2003. Taxpayers will need earned income of $86,111 in 2003 to make the maximum contribution in 2004. Where the individual participates in an employer-sponsored pension plan, the rules become more complex.

WHO WILL THEY BE NEXT YEAR

In last year’s ITWT we indicated that Revenue Canada had previously changed its name to the to the Canada Customs Revenue Agency (“CCRA”). We lamented that although it took us a long time, we had finally all come to regard the name Revenue Canada with such affection. Now that we were slowly getting used to CCRA, they snapped it away from us. Until the next change, our friendly tax man will be known as the Canada Revenue Agency (“CRA”). Some taxpayers may have other names for CRA; most of which we cannot reprint here.

In the spirit of our game show theme, we will be running a contest to guess what next year’s name will be. Might it be CR, or CA or RA, and what will it stand for? The following year we should be down to only one initial.

The new (and improved) Canada Revenue Agency will be referred to as CRA throughout this publication.
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 2002 T4 slip will reduce the RRSP contribution limit otherwise determined for 2003. The purpose of the pension adjustment is to put RRSPs for all individuals on the same playing field as employees with Registered Pension Plans. This RRSP limit may also be reduced if the employer reports a 2003 Past Service Pension Adjustment (PSPA). This will occur if past service benefits have been added to the plan on a retroactive basis.

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.

Many taxpayers have already been notified by the CRA as to their RRSP contribution limit for 2003. This information should have been included as part of the Notice of Assessment received by taxpayers for their 2002 tax returns. The 2003 RRSP Deduction Limit Statement section of the form reports any unused contribution room (discussed later) from 1991 to 2002. In addition, it also reports the amount of “undeducted” RRSP contributions available to be used in 2003. 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, earned income for 2002 plays a limiting role in determining the maximum 2003 RRSP contribution. 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 and capital gains. Earned income is reduced by such items as deductible alimony and maintenance payments and union or professional dues. It also does not include any income or losses from limited partnerships (other than from rental property), nor does it include any other pension benefits or retiring allowances.

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 2003 income, contributions to an RRSP must be made by February 29, 2004. Contributions made in the first 60 days of 2004 can be deducted in 2003 or any future year. An individual may also contribute to an 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 RRSP can be made up to the end of the calendar year in which an individual turns 69. Spousal contributions can be made by an individual over the age of 69, as long as the spouse is less than 69.

As with any deduction, the tax savings that result from an 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 20).

**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 is subject to a higher tax rate, to take the deduction. In the meantime, the unused contribution room is 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 into the future. There is no restriction on the ability to use this RRSP room as a future deduction. The unused contribution room carries forward and increases the available RRSP deduction in future years. This carryforward provision permits a taxpayer to make a tax-deductible contribution even if he 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 deducting previously undeducted contributions.
Consider the following scenario: Mr. Trebek’s earned income in 2001 was $50,000 and the PA reported on his 2001 T4 was $3,000. Based on this, his RRSP contribution limit for 2002 was $6,000 (18% x $50,000) – $3,000. Mr. Trebek chose not to make a contribution in 2002. In 2003, Trebek can contribute the $6,000 unused contribution plus his calculated contribution limit for 2003. Keep in mind that Trebek could have contributed this $6,000 to his RRSP in 2002 and chosen not to deduct it on his 2002 tax return. This approach would be prudent if Trebek’s taxable income in 2002 was below $31,677 (i.e. lowest tax bracket in 2002) 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 24%.

Although, as noted earlier, age 69 is the limiting age for purposes of making an RRSP contribution to one’s own plan, it does not limit the ability to deduct previously undeducted contributions. These undeducted contributions may be carried forward beyond age 69 and deducted to the extent of the contribution room available. In addition, it appears that contribution room can be generated for earned income after age 69 and this contribution room can be utilized for previously undeducted contributions. Individuals should consider making an “extra” RRSP contribution in December of the year in which they turn 69 equal to their available RRSP limit for the following year (plus the $2,000 overcontribution 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 70” year. This concept may not be easy to understand at first glance. If you are approaching age 69 be sure to contact your trusted tax advisor for more information.

If contribution room can be generated after age 69, an individual may utilize the contribution room by contributing to a spousal plan until the year the spouse turns 69. 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 69 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 currently $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 an 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 an RRSP have been narrowed over the years. RRSPs can generally be transferred to other RRSPs or RRIFs (see next section) without any problems.

It is now well established that periodic pension payments (including Canada Pension Plan and Old Age Security payments) cannot be transferred to an 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 an 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 which place restrictions on the ability to take funds out of the RRSP. 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 an RRSP. These limits allow for the transfer of a retiring allowance (i.e. amounts received in respect of a loss of employment) to an 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 2003, the RRSP contribution must be made by February 29, 2004. As an alternative, the employer can transfer the retiring allowance directly into an RRSP. This transfer cannot be made to a spousal RRSP. As noted, this transfer has been curtailed, but only in respect of years of service after 1995. The existing limits for years of service prior to 1996 continue to survive so that a future retiring allowance may be
A taxpayer can utilize a combination of any of the above investment philosophy and cash requirements. The appropriate decision is based on the individual’s personal annuitant wishes to continue managing his or her assets. The rate of return than that offered under the annuity or if the annuity may be the assurance of a fixed level of income that only lasts as long as funds remain in the plan. With an RRIF, that is the question! The advantage of an annuity or RRIF, that is the question!

Annuity or RRIF, that is the question! The advantage of an annuity or RRIF, that is the question!

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 $1,000 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 an RRSP. However, a minimum amount must be withdrawn from the RRIF each year. This withdrawal is subject to tax. RRIFs are discussed in more detail in a separate section of this commentary.

Annuity or RRIF that is the question! 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 RRSP into part annuities and part RRIFs.

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 an 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 $20,000 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 it 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 as that period, and the individual has lived in the home during the marriage, that individual will not qualify for the Homebuyer’s Plan. According to, 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 on buying a new house.

Each spouse is entitled to a $20,000 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 $20,000 limit. The Homebuyer’s Plan can be used again in the future as long as previous homebuyer 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. This form need not be filed with the income tax return. 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. The home generally must be acquired by October 1 of the year following the year of RRSP withdrawal.

If the home purchase does not close, an individual can usually return the funds from his/her RRSP without tax.
There are considerable merits to this proposal that allow inclusion.

obligation to repay the RRSP to avoid the immediate income a surviving spouse, he or she can elect to take over the within a specified time limit. In the case of death, if there is will be included in income, unless it is repaid to the RRSP

Homebuyer's Plan. In both cases, the outstanding amount operate on a plan-by-plan basis.

prior to the 90 days before the withdrawal. These rules can withdraw, without penalty, funds already in the RRSP the $6,000 contribution will not be deductible. In effect, you

with $20,000 in his RRSP $6,000 of which was contributed contribution made to the RRSP less than 90 days before the withdrawal will generally not be deductible. However, amounts contained in an RRSP prior to this 90-day period will be considered to be withdraw on a first-in, first-out basis for purposes of determining the portion of the non-deductible contribution. For example, if an individual with $20,000 in his RRSP $6,000 of which was contributed in the last 90 days, withdraw $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-resident 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 this proposal that allow RRSP funds to be used 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 Lifelong Learning Plan, students in full-time train- ing 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 $40,000 to finance their educa- tional costs. The RRSP annuitant or his/her spouse must be entitled, 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 Other Tracks 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 2003, repayment must begin in 2008 (by March 1, 2009). Earlier repayment may be required if the student does not attend or complete the appropriate educational program.

Foreign Content

To avoid some of the problems associated with direct investment in foreign entities noted in the Investment Income section, it may be worthwhile to consider maxi- mizing the foreign content within your RRSP (and other deferred income plans, such as RPP). The foreign content limit for 2003 and 2004 is 30%. The RRSP will be subject to a special tax of 1% per month, if the foreign property exceeds the allowable limit. The foreign content limit may go to 50% under certain circumstances. For every dollar invested by the RRSP in foreign entities, the foreign content may be increased by three dollars. The rules restricting the investment in shares of small business corporations are complex, and you should consult your professional advisor before considering this option.

It should be noted that individuals may still be subject to U.S. estate tax if they invest in U.S. securities through their RRSP instead of investing directly. See the “Some U.S. Tax Aspects for Canadians’ section for the discussion on U.S. estate tax.

Planning Points

Because the majority of banks and other financial institu- tions roll out their RRSP advertising campaigns to coincide with the contribution deadline, most taxpayers make their annual contributions at that time. Taxpayers should consid...
obtain funds from an RRSP on a potentially tax-free basis. Any do not have the available cash. It also enables a taxpayer to to taxpayers who desire to make an RRSP contribution, but investment" for RRSP purposes. This transfer is advantageous rules are very specific as to which property is a "qualified Not all investments can be transferred to an RRSP . The tax In order to do this, the RRSP must be a self-directed RRSP . Therefore, the capital losses triggered are available personally against capital gains. Consider contributing or selling shares or other invest- "catch-up" RRSP payments when the cash is available. Now that the carryforward period for utilizing unused RRSP worthwhile to borrow funds to contribute to an RRSP funds invested in the RRSP , and the loan will be repaid money borrowed is comparable to the rate earned on the 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 an RRSP prior to retirement. In years when a taxpayer's income is low, an 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, an 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 an approximate tax saving of $3,500 (based on the maximum 2003 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 an RRSP contri- bution 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 an RRSP. Note that the carryforward 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 invest- ments to an RRSP. This can be done in lieu of a cash contribution to an RRSP or to obtain cash contained in it. Capital gains may be triggered as a result of this transaction. Any capital losses generated on transfers to an RRSP are denied. Consider selling loss stocks outside an RRSP and contributing the cash to the RRSP. Therefore, the capital losses triggered are available personally against capital gains. In order to do this, the RRSP must be a self-directed RRSP. Not all investments can be transferred to an 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 an RRSP contribution, but do not have the available cash. It also enables a taxpayer to obtain funds from an 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 an 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 an RRSP and continue to hold equities outside the plan. With a self directed RRSP investments can be made in foreign stocks, foreign bonds and other foreign investments within certain limits. Only 30% of the cost amount of invest- ments held in an RRSP can be invested in foreign property. This limitation is based on the cost at the time of purchase, not market value. If this 30% limit is exceeded, a special tax of 1% per month is payable by the RRSP. This foreign content can be increased by investing in qualifying mutual funds that are not treated as "foreign" but that also have investments in foreign securities. A self-directed RRSP should be considered as it provides additional flexibility in making investment decisions within 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 benefits of spousal RRSP contributions and the related rules are discussed in the Income Splitting section. An individual can use his RRSP to hold a mortgage on his home. This is separate and apart from the Homebuyer's Plan. To qualify, the mortgage from the RRSP must be adminis- tered by an approved lender and the mortgage must be 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, and since the RRSP could invest in other similar mortgages, the principal advantage to this type of plan may only be psychological; i.e. the comfort of loaning money to yourself. 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 5-year period will be included in the spouse annuitant's hands and not the spouse contributor's hands. This differs from the 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 an RRSP. In most cases, it can hold the same investments as those in an RRSP. All income earned in a RRIF accumulates on a tax-free basis. However, unlike an RRSP contributions cannot be made to a RRIF and certain amounts must be withdrawn annually from the RRIF to be taxed in the planholder’s hands.

For RRIFs set up prior to 1993, the amount that must be withdrawn each year up to age 78 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 spouse turns age 90. For those who turned 78 after 1993, the amount that is required to be withdrawn increases at a slower rate thereafter (see following table), levelling out at 20% once age 94 is reached. The table below also outlines the minimum RRIF payments in each year for RRIFs set up in 1993 or later. The minimum RRIF payment in each year, if the person is under 71, remains the same as that under the previous system, i.e. 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 spouse turns age 90. The minimum values for age 69 and 70 have been included in the table for illustrative purposes. 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.

<table>
<thead>
<tr>
<th>Age</th>
<th>% RRIF</th>
<th>% RRIF</th>
<th>% RRIF</th>
<th>% RRIF</th>
</tr>
</thead>
<tbody>
<tr>
<td>69</td>
<td>4.76</td>
<td>76</td>
<td>7.99</td>
<td>83</td>
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</tr>
<tr>
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</tr>
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</tr>
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<td>7.85</td>
<td>82</td>
<td>9.27</td>
<td>89</td>
</tr>
</tbody>
</table>

Registered Pension Plan (RPP)

Many taxpayers are employed by organizations that offer the opportunity to participate in company pension plans (known as RPPs). Under such plans, employees 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.

Under a Money Purchase RPP the tax deductible contribution for 2003 is limited to the lesser of 18% of 2002 employment income and $15,500, less employer contributions to the plan. The limits in future years are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Limit</th>
</tr>
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<tbody>
<tr>
<td>2004</td>
<td>16,500</td>
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<tr>
<td>2005</td>
<td>18,000</td>
</tr>
<tr>
<td>2006 onwards</td>
<td>Indexed</td>
</tr>
</tbody>
</table>

The limits under a Money Purchase RPP are very similar to those for RRSPs.

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 limits are 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 an RRIF.

Effective 2004, RRIF-type payouts can be made from a money purchase pension plan. This measure will allow 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 an RRSP or RRIF.
Individual Pension Plan (IPP)

A shareholder/manager may be able to set up a personal pension plan called an IPP to provide for retirement. An IPP is like an RRSP but it is 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 an RRSP but at a significantly lower contribution amount.

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.

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 RESPs have obtained considerably more respect 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. Under proposed rules, 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.

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. 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 somewhat punitive 20% tax, in addition to the regular tax on the income.

Self-administered RESPs are also available. These plans may provide taxpayers with flexibility in investment decisions and beneficiaries. The features of competing RESPs should be carefully examined. 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 amongst the various children who are beneficiaries of the plan in the event that certain beneficiaries decide not to pursue post-secondary education.

Under the Canada Education Savings Grant (CESG) program, the federal government will provide a direct grant to the RESP of 20% of the first $2,000 of RESP contribution to a maximum of $400 per year for each beneficiary. The total available grant is $400 for each year that the individual is under age 18 for a total of $7,200 per beneficiary.

In cases where the $2,000 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 $800 (20% of the maximum annual $4,000 RESP contribution) and 20% of the unused CESG room.

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.

The maximum RESP contribution is limited to $4,000 per year and $42,000 lifetime in respect of any one beneficiary. If less than $4,000 is contributed in a year, there are no rules that allow for the carryforward of the unused RESP limit. 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 $42,000 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.
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 on capital transactions receive preferential tax treatment compared to gains on income transactions. Conversely, capital losses are treated less favourably than income losses. The preferential (or detrimental in the case of losses) treatment for capital transactions results from the lower inclusion (and thereby tax) rates associated with dispositions of such property. There are other special rules that favour certain capital transactions, but we'll talk more about that 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 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 in which a business will be operated, or to derive rent, 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.

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 deem that a capital property is disposed of 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. Deemed dispositions may occur on death, on becoming a non-resident of Canada, and as a result of the gifting of property, all with limited exceptions (see separate sections on Death of a Taxpayer and Emigration from Canada for details). The capital gain inclusion rate is 50%, back to its historic introductory rate. As noted in the Charitable Donations section, donations of certain securities and ecological property will be taxable at 1/2 of the normal inclusion rate. However, if there is any compensation or benefit received as a result of the gift, the amount of the benefit is deducted from the eligible amount of the gift in calculating the capital gain that is eligible for the 25% inclusion rate. If the value of the benefit exceeded 80% of the fair market value of the transferred property, the entire amount of the gift would not qualify for the 25% inclusion rate unless the transferor could establish to the satisfaction of the Minister that there was no motive for the gift other than a desire to benefit the charity in question.

The effective tax rates on capital gains realized in 2003 and 2004 are reflected in Schedule 1 on page 20. The top effective rate of tax on capital gains in Ontario in 2003 and 2004 is 23%. These rates are substantially lower than the tax rates applicable to ordinary income, as reflected in Schedule 1 on page 20.

As a result, there will certainly be increased 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. To ensure that stock market trades are treated as capital dispositions, an election can be filed. Once filed, all Canadian securities that are owned must be treated as capital property. Thenceforth, 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. If this is not possible, it may be advantageous to sell the asset and re-acquire it within six months. The rationale here is that the capital gains tax rate is 40% on long-term capital gains, whereas the ordinary income tax rate is 23%. Therefore, the effective tax on a capital gain is 15% (40% x 23/100). This is a tax savings of 17%.

It may also make sense, where possible, to split the capital gain (e.g., by claiming the capital gain reserve) over two years where there is minimal other sources of income. This approach may better “average” income by taking advantage of lower marginal tax rates in each year.
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 recent, and somewhat surprising court decisions that concluded that non-competition payments paid to the vendors in a sale of shares are not taxable, new rules have been proposed. Effective October 8, 2003, proceeds received for giving a restrictive covenant will be taxable as ordinary income. The vendor may 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 excess, if any, will be treated as ordinary income. Amounts received before 2005 pursuant to an arm’s length written agreement made on or before October 7, 2003, will be grandfathered.

Utilization of Capital Losses

Allowable capital losses are only deductible against capital gains and are not eligible as a deduction 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 those other years. Due to the changes in the inclusion rate for capital gains and losses through the years, the amount of the losses must be adjusted to the relevant inclusion rate of the year or years in which the losses are applied. In situations 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 spouse purchases the same property. This type of loss is known as a “superficial loss.” Capital losses will also be denied in other circumstances. For example, losses cannot be triggered on sales of capital property to your RRSP. Some 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, and artwork. Capital gains on personal use property are only taxed to the extent the sales price 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 after February 27, 2000 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. A donation of personal use property will be subject to normal rules concerning the recognition of capital gains.

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 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. Capital gains realized before 2004 (when the inclusion rate may be higher than 50%), and brought into income in 2003 as a reserve, will be deemed to have been realized on January 1, 2003, and will benefit from the reduced 50% inclusion rate, regardless of the effective inclusion rate applicable in the year the sale occurred. Non-residents are not eligible to claim a capital gains reserve. The maximum capital gain tax rates for and are the same. Therefore the maximum capital gains reserve should be claimed in 2003.

The five-year reserve (i.e. 20% of the gain reported each
or an uncollectible debt from an SBC. To claim the loss on an ABIL also includes the loss on shares of a bankrupt SBC person dealing at "arm's length" (unrelated) with a taxpayer. 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 an 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 an SBC if it was an SBC at any time in the 12-month period before the sale. Therefore, in situations where a business is sold and the 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 forward seven. After seven years, if still unused, the ABIL would convert to an ordinary capital loss and then 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 forward indefinitely. Correspondingly, if the capital gains exemption was not claimed in a prior year any ABIL claimed in a year against other income has a bearing on the available ability of the capital gains exemption in subsequent years. In other words, taxable capital gains equivalent to the amount of an ABIL claimed must be generated in subsequent years, before the capital gains exemption can be further utilized. What this means is that you cannot claim an ABIL and use the capital gains exemption at the same time.

As the rules noted above indicate, in certain cases an ABIL will not always be what it appears to be. These provisions are very complicated. However, taxpayers who are faced with such losses must adhere to these rules to ensure that they at least benefit from the losses from a business investment gone south.

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 will be 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.
Flow-through Entities

The election process had a different impact on properties known as “flow-through entities”. Income of flow-through entities is taxable in the hands of the shareholder, partner or beneficiary. These entities include certain investment corporations, partnerships, trusts, and mutual funds.

In these circumstances, an “except capital gains balance” was created. This exempt capital gains balance keeps track of the elected gain which will be reduced by future gains on the elected asset. This could include both a gain realized on the disposition of the asset itself (e.g. sale of the mutual fund), or gains flowed out to the individual by the flow-through entity (e.g. capital gains earned by the mutual fund that are allocated to the investor). Therefore, ‘flow-through’ gains can be sheltered from tax without having to sell the investment.

Separate exempt capital gains balances must be maintained for each flow-through entity elected upon. The balance from one fund cannot shelter gains from another fund. Therefore, careful tracking of these balances is required. The rules require that the exempt capital gains balances can only be utilized until the year 2004. However, if in the year 2005, an exempt capital gains balance exists and the individual still owns the related “flow-through entity”, the remaining balance may be added to the cost base of the units of the entity that remain. This enables the individual to realize a capital loss on the sale of the asset. For example, if all the remaining units of a mutual fund are sold for $100,000 in year 2005 and the adjusted cost base of the fund is $90,000 and the exempt capital gains balance is $20,000, a capital loss of $10,000 ($100,000 - $90,000 - $20,000) is realized.

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 property. The balance of our discussion in this area will focus on the former.

The $500,000 Capital Gains Exemption

The Basics

The exemption is available only to individuals resident in Canada. It also applies to such capital gains flowed through to 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) or qualified farm property are eligible for a lifetime $500,000 capital gains exemption. That is, capital gains of up to $500,000 realized on the disposition of these properties are exempt from tax. However, the $500,000 exemption is reduced to the extent that the taxpayer has already utilized the earlier $100,000 exemption for other property.

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 CBNL 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)

While a large number of tax motivated incentives have dropped off the table, the ‘enhanced’ capital gains exemption continues to survive. The introduction of the capital gains rollover on the sale of SBC shares makes achieving and maintaining this status even more beneficial.

This enhanced exemption, totalling up to $500,000, 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”), all or substantially all (i.e. at least 90% according to the CRA’s interpretation) of whose assets are used in an active business carried on in Canada. 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, shares of holding companies which own shares of a SBC may also qualify as a SBC. In some cases, investment type 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 such planning is carried out well before contemplation of the sale of corporate shares. Otherwise, the capital gain generated on the sale of shares may not be eligible for the exemption. Since in some cases a sale of shares or deemed sale (e.g. on death) may occur with little warning, it would be prudent to maintain SBC status at all times, if possible. In the case of
death, the shares need only to have met this 90% test at any
time in the 12 months prior to death.

Under the 90% test, a corporation need only be a SBC at
the time of disposition of the shares in order to qualify for the
enhanced exemption. However, two other tests must also be
met before this 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 propri-
etorship or partnership involved in an active business. The
second test requires that more than 50% of the value of a
company’s assets were used in an active business in
Canada throughout the 24-month period preceding the sale.

These rules become further complicated in situations where
holding companies are introduced into the picture.

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 will be approximately $23,000 in
2003 and 2004. 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 enhanced capital gains exemption.

There is no question that this enhanced 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, the opportunity to sell shares
still exists and should be considered where appropriate.

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 ben-
fits of complying with them are significant enough to
warrant considerable attention.

Some Exemption Planning Ideas

There are no guarantees that the $500,000 exemption will
remain a fixture in the Canadian tax system. Therefore,
proper planning in this regard becomes more important
than ever.

As the only assets still eligible for the capital gains exemp-
tion are qualifying small business corporation shares or
qualifying farm property, the following planning ideas are
only applicable to such assets.

The exemption is only available to individuals. As such, each
family member is entitled to his or her own exemption.

Therefore, where appropriate, ownership should be spread
among different family members to obtain multiple access
to the exemption. The use of family trusts would help
facilitate such planning.

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 affect the clawback of old
age security and 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.

Transfers to Related Persons

Taxpayers can generate tax-free capital gains through
non-arm’s-length transfers (i.e. transfers between related
parties). 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
asset in the hands of the recipient. Careful planning is also
required to ensure that taxpayers remain outside the
attribution rules noted in the Income Splitting section.

There are a number of corporate reorganization

techniques that can be used to artificially trigger or
“crystallize” a capital gain eligible for the exemption. These
methods provide for a “bump” in the tax cost of the asset
involved and protect against withdrawal of the enhanced
exemption in the future. All eligible taxpayers should
consider such crystallizations or similar planning.
The costs associated with this type of planning must be
considered before proceeding.

Estate Freezing

Taxpayers who own shares in a SBC may be able to
generate additional $500,000 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 (see following section) may adversely affect
an individual’s eligibility for the $500,000 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.

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 since 1985 exceed his or her CNIL after 1987. 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 the year and prior years commencing 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 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.
Circumstances may arise where a taxpayer initially purchases any planning in this regard should be done very carefully. The transfer is deemed to take place at fair market value.

It may make sense to transfer the ownership of a second residence to adult children (over age 18). If the adult child owns no other residence, he/she can utilize the principal residence exemption on the transferred property when it is sold. The initial transfer may result in tax to the parent since 1982, only one residence can be designated as a principal residence for a family unit (spouses and unmarried children under 18 years of age) 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.

As noted, each spouse was entitled to his or her own principal residence exemption for property owned prior to 1982. In situations where spouses owned two residences that were acquired prior to 1982, it may be beneficial that the ownership be structured 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.

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In Touch with Tax

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, only one residence can be designated as a principal residence for a family unit (spouses and unmarried children under 18 years of age) in any year.

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taxes payable. This credit is designed to approximate the tax already paid by the corporation distributing the dividend.

At the top Ontario individual marginal tax rate, a dividend will attract approximately 31% in 2003 and 2004. The tax rates on dividends at other income levels are noted in Schedule 1 below. As that schedule indicates, the tax rate on dividends is lower than for interest but is generally higher than the effective tax rate on capital gains, except at the lower marginal tax brackets. An individual without any other source of income could receive approximately $29,300 of cash dividends without attracting any tax.

Needless to say, tax plays an important role in investment decisions. Different types of income are subject to different rates of tax, which affects the ultimate yield on the investment. For example, a top rate taxpayer who received approximately $78 in dividend income 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 7.8% dividend return.

Stock dividends received from a Canadian corporation are subject to the same rules 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, capital dividends may be received from a Canadian private corporation. A capital dividend usually represents the untaxed portion of a capital gain generated by the corporation. However, it also may result from the distribution of life insurance proceeds received by a corporate beneficiary of an insurance policy. Capital dividends are received tax-free. Certain CRA reporting requirements must be met to avoid potential penalties. The capital dividend account is reduced by capital losses. Therefore, where a corporation has a capital dividend account, it should be paid before realizing any subsequent capital losses.

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 fund. 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 is relevant in computing the gain or loss on an eventual sale of the fund units.

### SCHEDULE 1

<table>
<thead>
<tr>
<th>Tax Brackets ($)</th>
<th>Interest 2003 %</th>
<th>Interest 2004 %</th>
<th>Dividends 2003 %</th>
<th>Dividends 2004 %</th>
<th>Capital Gains 2003 %</th>
<th>Capital Gains 2004 %</th>
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</thead>
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<tr>
<td>0 to 7,756</td>
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<td>NIL</td>
<td>NIL</td>
<td>NIL</td>
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<td>11.98</td>
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<td>Over 104,648</td>
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<td>31.34</td>
<td>31.34</td>
<td>23.21</td>
<td>23.21</td>
</tr>
</tbody>
</table>

1. Combines federal and Ontario tax rates include all surtaxes.

2. Tax brackets assume a single filer eligible for the basic personal tax credit. Tax brackets will be higher in 2004 due to indexing.
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.

Earning investment income through a corporation is not advisable from a tax deferral or tax saving point of view. There is a net tax cost of approximately 3% for an Ontario resident to earn investment income through a corporation. There may be circumstances when it may be beneficial to incorporate investment income, such as to avoid the Old Age Security Clawback, 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 a long-term investment that matures in 2004 is made on August 1, 2002, interest up to July 31, 2003 must be reported on the 2003 return. Similarly, interest from August 1, 2003 to July 31, 2004 would be reported on the 2004 tax return. Alternatively, interest accrued to December 31 of each year could be reported annually. These amounts must be reported even if the interest would not be paid until 2004.

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.

Foreign Investments

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 worldwide income.

As an example, if an individual invests $100,000 offshore and receives $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 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 all sorts of new investing arrangements allowed taxpayers to avoid all the existing rules. So, as governments are prone to do, a new set of rules have been introduced to try and “catch” these perceived abuses. These rules are known as Foreign Investment Entities (“FIE”).

Although these new rules were effective from January 1, 2003, the rules were still being amended as recently as October 2003. Unfortunately, but not unexpectedly, these rules are both very onerous and very complex. The unfortunate consequence of these wide-ranging rules is that many taxpayers may inadvertently run afoul of these rules without realizing it, and compliance will come at a great cost.

The rules dealing with Foreign Trusts have also been greatly expanded to cause many more foreign trusts to fall within the Canadian tax net. 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.

Now a closer look at these three sets of rules: FAPI, Foreign Trust and FIE rules.

Canadians (individuals and corporations) who invest in foreign corporations, which earn certain types of income may be subject to the FAPI rules. These rules will apply if the foreign corporation is controlled by five or fewer Canadians and that corporation earns income from property (such as interest, rents and dividends), or income from an investment business (such as insurance, factoring of receivables, and...
services provided to the Canadian investor or someone related to him/her). Any foreign corporate income tax paid, and foreign withholding tax on any distributions may reduce the amount of FAPI, which is required to be included in income by the Canadian investor.

The second set of rules, the Foreign Trust rules, have been significantly revamped, for trust taxation years beginning in 2003. In general, a foreign trust (except commercial foreign investment trusts) will now be subject to tax in Canada, as if it is resident in Canada, if a contribution to the trust has been made by a person who is resident in Canada at the end of the year. In addition, a foreign trust will be subject to tax in Canada if it has a Canadian beneficiary and a contribution has been made to the trust by a person who was a resident in Canada. They will also apply if the contribution was made within the five years before the person became a resident of Canada or the five years after the person ceased to be resident of Canada. An exception to these rules is provided for trusts set up by recent immigrants to Canada.

The third and newest set of rules are the FIE rules. These rules are intended to address investment in foreign investment funds and similar investment vehicles that may escape the application of the FAPI and Foreign Trust rules. These rules are potentially the most difficult to comply with. Individuals must first determine whether they are caught. The net is much broader than one might anticipate. For example, although the rules refer to foreign entities, it is possible to fall within these rules if one owns shares of a foreign corporation which are exchangeable for shares of a foreign company, or whose value is determined by reference to the value of a foreign company's shares. The rules may also apply to a minority investment in a foreign company (except widely held public companies), where the necessary information may not be available to the investor. Foreign insurance policies which have been set up to qualify as a tax-free investment vehicle, will now also be caught under the FIE rules.

If the FIE rules apply, the Canadian investor will be required to include income calculated under one of three methods. The default method is to include an amount equal to the cost of the investment multiplied by a prescribed rate of interest (which is 6% for the third quarter of 2003 and 5% for the balance of 2003). Under certain circumstances, including the FIE is a foreign insurance policy, the taxpayer is required to include income calculated on what is known as “a mark to market basis”. Under the mark to market basis, the amount included in income is the net increase in value of the investment during the year. A taxpayer may also report its share of the FIE's income computed under Canadian income tax rules (i.e. the “accrual” method), if the taxpayer has the required information.

Note that under the FIE rules, the prescribed rate method of reporting will always result in an income inclusion, even if the actual underlying investment has not earned income or increased in value. In circumstances where a taxpayer has the option of using the mark to market method of reporting income, or the accrual method instead of applying the prescribed rate calculation, an election form will need to be filed.

There are also a set of reconciliation rules to reduce the amount of FIE income reported to the extent it exceeds the taxpayer's economic gain from a disposition of the investment.

The preceding comments have attempted to highlight some of the issues associated with Canadian reporting of foreign income. As indicated, all these rules are quite complex and contain many other definitions and concepts. Taxpayers are urged to give these rules careful consideration.

It is important that all taxpayers with foreign investments consider the potential impact of these various rules. It may be prudent to consult your tax advisor on these issues or prepare to play the game.

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 occurring after 1997. 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, certain information must be filed with the CRA on a timely basis. 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 shareholder must also elect on his/her tax return for the year in which the distribution occurs. Previously, the CRA indicated that they would not accept any late-filed information or election. The regulations have been amended to allow a late-filed election, retroactive to April 11, 2002.

Currently, spin-offs involving other non-U.S. corporations are not eligible for the special treatment. It has been proposed that two non-U.S. spin-offs involving shares of Wilhelm Sonesson AB in 1999 and Trioga Technologies Ltd in 2000 will be allowed the deferral.
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 investments, interest must be accounted for on the accrual basis. Despite this fact, taxpayers acquiring treasury bills in 2003 can defer the reporting of interest income on these investments to 2004 by selecting a maturity date of January 1, 2004 or later instead of December 31, 2003. 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 an RRSP.

As noted elsewhere, interest and dividend income reduces the balance in the CNIL pool, which may have a direct bearing on the 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

Let the games begin. Who wants to be a tax billionaire? No doubt the game players at CRA have done their darnedest to attack various income splitting tactics. But don’t give up hope, not all of the income splitting plans 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 24%. In addition, as a result of indexing, the threshold for the highest tax bracket is still around 24%. In addition, as a result of indexing, the threshold for the highest tax bracket is still around 24%

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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. Financial 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. Prior to the introduction of this provision, income from a limited partnership was considered to be business income and thus was not subject to attribution.

Finally, any planning undertaken to circumvent these rules by shifting income 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 “game of last resort.”

A number of other rules that have not been mentioned could also have application to any income splitting plans. All of 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, and 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 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 parent’s tax on the same income, as the surtaxes will not apply at the lower income levels. For example, a dividend of $40,000 to a parent at the highest marginal tax bracket in 2003 will attract additional tax of approximately $12,500. A child with no other income will pay combined federal and Ontario Kiddie Tax of approximately $10,800, a saving of $1,700 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. The trust may sell these shares back to the parents, and trigger a capital gain 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.

Where a sale of the shares back 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 may exist.

**Planning Opportunities**

While it is apparent that income splitting has become more difficult over the years, there are still a limited variety of planning opportunities that can be exploited. As noted, the benefits previously associated with income splitting have been reduced. This does mean that income splitting is no longer possible. The following comments touch briefly on a few of the alternatives still available.

**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 neces-
sary 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. The inter-
est 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 low interest rates offer an income-splitting
opportunity that should not be missed. The prescribed rate
for the last quarter of 2003 and the first quarter of 2004 is
only 3%. A loan should be made from the higher-income
spouse to the other spouse at the 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 invest-
ment yield exceeds the interest paid on the loan. If interest
rates are expected to rise, there may be an advantage to loan
money to other family members and to lock 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 uncle’s or aunt’s 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.

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.

### SCHEDULE 2

#### 2003 Federal/Ontario Kiddie Tax Rates

<p>| Actual Amount of Dividend/ | Combined Federal/Ontario | Combined Federal/Ontario |</p>
<table>
<thead>
<tr>
<th>Split Income ($)</th>
<th>Rate on Dividends</th>
<th>Rate on Other Split Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends 0 - 75,548</td>
<td>27.12</td>
<td>40.16</td>
</tr>
<tr>
<td>Over 75,548</td>
<td>31.34</td>
<td>46.41</td>
</tr>
<tr>
<td>Other split income 0 - 51,025</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Over 51,025</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

3. Assumes no other sources of income.
4. Only dividend tax credit and foreign tax credit are allowed against kiddie tax.
Gifts to Children 18 and Over

Once a child turns 18 years of age, the attribution rules and the Kiddie Tax described above have no application to gifts made to such individuals. Therefore, amounts can be gifted to such children 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, no attribution will result. 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 of the transferred asset.

Gifts to Minors

Since capital gains on property transferred to minors do not attract attribution, 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 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.

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 approximately $8,000 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 High 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 any non-income-producing asset.

Such planning should be considered carefully for other than tax reasons. Sometimes concern for personal or professional liability would dictate that an individual direct himself or herself or 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/installments. 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 an RRSP within certain limits, for their spouse 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. Of the amount withdrawn, any amounts paid to the RRSP by the contributing individual in the year of withdrawal and the two previous years 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.

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
holding tax on such payments. The U.S. will not impose with-
tries, because only a maximum of 85% of such income is
taxable in Canada under the treaty between the two coun-
veterans and war pensions.

Income tax treaties between Canada and foreign countries
may also affect the extent 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 coun-
ties, because only a maximum of 85% of such income is
taxable in the United States. The U.S. will impose with-
holding tax on such payments.

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 is 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 what is called a
pension adjustment. If so directed, a foreign pension
plan's retirement benefits be paid to their spouses. If so directed,
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 is subject to a claw back (repayment), with a
corresponding deduction to eliminate the income inclusion
(see Deductions and Credits section). 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
veterans and war pensions.

Income tax treaties between Canada and foreign countries
may also affect the extent certain foreign pensions are
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taxable in the United States. The U.S. will impose with-
holding tax on such payments.

In Touch with Tax

SPOUSE AND OTHER PARTNERS

Many view Canada as one of the most progressive nations, in
terms of its social policies. Common-law couples of the
opposite sex have been treated as "spouses" for all purposes
of the Income Tax Act since 1993. To be considered spouses,
the common law partners must live together in a conjugal
relationship for at least 12 months, or have a child in
common. Since 2001, the benefits and obligations of "spouses" under the Income Tax Act have been extended to
same-sex couples. The recent changes in provincial law in
B.C., Quebec and Ontario, allowing same sex marriages to
be registered in the three provinces (in B.C. and Ontario
effective in 2003, and not until September 2004 in Quebec)
will have little or no income tax impact as a result. The most
(only?) significant difference may be that same-sex married
couples will have the tax benefits and obligations of "spouses" without having to wait 12 months.

Same-sex couples will find that the change is not always
beneficial for income tax purposes. On the one hand, a
person will be able to claim a tax credit for and will be able
to transfer property on a tax-free basis to a same-sex partner.
On the other hand, if each partner owns a home, only one of
the homes may be designated as a principal residence
beginning in 2001. It may also affect the claim of tax credits
or deductions which are dependent on income of the two
partners such as the child care expenses, certain provincial
tax credits, the goods and services tax credit, and the Canada
Child Tax Benefit.

Child Tax Benefits

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.

Credits section). Foreign pensions, whether government
sponsored or from private plans are generally taxable in
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ties, because only a maximum of 85% of such income is
taxable in the United States. The U.S. will impose with-
holding tax on such payments.
For the sake of simplicity, we will refer to both legally married persons and common law partners (of the same or opposite sex) as “spouses” in the commentary.

DEDUCTIONS, CREDITS AND OTHER PRIZES

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 in force over the past decade.

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% of the tax. On the other hand, 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 in 2005 is 16%. After factoring in provincial tax and surtaxes, the combined Federal/Ontario credit is worth approximately 25% in 2005 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 GST 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 RRSPs (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 on page 20 to taxable income. There are four federal tax brackets (16%, 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 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 their share of that income.

The Ontario marginal tax rates (6.05%, 9.15% and 11.16% in 2003-2004) will be applied to Ontario taxable income. Unlike the federal government, Ontario has not moved towards four tax brackets. The Ontario tax brackets, and the amounts on which non-refundable credits 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 50% slapped on for “high” income individuals. The basic surtax will apply when taxable income is just over $57,000. The 56% surtax impacts those individuals earning approximately $67,000. The taxable income thresholds will increase in 2004 to approximately $59,000 and $69,000. These surtaxes bring the effective highest Ontario tax rate to be approximately 17.4%, or approximately 60% of the highest federal tax bracket. The basic surtax that was scheduled to disappear in 2004 has now magically reappeared, courtesy of your friendly new provincial government.

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 17.4% to 24% of taxable income. Quebec, not surprisingly, is the only province (for now) that requires its residents to file separate...
Income tax purposes. 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 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, for taxation years beginning after April 30, 1997, the interest on such loans will not be deductible. This is because the CRA will not accept that interest is deductible if it is used to acquire a home or other personal assets, or used to pay income taxes.

Interest incurred on other loans 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 purchase an RRSP 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 positions 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 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.

There are special rules which deal with foreign currency loans made after February 2, 2000. These rules target transactions which are structured to produce a higher than normal interest deduction with the expectation that there will be a foreign exchange gain at the end. If applicable, this type of investment should be discussed with a professional advisor.

**Alimony and Maintenance Payments**

This subject matter has undergone radical changes in the past several years as a result of intense media attention. The government introduced sweeping changes in 1997 to change the taxation of child support payments to counter accusations that the previous system was unfair. Under the prior regime, which continues to apply to alimony and spousal maintenance payments, and may apply to some child support payments, payments were deductible to the payor and taxable to the recipient if they met certain conditions (as described below).

Under the current rules, 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. These new rules will not apply to agreements in place before May 1, 1997, unless that 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. Guidelines have also been introduced for the courts when setting child support amounts.

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.

Alimony and maintenance payments for the benefit of a spouse (including 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. These rules continue to apply to child support payments made under agreements entered into prior to May 1, 1997. 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. Your tax advisor - Don't break up (your marriage) without him/her.

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 year that the agreement/order is in place or in the preceding year. 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 alimony and maintenance, 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.

As we have noted in the Spouses and Other Partners section, common law partners of the same sex have the same rights and obligations as married persons and common law partners of the opposite sex beginning in 2001. The rules described above will apply to support payments made to same-sex common law partners in 2001 or later under a court order or a written agreement made after 2000. 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 new rules apply to them.

Child Care Expenses

In certain circumstances a taxpayer is allowed to claim the cost of caring for children under age 7, or for children over 16 years of age if the child is physically or mentally infirm. 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 and $100 per week for children of ages 7 to 16. 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. Generally, to qualify as a deduction, the expenses must have been incurred to enable the taxpayer or a supporting person 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 involves 12 hours per month or more of course work.

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. The limit is $4,000 for children from age 7 to 16 and for less severely disabled children of any age. There is no overall family limitation.

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 deduction is $175 for each child under 7 and $100 for children aged 7 to 16, 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 and $100 per month for each child aged 7 to 16. 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.

Childcare expenses remain one of the deductions that do not have to be substantiated by the filing of receipts with a
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 (excluding GST) 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.

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 (whether or not in Canada), 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 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 2003 rate is 45.5 cents per kilometre. In addition, a person can claim $15 per meal, for a maximum of $45 per day for meal costs incurred during the move.

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 after 1994 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.

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 counselling 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 CRA will also allow the deduction of legal costs incurred to obtain support, to increase support & to make child support non-taxable.

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.

Adults who take basic education at the primary or secondary school level to upgrade their skills may, in certain cases, deduct the amount of tuition assistance (which is taxable) from their income. This measure is retrospective to 1997. Prior years tax returns need to be amended to claim these refunds.

Non-refundable Tax Credits

Personal tax credits are now fully indexed. However, they remain, except where noted, non-refundable, i.e. if the
credits exceed the amount of federal or Ontario income tax otherwise payable, the excess will not be refunded. The amounts on which the federal credits are applied (with certain exceptions) have been increased by 1.6% in 2003 as a result of indexation, and will increase by 2.9% for 2004. The federal tax credit is, unless indicated otherwise, calculated using the lowest tax rate, which is 16%. Please refer to Schedule 3 below 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 6.05% in 2003 and 2004. In 2003 Ontario will index the personal amounts by 1.6%, and 2.9% for 2004. 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 16% of eligible pension income, up to a maximum of $160. This is based on maximum eligible pension income of $1,000. As noted, this credit is non-refundable if it exceeds taxes otherwise payable. Unfortunately, this $1,000 limit is not affected by the measures to restore full indexation as noted above for federal purposes. The amount eligible for the pension credit is indexed for Ontario purposes. Ontario will allow a pension credit of $1,081 in 2003, and $1,112 in 2004. 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 an 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 age 65 may wish to annuitize part of their RRSP prior to when required in order to generate $1,000 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 $1,000 of pension income that is generated. The pre-payment of tax, however, is offset by the tax benefit of utilizing the $160 federal credit.

Medical Expenses

Individuals are entitled to a federal tax credit equivalent to 16% of their allowable medical expenses, over a stipulated threshold. The amount of allowable medical expenses will be

| SCHEDULE 3 |
| 2003 TAX CREDITS |
| Personal Tax Credits |
| Federal Tax Credit | Combined Federal/Ontario Credit* |
| Basic | 1,241 | 1,714 |
| Married | 1,054* | 1,455 |
| Equivalent-to-married | 1,054* | 1,455 |
| Infirm dependants over 18 | 586* | 809 |
| Other dependants | NIL | NIL |
| Caregiver | 586* | 809 |
| Age 65 and over | 606 | 837 |
| Disability | 1,005 | 1,387 |

1. Calculated using the appropriate federal and Ontario tax rates, excluding surtaxes.
2. Credit is reduced by 16% of net income in excess of $649 ($653 in Ontario).
3. Credit is reduced by 16% of net income in excess of $5,115 ($5,150 in Ontario).
4. Credit is given to an individual who provides home care for an adult relative. No credit is available if the relative’s income exceeds $15,917 ($16,018 in Ontario).
5. Credit is reduced by 15% of net income in excess of $27,749 ($27,938 in Ontario).
Reduced by the lesser of $1,755 in 2003 ($1,813 in 2004) and 3% of net income, before application of the 16% credit. This limitation will allow certain high-rate taxpayers with large medical expenses (i.e., in excess of $1,755 or $1,813) 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.

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), 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 change will provide greater tax savings for individuals with more than $52,000 of income.

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 dependents. 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. It doesn’t matter who paid the medical expenses. It is the relationship with the patient that matters. Other than children or grandchildren, all other dependants must reside in Canada. If the dependant has net income under $7,756 in 2003 and $8,012 in 2004, there is no restriction on the amount of medical expenses that may be claimed. To the extent the dependant’s net income exceeds $7,756 or $8,012, the medical expense claim is reduced by 48% of the excess. A decision as to which spouse should claim the medical expenses will depend upon the income level of each spouse and the eligible dependants. Because of the threshold limitation, all of a family’s medical expenses should be claimed on one person’s return. In many but not all 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 $2,719 in 2003 and $2,809 in 2004. This amount of the claim is limited to the lesser of $544 ($562 in 2004) and 25% of allowable medical expenses, and is reduced by 5% of the amount of income in excess of $20,621 in 2003, and $21,901 in 2004. The maximum amount of the credit is $887 in 2003, and $90 in 2004. 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 16% 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 6.05% on donations up to $200, and 11.16% on donations over $200. Since the 29% credit for donations in excess of $200 is equivalent to the top federal tax rate, 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 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. The charity is required to report on the receipts, the eligible amount of the gift received after December 20, 2002.

Additional rules were introduced in 2003 to further attack certain “buy-low”, “donate-high” arrangements. For donations after 6 p.m. on December 5, 2003, the value of a donation is limited to the donor’s cost, if the property is acquired in or in contemplation of a gifting arrangement, or if the property is donated within three years of acquisition.

In order to obtain the credit in the 2003 taxation year, charitable donations must have been made on or before December 31, 2003. 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 7% of income from the U.S.
The charitable donations limit of 75% of net income is further 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 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) which 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 which may result. This rule will be applied retroactively to gifts made after 1999.

Favourable tax treatment is given for donations of securities listed on prescribed stock exchanges, and ecologically sensitive land. The capital gains inclusion rate for such gifts will be equal to one-half of the normal capital gains inclusion rate; i.e. 25% of the capital gains realized in 2003. Initially, this rule originally applied only to gifts made before 2002, but the federal government has made this special rule permanent. As a result of this rule, individuals should consider making donations of securities in lieu of cash to obtain more favourable tax savings.

For example, Mon T. Hall owns 100 shares of LMAD 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 25%) would be approximately $15,000. He would donate his after tax proceeds of $85,000 to the charity, and receive a tax credit of approximately $40,000. His net tax savings would be $42,000.

If Mon 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 only be $15,000 (25% of the capital gain of $60,000), and the tax thereon will be $6,000. The $100,000 donation would also give him a tax credit of $46,400. His net tax savings would be $39,400.

A donation of property such as art, jewellery, household furniture and other personal items, will be subject to the 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, 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 an 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. Therefore, donation receipts made out to a husband or wife should be claimed by one spouse to ensure they obtain the favourable tax credit on donations over $200. In addition, the donations should 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 married credit and in some cases, the credit for dependent children. These credits are now fully indexed.

The basic personal tax credit is 16% of $7,756 in 2003 and $8,012 in 2004. The spouse credit is 16% of $6,586 to the extent the spouse's income for the entire year does not exceed $659. The amounts will be $6,805 and $681 in 2004.

Personal Tax Credits

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

The basic personal tax credit is 16% of $7,756 in 2003 and $8,012 in 2004. The spouse credit is 16% of $6,586 to the extent the spouse's income for the entire year does not exceed $659. The amounts will be $6,805 and $681 in 2004.

The most important other credit is the equivalent-tospouse 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.

Eligible dependants for purposes of claiming the equivalent-tospouse credit will be restricted to related minor dependants, the taxpayer's parents or grandparents, and any other
Parents with infirm children age 18 and over are entitled to a dependant credit of up to 16% of $3,663 in 2003 and $3,784 in 2004 for each 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 $5,197 ($5,238 in Ontario) in 2003, and $5,368 ($5,390) in 2004. If the dependant’s income, including pension income, is over $8,860 in 2003 or $9,152 in 2004, no amount can be claimed.

Individuals age 65 or over by the end of the year may be eligible for a federal tax credit of $606 in 2003 and $626 in 2004, known as the age credit. The available age credit is reduced by a formula that kicks in when the individual’s income exceeds $28,193 in 2003 and $29,124 in 2004. The credit is completely lost for individuals whose income exceeds $53,440 in 2003 and $55,204 in 2004.

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 32 and 35 outline the various credits that are available in 2003 and 2004.

**Disability Tax Credit**

If a taxpayer has a severe and prolonged mental or physical impairment, he 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 which 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. A claim may also be made for a disabled dependant. 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 $1,005 in 2003 and $1,038 in 2004.

A supplement to the disability amount may be claimed in respect of a disabled minor child. The amount which can be claimed is 16% of $3,663 for 2003 and $3,784 in 2004. The supplement is reduced if the amount of childcare and attendant care expenses claimed in respect of the child exceeds $2,145 in 2003 and $2,216 in 2004.

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**In Touch with Tax**

**SCHEDULE 4**

**Other 2003 Tax Credits**

**Federal and Ontario Tax Credit**

<table>
<thead>
<tr>
<th>Item</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pension income</td>
<td>16% of eligible pension income; maximum $160; unused credit transferable to spouse. Maximum Ontario tax credit is $65.</td>
</tr>
<tr>
<td>Tuition fees</td>
<td>16% credit for post-secondary tuition and ancillary fees, up to $800 (combined with education credit) transferable to spouse or supporting parent or grandparent. Ontario maximum amount of credit transferable is $127.</td>
</tr>
<tr>
<td>Education</td>
<td>$64 credit per month for each month in full-time attendance, and $19 credit per month for part-time; transferable within $800 combined limit. Ontario credit is $25 for full-time and $8 for part time.</td>
</tr>
<tr>
<td>Medical Expenses</td>
<td>Credit of 16% for uninsured medical expenses in excess of lesser of 3% of net income and $1,755 ($1,770 in Ontario). Refundable medical expense tax credit of up to $87 is also available for low-income families.</td>
</tr>
<tr>
<td>Charitable donations</td>
<td>Credit of 16% for first $200 per year; 29% credit for remainder of contributions up to 75% of net income. Ontario credit is 6.05%, and 11.16% respectively.</td>
</tr>
<tr>
<td>CPP/QPP and UI premiums</td>
<td>Credit at 16% (federal) and 6.05% (Ontario).</td>
</tr>
</tbody>
</table>
Federal tax credit for 2003 is calculated as the aggregate of:

- its

Official receipts are necessary to support a claim. The while Ontario contributions will produce Ontario tax credits, federal political parties will generate federal tax credits, at taxable income, but instead generate tax credits which

Political Contributions

- the EI/CPP credit.

The credit is 16% of $3,663 in 2003 and $3,784 in 2004, and is reduced if the dependant's income exceeds $12,509 in 2003 and $12,921 in 2004. No credit is available if the dependant's income exceeds $16,172 in 2003 and $16,705 in 2004.

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 payable to nil, the following credits may be transferred to a supporting spouse: age credit, pension credit, disability tax credit and tuition/education credit (maximum $800).

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 all credits, other than the personal tax credits and the EI/CPP credit.

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 16% of $3,663 in 2003 and $3,784 in 2004, and is reduced if the dependent's income exceeds $12,509 in 2003 and $12,921 in 2004. No credit is available if the dependent's income exceeds $16,172 in 2003 and $16,705 in 2004.

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. Official receipts are necessary to support a claim. The Federal tax credit for 2003 is calculated as the aggregate of:

- 33-1/3% of the first $400, plus
- 50% of the next $450, plus
- 75% of the next $100, plus
- 50% of the next $350, plus
- 75% of the balance, for a maximum credit of $500.

The federal credit will be increased for political contributions made after December 31, 2003. The credit will be:

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

In addition to contributions to the registered federal party and confirmed candidates of a federal election, contributions to registered electoral district associations will qualify for the political credit, beginning January 1, 2004.

Under proposed rules, the amount of contribution 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 $100 and $550, 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 2004 to be eligible as a credit in 2003.

Tuition Fees and Related Matters

A student may claim a tax credit for tuition fees paid in the year for courses taken in the same year. Certain requirements must be met in order to qualify for this tax credit. Of particular note, the fee 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 costs of books included in the fees for correspondence courses, are also eligible. Other requirements pertain to the duration of the course and the type of educational institution that was attended. Only post-secondary level programs qualify for the tuition fee credit.

Fees paid to private schools for grade school or high school education are not eligible for the credit. 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 tuition assistance received (see comments in the Miscellaneous Deductions section). In addition, up to $3,000 of scholarships received by any student will be exempt from tax.

Individuals who pay tuition fees will be eligible for a federal credit of 16% of tuition fees paid. In addition, an education tax credit of $64 may be claimed for each month of full-time

...
attendance in a qualified program. Part-time students will be eligible for a $19 per month credit as long as the program is at least 3 weeks long and involves 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.

The rules allow for the transfer of the combined tuition and education credit. In the past, only the student could claim tuition fees. The tuition and education credit can be transferred (to a maximum of $800) 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 $800 and the actual tuition/education 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. This situation, only the student may make a claim for the unused amount carried forward.

A student can also claim a 16% federal non-refundable tax credit for interest paid in the year or any of the five preceding years (after 1997) 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.

Effective January 1, 2003, the new provincial government cancelled the Equity in Education Tax Credit.

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.

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 $57,879 in 2003 and $59,789 in 2004 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 $57,879 in 2003 and $59,789 in 2004. Full clawback of OAS benefits occurs at around $93,000 of income. 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 $57,879 or $59,789 limit. Accordingly, the use of spousal RRSPs and other means of income splitting should be considered to help equalize future income, where appropriate.

The following example illustrates how the clawback works in 2003:

$ Taxpayer’s net income 63,215
Old Age Security 5,539
Clawback: ($63,215 - $57,879) x 15% = 800

The $800 would be added to the taxpayer’s tax liability in 2005. However, this taxpayer would only be taxed on $4,739 ($5,539-$800) of old age security on his return if tax was withheld from this individual’s OAS payments, it will be credited against the $800 liability.

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

Child Tax Benefit

The “Child Tax Benefit” system includes two components:
Child Disability Benefit

A new child disability benefit of $1,600 will be paid to disabled children of low-income families. The full benefit of $1,600 is available if the family income is below the amount at which the child tax benefit supplement is fully phased out (i.e., $33,487 in July 2003, if there are 3 or less children in the family). Beyond that income level, the benefit will be reduced by 12.5% for each additional child, and 25% for two or more disabled children. Accordingly, the benefit will be fully phased out as family income reaches $46,602 for one disabled child, $47,584 for two disabled children, and $48,211 for three disabled children. The benefit amounts and the income thresholds will be indexed annually for inflation.

The benefit became effective in July 2003, but will not be paid until March 2004. The March 2004 payment will include a retroactive amount for the period from July 2003 to March 2004.

Self-Employed Individuals

There is the perception on some fronts that being self-employed is the ultimate goal. 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 GST, PST and other assorted compliance matters today’s owner-manager 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 workplace; are not provided with employment benefits (such as vacation pay, sick leave, and health plans) and cannot collect employment insurance 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).

Self-employed individuals generally have a greater ability to take advantage of tax planning opportunities than 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 own tools, whether he is entitled to various employee benefits and whether the opportunity for profit or risk of loss depends on the individual’s activities.

Fiscal Year-End

Since 1995, all unincorporated business, whether a proprietorship or a partnership, that has 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 December 31st. Most choose the December 31st option.

As a result, some self-employed individuals may have been required, as a result of these changes, to include two business years on the 1995 tax return. The rules allowed for a reserve mechanism that would tax the 'stub' period income (i.e. the period between the former year-end to December 31, 1995) over 10 years. Specifically, at least 5% of that income must have been reported in 1995, 10% must be reported in each of the next 8 years, and 15% in the year 2004. As a result, at least 10% of the 'stub' income must be included in the 2003 tax return, with the remaining balance taxable in 2004, subject to the following comments. It is hard to believe that the 10-year stub period is finally coming to an end in 2004. My, time goes by fast when you’re having fun.

The rules offer an alternative method that permitted taxpay- ers to retain their pre-1995 existing non-calendar year-ends, but will essentially provide the same tax result (i.e. eliminate the deferral benefit) as adopting a December year-end.

The rules which permit taxpayers an 'alternative method' in reporting income are based on an estimate of income to December 31 of each year determined by prorating the income of the prior period. The following example illustrates how this estimate is determined. Assume that a taxpayer has a January 31, 2003 year-end. He would include in his 2003 income the income for the fiscal period ending on January 31, 2003 (which includes the 2002 stub period, referred to below). He would include an additional 11/12 of the January 31, 2003 income in his 2005 income. Because he would have already included an estimated amount, (calculated as 11/12 of the January 31, 2002 income) in respect of the stub period February 1, 2002 through December 31, 2002 in his 2002 income, this amount may be deducted from his 2003 income. In addition, he would include 10% of the 1995 stub period reserve in his income, in the manner described above.

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.

As always, there are many details and exceptions relating to these rules. Again, professional advice may be required.

**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 dues and green fees have not been deductible since the days of Sam Snead. 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.

**Office in Home**

A large number of taxpayers have claimed 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 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. One can usually exclude common areas such as hallways, bathrooms and kitchens when making this calculation. 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

For cars purchased in 2001 through 2004, only the first $30,000 plus GST and the applicable provincial sales tax ($34,500 in Ontario) of the cost of an automobile will qualify for purposes of claiming capital cost allowance (CCA). The limits were $31,050 for cars purchased in 2000, $29,900 for cars purchased in 1999 and 1998, $28,750 for cars purchased in 1997 and $27,600 for cars purchased from 1991 to 1996. 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 $920 ($880 plus GST and PST) for leases entered into in year 2001 through 2004, $895 ($870 plus GST and PST) for leases entered into in year 2000, $874 ($850 plus GST and PST) for leases entered into in 1999 and 1998, and $832 for leases entered into in 1997. 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 $500/month for cars purchased in 2001 through 2004, $450/month for cars purchased in 2000, and $425 per month for cars purchased in 1997 to 2000. 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 50% 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.

For more details concerning the rules governing automobiles, please refer to our separate publication, The Automobile - From Dealer To Scrap Yard.

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 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 may not qualify for deduction.

Payroll Taxes

An employee does not have to bother with the administration 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. This results in a saving of $1,966 in 2003 (taking into account both the employer and employee portion of EI) and $1,853 in 2004. However, they also cannot claim EI benefits should their business fail. Self-employed individuals have to pay both the employer and employee portion of CPP (this amounts to $3,604 in 2003 and $3,663 in 2004). 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.
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, 2003 year-end and who disposes of capital property in August 2003 will have to report the gain on his 2003 tax return even though the disposition occurs during his 2004 fiscal year. It is interesting to note that this rule does not apply to gains realized through partnerships. 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.

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. This protection 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. If any of these risks are likely, the business should be incorporated from day one, irrespective of any tax considerations.

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 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 will depend 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.

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. This protection 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. If any of these risks are likely, the business should be incorporated from day one, irrespective of any tax considerations.
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.

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 currently pays tax at a flat rate of approximately 19% on its first $225,000 of net income. Although this rate is scheduled to decline annually to 17% by 2005, the new Ontario government has proposed to freeze the rate and limits to 2003 levels. In 2003, this 19% rate is roughly 27% 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 $10,000 of income (see Schedule 1 on page 20).

At first blush, there appears to be a major tax advantage to incorporate - there is! The major tax benefit is the ability to defer tax on income retained in the corporation. 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 $19. 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.

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. Dividends on the other hand are not deductible to the corporation. However, do not forget that there is a tax cost to distribute the surplus when it is paid to shareholders by way of dividend. The concept of integration described in the Investment Income section works to ensure that income, subject to the low corporate tax rate, flowed through the corporation to the shareholder attracts approximately the same tax burden as it would have, if the income had been earned directly by the individual. Accordingly, if all such income earned by the corporation, after corporate taxes, were paid out annually to the shareholder/manager as a dividend, virtually no tax benefit would be realized, at least in theory.

Salary/dividend planning should be done annually to determine the most appropriate owner/manager remuneration mix. Issues such as CPP contributions, effect on RRSP limits, and EHT on salary, among others, should be considered in this decision. In many cases, sufficient salary should be paid to reduce the corporate income below $225,000 (subject to the following comments) so that all of the corporate income is taxed at the low corporate rate. The federal and Ontario governments have increased the threshold of income eligible for the small business tax rate. However, the federal rate for active business income between $225,000 and $300,000 is approximately 9% higher than the rate applicable on the first $225,000. In addition, Ontario will allow the small business rate on $320,000 (increased to $400,000 in 2004 by the new provincial government) of active business income. Income above this limit will be subject to an additional tax that claw back the benefit of the small business deduction. As a result, there is still a net tax cost to leaving more than $225,000 of income to be taxed in the corporation. 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 decision should be made with your tax advisor.

If amounts have been advanced to a corporation by way of loan or in acquiring shares from the company, the amount advanced to the company can be returned to the shareholder without tax consequences. Often times, 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 appropriately 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

Ontario legislation allowing professionals to incorporate have been passed and proclaimed in 2001. Members of the following professions will be 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 will be responsible for the certification or licensing of professional corporations under their jurisdiction, and will issue any necessary regulations or by-laws. These regulations and by-laws will determine the degree of flexibility each profession will have in the ownership of these corporations.

All issued and outstanding shares of the corporation must be legally and beneficially owned, directly or indirectly, by members of the same profession. It would appear, therefore, 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 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 provincial tax returns are just a few of the additional requirements and costs that result from incorporation.

Individuals and partnerships are not subject to capital tax. Corporations, however, are subject to federal and provincial capital tax on its taxable capital comprising share capital, retained earnings and certain types of debt. Taxable capital is reduced for certain types of investments. No capital tax is payable federally if an associated group of companies have less than $10 million of taxable capital. The Ontario exemption is $5 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.

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 proprietors or partnerships do not qualify.

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. 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. Owners-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. 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 business.

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 $500,000 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

"Hundreds of Rich Pay No Tax!" Sounds too good to be true? The media, and the Auditor General, periodically express outrage at taxpayers who earn high levels of income, and pay no income tax, or politicians that cheat the taxpayers. What these sources fail to mention is the fact that one of the primary causes for high income-earners who pay no tax is the losses previously suffered by these taxpayers. As this section describes, the Canadian tax system offers some significant relieving provisions in connection with losses and the ability to utilize them. To the extent possible, 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.

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 recent Supreme Court decision, in dealing with purely commercial ventures. If there is a personal element in the venture, there is a still an onus to prove that the venture is undertaken with an intention to earn a profit, and there must be businesslike behaviour which supports the 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.

The government proposed to legislate the "reasonable expectation of profit" test to override the court decision referred to above. Under these rules, whether a loss from business or property can be deducted is evaluated each year. The definitions anticipate that a person may realize start-up losses in the early years of a venture, or may realize losses in some years, and profits in others. Accordingly, in the year of the loss, it must be reasonable to expect that a cumulative profit will be realized over the anticipated holding period of the investment, or the period during which the business will be carried on, and not just in the current year. Profit does not include any capital gain which may be realized on the sale of the business or property. The rules are not scheduled to come into effect until 2005.

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. Any unused non-capital losses arising in a year may be carried back three years or forward seven years on the same basis.

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. In addition, as a result of the change in the capital gains inclusion rates in 2000 from 76% to 66.2/3% and then subsequently to 50%, any net capital losses carried forward or back will need to be
may make sense to the extent that other credits are available. In addition, it below approximately $7,800. This threshold would increase individuals should not utilize losses to bring their income below the level when no tax would be payable. For example, because of the basic personal tax credit, income below the level when no tax would be payable. 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 ten years, but only to be deducted against farming income.

The utilization of any of these loss carryovers is fully discretionary in the year of application. 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 where no tax would be payable. For example, because of the basic personal tax credit, individuals should not utilize losses to bring their income below approximately $7,800. 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 lower 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-economic 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 whammys in the past number of years. Because of a perception that the tax benefits provided to investors are unwarranted, and took advantage of unintended loopholes in the tax legislation, tax shelters which have applied for, and received favourable income tax rulings from the government, may still be 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 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 shrink. Great care should be exercised before making these types of investments. It is imperative to examine the investment and business merits of a shelter of which the tax benefits only play a part, prior to investing.

A number of tax changes made over the years have reduced the impact of the deductions available from specific tax shelters. The AMT, 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 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. Recent proposals to codify the reasonable expectation of profit test will take effect in 2005, and once implemented will reverse recent court decisions in this area. In essence, a loss will only be deductible in any year if a cumulative profit can be expected over the anticipated holding period of the investment. Capital gains are not taken into consideration in determining profit. Meanwhile, the 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, before the new rules take effect in 2005.

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” 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.

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

Charitable Donations

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 of 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 proposals appear to have shut down most of 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 favorite 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, often in excess of the amount of the limited partner’s investment.

Those days are long gone. The current rules limit the amount of investment tax credits (ITCs) and business losses available from limited partnerships. In essence, these rules were introduced to restrict a limited partner’s claim of ITCs and business losses 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 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 resulted 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, that are still in business are exempt from these rules.

In many of these arrangements, the limited partner may finance his 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 may also 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.

Film Investments

Since the government eliminated the tax credits available for direct investment in motion picture and television production, film investments are generally structured as limited partnerships formed to fund production expenses and provide production services. The partnership will receive fees for services provided, and a percentage of net revenues, if any, from the production.

These investments were sold as tax deferrals, not outright tax savings vehicles. The tax saved in the earlier years, principally the first two years, must be be “repaid” (generally) ten years later. Accordingly, these deals should be looked at as a ten-year interest free loan.

Generally, these investments are structured to avoid the “matchable expenditure rules”, which limit the tax deduc-
eligible junior mining companies. These tax credits will be credits (15% federal, and 5% Ontario) for investments in federal government and Ontario will give investors tax or credits and pass them through to their shareholders. The partnership arrangement or corporate “flow-through shares” which allow the corporation to forego certain tax write-offs and pass them through to their shareholders. Resource tax shelters generally use a limited instructions at year-end for use in completing a personal tax return. Mortgage interest expense, property taxes and other maintenance costs can be applied against income for other sources. Mortgage interest deductions available to taxpayers from a resource property remain a source of confusion for most taxpayers. As previously noted, these investments are tax deferral vehicles. Invest the deferred savings wisely. One doesn’t want to be confronted with a hefty tax bill in ten years (or earlier if the CRA successfully challenges the write-offs) and discover that the earlier savings have “disappeared”.

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 for 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 Real Estate Investment Trust (“REIT”). 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.

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 government and Ontario 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 are scheduled to expire after 2004.

Labor-Sponsored Venture Capital Corporations

A number of provinces, including Ontario, have established legislation to promote equity investments in developing businesses. Many of these arrangements involve venture capital corporations which provide provincial tax credits to individuals who invest in shares of labour-sponsored corporations. These are known as Labour-Sponsored Venture Capital Corporations (“LSVCC”). For 2003, the federal and Ontario government each provides a tax credit of 15% on an investment up to $5,000 for a total credit of $1,500. The deadline for a purchase that permits a claim for the 2003 tax year is February 29, 2004.

Although providing an attractive tax result, especially if purchased through an RRSP, be aware of the redemption restrictions and investment aspects of the LSVCCs. Pre March 6, 1996 investments must be held for at least 5 years, or 2 years for individuals aged 65 or older. Post March 5, 1996 investments must be held for at least 8 years, without any age exemption. 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 over a number of years. These policies and arrangements can be used to accomplish several objectives including the obvious provision of insurance coverage, as well as providing retirement income through tax-sheltered earnings. Under proposed rules, insurance policies issued by non-resident insurers will not be eligible for tax shelter treatment, beginning in 2005 (see our comments in the Foreign Investments section). Creative ownership arrangements have also been developed that may reduce the costs associated with owning life insurance. Consideration of life insurance as a form of tax shelter should not be dismissed too quickly. However, these investments may be difficult to understand and anyone interested in this type of planning should consult them only with the appropriate professional advice.
ALTERNATIVE MINIMUM TAX (AMT)

Alex, I’ll take “Famous Oxymorons” for $1,000. The answer is: “Alternative Minimum Tax.” The question is: “What tax has a name that is somewhat misleading?” Firstly, taxpayers who are subject to the AMT must pay it - there is no alternative. Secondly, in cases where the AMT is applicable there are no guarantees that the amount will be “minimal.” At least one thing is for sure - it is a tax.

It is most likely to arise for taxpayers with large capital gains eligible for the exemption or those taxpayers that have significant interests in tax shelters. Otherwise, the AMT has not been a significant burden to most taxpayers.

The AMT was introduced to inject a measure of fairness into an apparently “unjust” tax system. It was designed to attack the perception associated with those high-income taxpayers who were perceived to pay little or no personal income tax through the use of so-called tax preferences (shelters). While the majority of taxpayers will not end up paying AMT, the possible application of AMT must not be forgotten in the course of tax planning and the filing of tax returns.

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, plus any Kiddie Tax payable (see the Income Splitting section).

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 to determine the taxable income subject to AMT. These include tax depreciation (“CCA”) and carrying charges (such as interest and borrowing costs) claimed on leasing, rental and film properties, losses from limited partnerships, tax shelters, resource expenditures and flow-through shares, and related carrying charges. Sixty percent of the untaxed one-half of capital gain is included in AMT taxable income. Only actual dividends (not the gross-up) are included in the AMT base.

2. The federal tax rate applied to AMT taxable income is a flat 16%. The taxpayer must pay the higher of the federal tax otherwise determined and the AMT. The applicable provincial rate is then added. The combined 2003 federal-provincial AMT rate is approximately 25%, including all surtaxes. Only certain tax credits are deducted in computing the ultimate AMT liability. Dividend tax credits and investment tax credits are examples of some of the credits not allowed in computing AMT. Under recent proposals, a taxpayer must claim the same amount of those tax credits (which are allowed for AMT purposes), in calculating regular tax and AMT.

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 comply with the multitude of tax payment deadlines inherent in the system. This is especially the case in the area 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. For 2003, individuals were required to make quarterly instalments if the difference between tax payable and amounts withheld at source is greater than $2,000 in both the current year (i.e. 2003) and either of the two preceding years (i.e. 2001 and 2002). 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 March 15, June 15, September 15 and December 15. 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 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.

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 2003 instalments are based on 2001’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 2003 instalments are based on 2002’s liability with an adjustment to ensure total instalments end up equaling 2002’s tax liability).

The CRA sends out notices informing taxpayers of their instalment requirements 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. Professional advice may be warranted.

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, 2004. 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 sooner rather than later 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.

In Touch with Tax

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ed if the CRA decided to pay interest on overpaid accounts. Unfortunately, it is unlikely to happen.

The CRA does pay interest on tax refunds to individuals. For 2003, the interest clock will start 30 days (reduced from 45 days) from the later of the filing deadline and the day on which the return was actually filed. For individuals that have a June 15 filing deadline, interest will not be paid until 30 days after April 30 or 30 days after the return is actually filed, whichever is later. 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.

There are rules that address, albeit only partially, the inequity facing a taxpayer who owes the CRA money for one taxation year at the same time that the CRA owes him money for another taxation year. He is taxable on the refund interest but he cannot claim an offsetting deduction for the interest that he has to pay the CRA. Under the proposed rule, which has yet to be legislated, refund interest will only be taxable to the extent it exceeds any arrears interest that accrued over the same period. This will apply to arrears and refund interest amounts accruing after 1999, regardless of the taxation year to which the amounts relate. The CRA will advise the taxpayer the amount of the refund interest that must be included in income.

**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 in both 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 onside 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 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 whenever possible. It can save time and money.

The impact of these rules is best understood when one examines some numbers. Assume that the prescribed rate is 8%. When the effect of daily compounding is factored in, the effective rate is close to 9%. 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 approaching 26% (at the top rate of tax in Ontario). If this does not send a clear signal that paying instalments is vital, what does? 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 more onerous for frequent offenders. 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 1 to file their returns 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 of "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 generally assesses such a penalty on a taxpayer who repeatedly fails to report income, or if the income omitted is sizeable. A taxpayer may face criminal prosecution for more serious offences.

**Waiver of Interest and Penalty Charges**

The government has enacted a fairness package to deal with, among other things, the potential cancellations 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 and penalty charges should consider whether the provisions of the fairness 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 requested by the CRA.

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
of death. In computing income on that return, a number of
special rules apply.

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, 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
received, must be included in income. For example, if Mrs.
Vanna died on June 1, 2003, and at the time of her death, she
owned a GIC which she bought on March 1, 2003 with a
maturity date of September 1, 2003, 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 will
trigger recapture of depreciation claimed previously or a
terminal loss on depreciable assets such as buildings. These
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 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 preced-
ing 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 previously 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 can be car-
ned 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. 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 have been made
within 36 months after death. The Executors may apply
for an extension of the 36 months 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 any 24-month period
that includes the date of death. 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 without attracting tax. This is especially
relevant in situations where the deceased was an employee
of a closely held family corporation.

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, 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 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 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.

**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 $32,000. The estate does not get the basic personal tax credit.

**RRSP/RRIF 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 but the spouse can defer the tax but only 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 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 sold 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 to utilize a spouse trust in lieu of transferring assets directly to a spouse on death. Firstly, the use of a trust enables the deceased to continue to split income 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...
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 their wills.

It is very important to choose the right executor(s) for the estate. Executors play a 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 or chooses not to act as executor. The choice of executor is a decision which should not be made lightly.

In addition to a will, a power of attorney should be prepared for both decisions related to finances and personal care. A power of attorney should be prepared for both 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 asset 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 in the cases of businesses operating through corporate entities.

The mechanics of an estate freeze can best be illustrated in an example. Consider a corporation currently owned 100% by Dad that is valued at $500,000. Dad could implement an estate freeze by converting his existing equity shares into fixed value preference shares worth $500,000. 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 $500,000 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 that 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 to provide 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.**
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 recipients 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 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
minimize the EAT, where appropriate. Substantial. Prudent planning should be considered to

The amount of EAT assessable on a large estate may be

of value and 1.5% of the value in excess of this amount.

EAT in Ontario is charged at 0.5% of the first $50,000

the executor.

require proof of probate before they will release assets to

ity to administer the estate. Institutions such as banks often

deceased’s will is valid, and that the executor has the author-

than debt on real estate) in order to confirm that the

In all provinces except Quebec, EAT is levied on the total

EAT in Ontario is charged at 0.5% of the first $50,000

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.

For example, property that is owned jointly with right of

survivorship is not subject to probate. Accordingly, where

possible, assets and bank accounts should be owned

jointly. Any planning in this regard should also take into

account the relevant income tax implications.

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 may be possible for

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

will 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 a deemed disposition of the property at fair market

value. However, the property in the trust may be distributed
to the contingent beneficiaries without requiring probate.

**EMIGRATION FROM CANADA**

When a person is considering becoming a non-resident of

Canada (see our commentary on Taxation of Non-Residents

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.

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 a short-term assignment.

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.

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 will continue to be exempt and will be subject to tax when sold. Rights under certain employer-sponsored or legislated plans or arrangements, such as RRPs, RRSPs, salary deferral arrangements, and U.S. Individual Retirement Accounts, are also exempted. As well, rights under employee stock option plans are exempt. Some of these rights were taxable under the former departure tax rules.

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. The CRA may, in extreme hardship cases, accept modest security. 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 $50,000 of taxable capital gain. Once the asset is sold, the departure tax will be due on April 30 of the following year. Interest and penalty 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 immigrating 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 agreed in principle 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 the meantime, 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 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 still 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 increased scope 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, 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, including personal use property such as foreign residences and vacation properties.

Information reported on these returns will be entered into a national database. These 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. These 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 substantiate 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. 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 it 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. It is therefore, advisable to assemble the necessary documentation as early as possible.

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 is subject to tax in Canada on his 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 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 spouse or common-law partner, and the location of dependants. 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.

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, Canadian driver's license, etc..

The CRA may presume that an individual maintains his Canadian residence status if he is away from the country temporarily. Previously, the CRA considered a stay abroad of less than two years to be insufficient to indicate that the person has become a non-resident. The CRA now 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 residential ties with Canada, he will be considered to be a non-resident, even if his 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 or her employment, and returns each night to his 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 dependents, 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 he meets one of the following conditions:

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

Any non-resident who falls into categories (1) to (3) above 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.

Non-residents in receipt of the types of income in category (4) will generally be subject to withholding taxes at source. There are certain types of interest payments, such as interest on government bonds, which are exempt from the 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. For example, the withholding rate for such income earned by U.S. individuals is reduced to 15% and, in some cases, 10% or lower.

Special rules exist when a non-resident disposes of most types of taxable Canadian property. A disposition may include many transactions which may otherwise take place on a tax-deferred basis, including exchanges of shares of one Canadian corporation for shares of another Canadian corporation. Taxable Canadian property is a defined term in the Canadian tax system. It includes real estate situated in Canada, property used in a business in Canada, shares of a private corporation resident in Canada, shares of certain non-resident corporations, certain partnership interests, 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.

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. As an alternative, a non-resident can obtain a certificate from the CRA that replaces the withholding requirement. To obtain this certificate, among other things, the vendor must remit (or provide adequate security for) 25% of the estimated gain. Any tax withheld pursuant to the above mechanism is credited against the ultimate tax liability reported on the non-resident’s tax return. A 50% withholding tax is applicable on certain types of property, such as life insurance policies, or real estate inventory.

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.
Special Election Rules

As noted earlier, non-residents are subject to withholding tax on certain types of passive income. In some circumstances an individual may 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.

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 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 behalf and he 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. As noted earlier, non-residents are subject to withholding tax on certain types of passive income. In some circumstances an individual may file an election to obtain a reduction in the tax otherwise payable on such income.

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 where the property is generating net rental losses.

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.

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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. Generally, he or she would 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 look at, as the following order in which country an individual has a “permanent home”, closer “personal and economic relations”; or a “habitual abode”; or of which country the individual is a citizen. 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. Otherwise the IRS may deny treaty relief, and assess U.S. tax on worldwide income.

c) An individual who is present in the U.S. for 51 days or more, but less than 183 days in a calendar year, may also be considered to be resident in the U.S.

If this condition applies and the individual meets a substantial presence test, a U.S. tax return is required. The substantial presence test is met if the total of:

- all the days present in the current year (2003), plus
- 1/3 of the days present in the 1st preceding year (2002), plus
- 1/6 of the days present in the 2nd preceding year (2001) equal 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.

The requirement to file a U.S. return under the substantial presence test may be avoided if the individual has a closer connection to Canada and files a “Closer Connection” statement (Form 8840) with the IRS.

d) The individual carries on business in the U.S.

If an individual carries on business in the U.S. (either directly or through a partnership), he or she may be required to file a U.S. tax return. This is so even if his business activities are exempt from U.S. tax under a provision of the Canada-U.S. Tax Treaty. If the individual sold U.S. real property interests (whether or not they are capital assets), or elected to treat income from the rental of U.S. real property 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.

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.

If an individual is not caught by a), b), c) or d), 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, 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 current negotiations between Canada and U.S. may reduce the rate of withholding further. 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 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. Under recent legislation, the estate tax will be gradually phased out, beginning in 2002 (see table in this section for the estate tax rate applicable for each year). No estate tax will be payable on estates of persons who pass away in 2010. However, as the legislation contains a sunset clause, without further legislative action, the estate tax will be restored to the current level of up to 55% in 2011. President Bush has proposed to make the estate tax elimination permanent in his 2003 Budget. Time will tell if the estate tax will actually become a thing of the past.

The 2003 U.S. estate tax is calculated using graduated rates ranging from 18% to as much as 49% on estates with values over U.S. $2 million. This tax is also applicable to non-residents who own U.S. property such as real estate (including vacation property) and shares of U.S. corporations, as well as certain debt obligations. 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. The exemption amount has not been increased under the recent amendments. After this threshold, the tax rates may become very onerous.

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.

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.

In 2003, Canadian residents will be entitled to a tax credit, equal to a pro-rata portion of U.S. $345,800 which has the effect of providing a U.S. $1,000,000 exemption (currently approximately Can $1,300,000) on the value of an individual's worldwide gross estate. The exemption will rise gradually to U.S. $3.5 million in 2009, and will be eliminated in 2010, as detailed in the following table: This is the same threshold allowed to U.S. residents.

<table>
<thead>
<tr>
<th>Year</th>
<th>Estate Tax Exemption Threshold</th>
<th>Maximum Estate Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>1 million</td>
<td>49%</td>
</tr>
<tr>
<td>2004</td>
<td>1.5 million</td>
<td>48%</td>
</tr>
<tr>
<td>2005</td>
<td>1.5 million</td>
<td>47%</td>
</tr>
<tr>
<td>2006</td>
<td>2 million</td>
<td>46%</td>
</tr>
<tr>
<td>2007</td>
<td>2 million</td>
<td>45%</td>
</tr>
<tr>
<td>2008</td>
<td>2 million</td>
<td>45%</td>
</tr>
<tr>
<td>2009</td>
<td>3.5 million</td>
<td>45%</td>
</tr>
<tr>
<td>2010 (without further legislation)</td>
<td>N/A Tax repealed</td>
<td>N/A Tax repealed</td>
</tr>
<tr>
<td>2011 (without further legislation)</td>
<td>1 million</td>
<td>55% + 5% surtax on large estates</td>
</tr>
</tbody>
</table>

Canadian residents with worldwide estates valued at less than U.S. $1.2 million. Under these relieving provisions, 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. 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 income tax in Canada.
i) Acquire property jointly with a spouse or perhaps (partial) solutions may include: unsatisfactory solutions must still be considered. These problems have not been solved and the current somewhat For those Canadians with significant estates, the existing under certain circumstances.

Property which is transferred to a surviving spouse may already paid by Mr. Swamp's estate at the time of his death. If the property had a nominal cost, he would have to pay Canadian capital gains tax of approximately U.S. $958,000. Before the repeal of the estate tax, Mr. Swamp would pay U.S. estate tax on the U.S. $250,000, and the tax would be claimed as a credit on his Canadian income tax return as a foreign tax credit. The beneficiaries would receive the property at the stepped up value for both Canadian and U.S. tax purposes.

After the repeal of the estate tax, the beneficiaries would not receive a step up in the cost base of the property for U.S. tax purposes. On a future sale of the property, the beneficiaries would have to pay U.S. capital gains tax on the U.S. $250,000, with no offsetting relief for the Canadian capital gains tax already paid by Mr. Swamp's estate at the time of his death.

The repeal of the U.S. estate tax may create new problems for taxpayers who will be subject to capital gains tax in Canada on death. For example, Mr. Swamp owned a Florida vacation property worth U.S. $250,000 at the time of his death. If the property had a nominal cost, he would have to pay Canadian capital gains tax of approximately U.S. $958,000. Before the repeal of the estate tax, Mr. Swamp would pay U.S. estate tax on the U.S. $250,000, and the tax would be claimed as a credit on his Canadian income tax return as a foreign tax credit. The beneficiaries would receive the property at the stepped up value for both Canadian and U.S. tax purposes.

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For those Canadians with significant estates, the existing problems have not been solved and the current somewhat unsatisfactory solutions must still be considered. These (partial) solutions may include:

i) 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.

ii) Attach non-recourse financing to the U.S. asset, either upon acquisition or at some later date. 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.

iii) Obtain life insurance specifically to fund the estate tax liability created on death.

iv) 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 income tax consequences, Canadian and U.S. resulting from the sale (e.g., capital gains tax or gift tax).

e) Acquire or perhaps transfer U.S 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. As well, the CRA may consider that a corporate benefit has been conferred on a shareholder or in the case of a personal use asset. At present, the CRA applies administrative relief, as long as certain conditions are strictly adhered to.

f) Set up a spousal trust which qualifies for rollover treatment under both U.S. estate tax law and Canadian tax law.

g) 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. On death, U.S. estate tax may be avoided. This 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% for dispositions after May 5, 2003 (20% for dispositions prior to May 6, 2003). 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 25% in 2003 and 2004. 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 from January 1, 1985 will be subject to U.S. tax. This can be based on a value of the property at January 1, 1985 or alternatively based on a proportion 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 sell-
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 contestant was rewarded with company cars, club memberships, big offices and important sounding job titles. In recent years, employees strive for an even more glamorous "fringe-benefit": stock options. Employee stock options have become the most talked about, and most demanded prize in the last number of years, particularly in the dot.com sector. The tax rules concerning stock options give employees tax consequences which are generally more favourable than other forms of benefits. However, with the recent volatility of the stock market, and in particular the dot.com sector, employees may prefer the more traditional forms of compensation again.

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. Assume that a corporation, TPIR Inc. granted its employee, Robert Barker an option to purchase 1,000 common shares of TPIR at $10 per share. Robert may exercise the option to acquire all 1,000 shares immediately (i.e. the options vest immediately). At the time the option was granted, the shares of TPIR were worth $8 per share. There is no immediate tax consequence to Robert.

If the fair market value of the TPIR shares dropped, TPIR may exchange the stock option held by Robert for new stock options with a lower exercise price. As long as the exercise price were dropped to $8 per share at a time when the TPIR shares were worth $8 per share, there would still be no net benefit to Robert. The exchange, therefore, would not result in any immediate tax benefit to Robert. Under proposed rules, 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. Robert decides to exercise the stock option when the shares are worth $18 per share. Once Robert buys the 1,000 shares under the stock option plan, he will realize a taxable benefit of $18,000 which is equal to the difference between the fair market value of the shares (i.e. $18.00) on the day the shares are purchased and the option exercise price of $10 per share (i.e. $10,000). If certain conditions (described in the section concerning tax 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.

If TPIR was a Canadian Controlled Private Corporation ("CCPC") at the time the stock option was granted to Robert, Robert would not be taxed on the benefit until he actually sold the shares. That would be true even if TPIR were no longer a CCPC when Robert purchased the stock option shares.

If TPIR were not a CCPC, however, Robert would be taxed on the benefit when he exercised the option and purchased the shares. The tax liability resulting from the taxable benefit may cause Robert financial hardship, unless Robert can sell some or all of the shares in order to fund the tax owing. If Robert is unable or unwilling to sell the shares, she will have to obtain cash from other sources in order to pay her tax liability.

The federal government bowed to intense pressure, and extended the more favourable rules, previously available only to employees of CCPC's, to employees who receive publicly listed shares under stock option plans. As a result, these employees will be able to elect to defer the taxable benefit to the year the option shares are sold. These rules apply to stock option shares acquired after February 27, 2000, regardless of when the options were initially granted. In order to qualify, the option price cannot be less than the fair market value of the shares at the time the option is granted. There is a limit of $100,000 on the total value of stock options which can vest in any year (based on the fair market...
value of the shares at the time the option is granted. Employees who receive shares of private corporations, other than CCPC shares, will not benefit from these changes.

Robert’s options from TPIR (if TPIR were a publicly listed corporation) would qualify for the deferral because the option price of $10 a share was higher than the fair market value of $5 at the time the option was granted, and the total value of the shares that vested in the year was only $5,000 ($5 x 1,000 shares).

To benefit from these rules, an employee will need to file an election by January 31 of the following year to inform his/her employer (or the corporation whose shares are being acquired) that he is eligible to, and intends to defer the recognition of the taxable benefit until the time that the shares are sold. It is important, therefore, to review your own personal situation with your tax advisor well before income tax filing deadlines. The employer must, in turn, report the taxable benefit which has been deferred, on the employee’s T4 for the year. The employee will have to file a special form with his/her tax return each year to track the amount of the benefit which has been deferred.

If the employee owns other shares of his/her employer (that he/she acquired on the open market, for example) in addition to shares purchased under a stock option plan, there are complicated rules which will govern the timing of the recognition of any taxable benefit. Generally, shares which 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 which 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 assumes that Robert deferred the taxable benefit until he sold the shares.

<table>
<thead>
<tr>
<th>Stock option shares</th>
<th>Cost of shares ($)</th>
<th>Fair market value ($)</th>
<th>Sale price ($)</th>
<th>Capital gain/loss ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before sale</td>
<td>10,000</td>
<td>15,000</td>
<td>20,000</td>
<td>5,000</td>
</tr>
<tr>
<td>After sale</td>
<td>18,000</td>
<td>15,000</td>
<td>15,000</td>
<td>(3,000)</td>
</tr>
</tbody>
</table>

Stock Option Deduction

Under certain circumstances, Robert will be able to claim a deduction to partially offset the amount of the taxable benefit. Since Robert 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 TPIR shares on the date the option was granted to him, Robert would be able to claim a stock option deduction. If Robert could not defer the taxable benefit, he would be taxed on the benefit when he exercised the option, and he would claim a deduction of 1/2 of the benefit. If Robert were eligible to defer the taxable benefit, the benefit would be taxable when he sold the shares, and the amount of the deduction would depend on the inclusion rate on the date the shares were sold, rather than the option exercise date. The 1/2 deduction results in net taxable amounts which are comparable to capital gains.

Alternatively, if TPIR were a CCPC, Robert may be eligible to claim a similar deduction if he held the TPIR stock option shares for two years before selling. He is only allowed to claim one deduction under either the regular rules or the rules applicable to CCPC’s.

If Robert had exercised her stock options in TPIR on June 1, 2003 (and was eligible to defer the taxable benefit under the rules discussed previously), and he sold the shares on January 1, 2004, he would be taxed on the $8,000 taxable benefit in 2004. The result would be as illustrated in the following example.
example under the “Sale of Stock Option Shares” section. He would be able to claim a deduction equal to 1/2 of the $8,000 taxable benefit. The net amount taxable to her in 2003 as an employment benefit would be $4,000.

In the example, Robert also realized a capital gain or loss as a result of a fluctuation in the share price of TPIR 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 over the last few years, many corporations have 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.

Donation of Stock Option Shares

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 1/4 of the taxable benefit, for a net taxable amount of 1/4 of the taxable benefit. The net taxable benefit will be equivalent to half the capital gains inclusion rate.

If the shares decrease in value between the times they are acquired and 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.

Ontario Research Employee Stock Option

Ontario introduced an additional incentive to certain employees of high technology companies which carry on research activities in Ontario. The employee must spend at least 50% of his/her time on research and development activities, have been employed for at least 6 months, and cannot own more than 10% of the shares of his employer. Only stock option agreements entered into after December 21, 2000 will qualify. The employee must be resident in Ontario in the year in which the option agreement was entered into, and also in the year the option is taxable to the employee.

The employer will have the responsibility of advising the Ontario government, as well as the employee, in the year a stock option agreement is entered into, of the eligibility of the stock option plan for this additional benefit. The employer must issue a certificate of eligibility to the employee who must keep this certificate in order to benefit from this incentive.

An eligible employee will be able to notionally reduce his Ontario taxable income by the lesser of $100,000 and the amount of the taxable benefit (net of the regular stock option deduction) included in income during the year and the taxable capital gain realized on stock option shares. The difference between his/her actual Ontario tax liability and the tax on the notionally reduced taxable income is treated as an overpayment of tax. The employee must file an application by September 30 of the second following year and attach copies of the certificates from the employer, to obtain a refund of this tax.

Accordingly, an eligible employee will essentially pay only federal tax (ignoring the Alternative Minimum Tax) of a maximum of 14.5% on up to $100,000 of taxable benefit and or taxable capital gain on eligible stock options. The benefit of this Ontario incentive can be substantial, and should not be ignored.

T**HE GOODS** **AND** **SERVICES TAX (GST)**

The GST is a fixture in the Canadian tax system. The Maritime provinces (excluding Prince Edward Island) have instituted a unified tax in conjunction with the federal government called Harmonized Sales Tax (HST) which works exactly like the GST and imposes a 15% rate on goods and services. For residents of these provinces, substitute 15/115 for references to 7/107 in the balance of this section. Quebec administers its own sales tax system which also combines the collection of GST. Following are a few comments on specific GST issues that may affect individual taxpayers.

**Employees**

**Employment income and benefits**

Wages and salaries are not subject to GST

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). For example, an employer owns a car which cost $28,750 ($25,000 plus GST and PST of $3,750) and makes it available to an employee for both business and personal use. The employee will have to include in income a benefit (known as a standby charge) of 2% of the $28,750 for each month the car is available to him for personal use, less any amounts reimbursed by the employee to the employer. The employee will also be taxed on the personal use portion of any operating costs (known as an operating cost benefit) paid by the employer. The employer is required to remit GST on the full amount of the benefit, whether or not it is otherwise entitled to claim an input tax credit (refunds of the GST paid on purchases relating to the business) or a rebate on any GST actually paid. The amount of GST to be remitted by the employer with respect to any taxable benefit other than the operating cost benefit will be 6/106 (14/114, in the case of an employee who works in the provinces in which HST applies) of the tax-included "total consideration." The "total consideration" is equal to the sum of the tax-included benefit reported for income tax purposes (i.e., inclusive of both GST and PST) and all reimbursements made by the employee or shareholder that are in respect of expenses incurred in relation to the operation or use of a motor vehicle. For the operating cost benefit, the GST to be remitted by the employer will be equal to the prescribed percentage, currently 5% of the total consideration (i.e., 5% of the total benefit amount including PST, GST and reimbursements). The prescribed percentage for the HST provinces is 11%.

Employee Rebate

Employees may, in certain circumstances, file for a rebate of the GST they have paid on certain expenses and on capital cost allowance ("CCA") relating to an automobile. An employee may be able to claim a GST 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 GST. Further, if the employee receives mileage reimbursement from his/her employer, he would be entitled to a GST rebate only if the employer certifies that the reimbursement is unreasonable, and that the employer

### GST Rebate to Employee - Example

<table>
<thead>
<tr>
<th>Description</th>
<th>2003 Expenses</th>
<th>2004 Income Inclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Automotive costs (actual total costs)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Oil and gas</td>
<td>$1,070</td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td>$720</td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>$780</td>
<td></td>
</tr>
<tr>
<td>Repairs and maintenance</td>
<td>$650</td>
<td></td>
</tr>
<tr>
<td>Capital cost allowance</td>
<td>$3,220</td>
<td>$3,000</td>
</tr>
<tr>
<td>Less personal portion - say 25%</td>
<td>$6,220</td>
<td>($1.353)</td>
</tr>
<tr>
<td>GST rebate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital cost allowance</td>
<td>$1,720</td>
<td>$3,000</td>
</tr>
<tr>
<td>Amount deductible for income tax - say 75%</td>
<td>$3,540</td>
<td></td>
</tr>
<tr>
<td>Rebate 7/107 x $3,540</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Impact of GST rebate filed for 2003, received in 2004</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Include in income - ($1,070 + $650) x 75% x 7/107</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deduct from capital cost - $3,000 x 75% x 7/107</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Impact of GST rebate</td>
<td>$85</td>
<td>$147</td>
</tr>
<tr>
<td>Deduct from capital cost - $3,000</td>
<td></td>
<td>$232</td>
</tr>
</tbody>
</table>
would not be claiming a GST credit with respect to the
notional GST on the amount of the reimbursement. As a
result, this rebate is not available to all employees.

The amount of the rebate is 7/107ths of the expense being
deducted or of the CCA being claimed. In Schedule 5, the
example shows how this would be calculated. GST must
have been paid before the rebate is available. Many expenses
include GST such as gasoline, parking expenses, airline tick-
ets, meals, hotels, and so on. Others do not, such as interest,
and insurance.

The rebate is the good news. The bad news is that rebates
received in the year must be included in income in the year
received or reduce the capital cost of the asset on which the
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 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 GST 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 GST paid relating to his or her
commercial activities, provided that person is registered.

Registration under the GST is required for self-employed
individuals who carry on GST 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 GST on their expenses. If
these individuals also carry on taxable activities, they may be
required to charge GST (and recover GST on a portion of
their expenses) on the taxable activities.

An individual who is registered will be required to charge the
GST 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 GST should
ultimately not be a cost of doing business.

Where an individual is not required to be registered (e.g.
those in exempt activities or gross revenues under $30,000),
GST would not be charged on sales. However, input tax
credits would not be available. Some relief is provided
through, as the GST 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 business-
es with annual taxable sales of $200,000 or less (including
GST and HST) can use this method. 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 exclusively outside or in the
HST provinces, or both in and out of those provinces. Retailers
and wholesalers outside of the HST provinces can remit 2.5% of their taxable sales as GST for sales outside HST
provinces, or 9.5% as HST, for sales in HST provinces. Other
types of businesses are eligible for a 5% rate (11.6% in HST
provinces). These rates are lowered by 1% to 1.5% (8.5% for
HST) and 4% (10.6% for HST) respectively, for the first
$50,000 of tax-included sales. The remittance rates for
entities selling through a permanent establishment in a HST
province are lower than those indicated above. 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 account-
ing method is available for businesses with annual sales not
exceeding $500,000, and taxable purchases of less than $2
million. Under this method, purchases which are subject to
GST are totalled and businesses can claim 7/107ths of the total
for input tax credit purposes. Under this method, purchases
include GST, provincial sales tax, late payment penalties and
tips. This method should result in a larger claim for input tax
credits than the actual amount of GST 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
GST. In addition, the partnership must have been entitled to
claim an input tax credit if 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 GST 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, as the
subsequent year.
Other Matters

**Harmonized Sales Tax ("HST")**

The GST in Nova Scotia, New Brunswick and Newfoundland were repealed. Instead, the tax in these provinces was increased to 15% which includes 7% as a federal component and 8% as a provincial component. HST and GST apply to the same goods and services. All GST registrants in Canada must collect HST on taxable supplies made to or in the Maritime provinces noted above. Collection, reporting and remittance of HST are done through the existing GST system.

**GST 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 GST paid by these families. However, the amount of the credit does not bear any relation to the actual GST paid. Rather, it is based on family income.

The maximum credit available in 2003 is $216 per adult and $114 per "qualified child". These credits are reduced by 5% of family income in excess of $28,193. As a result, a family with two children would not be entitled to any part of this credit if their combined net income of the husband and wife exceeded approximately $41,400.

A GST credit supplement of up to $114 is available to singles, including single parents. This supplement is phased in at a rate of 2% of net income over $7,022, and reduced by 5% of net income in excess of $28,193. For those entitled to the credit, the CRA mails cheques in January, April, July, and October. A single payment in July is made for those eligible for less than $100 in GST credit.

**Purchase of a New House**

The purchase of a newly constructed home in Canada is a GST taxable event. That is, the 7% GST (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 GST that a family may make.

**GST New Housing Rebate**

The GST new housing rebate may be available to the purchaser of a new house. The rebate is only available if certain conditions are satisfied. The key conditions are that the new house does not cost more than $450,000 and 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 these and other conditions are satisfied, the GST rebate is available. The maximum rebate is $8,750, which results when the purchase price is about $350,000. Where the price is less than $350,000, the rebate is equal to 36% of the GST paid (or 2.52% of the purchase price), to a maximum of $8,750. 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. For each $1,000 that the purchase price exceeds $350,000, the rebate is reduced by $87.50.

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 GST payable so that the purchaser pays the net GST after deducting the rebate.

**Purchase/Sale of a Used House**

The sale of used (previously owned) housing is exempt from GST. Plain and simple. The purchaser does not pay any GST on the transaction. As a result, the GST new housing rebate does not apply if GST is not paid, then the purchaser should not be entitled to a rebate.

It should be noted though, that GST 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 GST will apply to the rent. Accordingly, one will not be able to recover GST paid on expenses related to the property.

If you have built, renovated or converted property into residential rental units after February 27, 2000, you will be allowed a rebate equal to 2.5% of the GST 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 GST and one is able to recover GST on expenses paid. If rental income is less than $30,000 one can choose whether to register for GST. The owner may wish to register and collect the GST 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 landfill will be able to claim input tax credits for GST paid on expenses.
Trade In of a Used Vehicle

GST 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 GST registrant and you use your vehicle primarily for your business, you are required to collect the GST from the dealer and remit the amount to the CRA when you trade in your vehicle.

Non-resident rebates

Non-residents are eligible for a full refund of GST on goods which are taken out of Canada, as well as hotel accommodation while in Canada. The rebate does not apply to alcohol and tobacco, nor does it apply to purchases or services consumed in Canada. Rebate can be claimed for a minimum of $200 in purchases.
**THE BILLION DOLLAR QUESTION**

*Rich S. Cashbin:* Average Joe taxpayer breezed through the preliminary rounds with the help of Teddy Taxpert! The Taxman has been eliminated. He’s left the scene. Those tax planning tips were too much for the Taxman.

Now Average Joe taxpayer is on his own. No more help from Teddy Taxpert. Here’s the final question. For one billion dollars....

**$1,000,000,000**

What famous four are known for their special tax expertise?

- A. The Four Horseman of the Apocalypse
- B. The Fab Four (Beatles)
- C. Bobby Orr
- D. GCSE

*Average Joe:* Can’t have a lifeline?
In Touch with Tax

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