

Year End Income Tax Planning Issue

2010

INTRODUCTION

This issue is a summary of some of the tax planning opportunities you may wish to consider as we reach the end of 2010 and look forward to 2011. Our objective is to simplify some of the more complex rules and to offer basic personal and corporate tax planning suggestions for this and future years.

This publication is not intended to be an exhaustive summary of the technical provisions of the *Income Tax Act*. Before you undertake any complex tax planning strategy, be sure to review it thoroughly with your tax advisor.

We hope this newsletter will prove to be a useful reference.



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INCOME SPLITTING

General

Over the past several years, we have been faced with a complex series of income attribution rules. These rules basically attribute taxable income back to the high-income earner if he or she attempts to transfer funds or investments to a spouse or a minor child.

Income earned on money loaned to any person who does not deal at arm's length with a taxpayer will generally be taxable in the lender's hands, regardless of the age of the debtor. The rule does not apply if interest is charged on the loan at CRA's prescribed rates. *CRA's current prescribed rate of interest for family loans is 1%. This creates an opportunity to lock in a family loan at a low rate of interest and save tax on a portion of the investment income earned on the loaned funds.*

In order to take advantage of this method of income splitting, a genuine loan with proper documentation must be entered into, and the interest must be paid annually by January 30th of the following year.

A parent could also gift funds to an adult child without attribution rules being applicable. The gift may be made through a trust to ensure that the parent retains some control over the use of funds.

Attribution will not apply to capital gains subsequently realized by a child. Therefore, a taxpayer may transfer investments with future capital gains potential to a minor child. Upon disposition, the capital gain will be taxed in the child's hands.

Pension Income Splitting

It is possible to split pension income with a spouse. Pension income eligible to be split is income eligible for the pension income credit which includes:

- pension from a registered pension plan (RPP) regardless of the recipient's age
- periodic income from a registered retirement savings plan (RRSP) annuity, registered retirement income fund (RRIF), a locked in retirement income fund (LIF) or a deferred profit sharing plan (DPSP) if the recipient is 65 or older
- periodic income from a RRSP or RRIF if under age 65 and if received as a result of the death of a spouse or common-law partner

Old Age Security benefits, Canada Pension Plan benefits, lump-sum RRSP withdrawals, income from retirement compensation arrangements (RCAs) and RRSP, RRIF and DPSP annuities (if recipient is under age 65) are not eligible for pension income splitting.

Individuals can allocate any amount up to 50% of the eligible pension income to their spouse or common-law partner.

The pensioner and the spouse must make a joint election on new form T1032 that must be filed with the tax return for the year in which the pension is split (for electronically filed returns the form need not be submitted to the Canada Revenue Agency unless requested). Any tax withholding on the pension must be allocated in the same proportion as the pension income is allocated. There is no requirement to inform the payer of the pension of the intention to split the income.

The benefits of pension income splitting could include: income being taxed in a lower tax bracket in the recipient spouse's hands, reducing or eliminating Old Age Security clawback and accessing an additional pension income credit.

Transfer of Capital Losses

As we know, spouses file separate income tax returns in Canada. Because each spouse is responsible for their own income taxes and is not able to transfer deductions or credits (except in limited circumstances), you can sometimes have a situation where one spouse is being taxed on income or a gain when the other spouse has suffered an economic loss. This tax result can seem unfair when you look at the economic impact to the spouses combined.

This unfair result can be avoided in the case that one spouse has realized a capital gain and the other spouse has unrealized capital losses.

An example will illustrate the issue. Let's assume Mr. Winsome purchased shares of Lossco several years ago for \$1,000. Since then the value of the shares has declined such that they are now trading at \$100. Mrs. Winsome, on the other hand, has sold an investment during the year and realized a capital gain. She would like to reduce the tax impact of the gain.

To achieve this Mr. Winsome will sell his shares to Mrs. Winsome for their current value of \$100 (Mr. Winsome has

to make an election under the Income Tax Act to ensure he is not deemed to have transferred the shares at their cost of \$1,000). The sale triggers a capital loss of \$900 but the loss is denied to Mr. Winsome. As long as Mrs. Winsome holds the shares for at least 30 days after the transfer her cost base is calculated as the total of what she paid for the shares (\$100) and the loss that Mr. Winsome would have otherwise realized on the sale (\$900). In other words her cost base is now \$1,000. Mrs. Winsome can now sell her shares to a third party and realize a capital loss of \$900 that partially offsets her capital gain already realized.

The above noted strategy is subject to several involved provisions of the Income Tax Act and specific advice should be obtained from your tax advisor before proceeding with any such plan.

TAX TIP

There is no attribution of income earned on Canada Child Tax Benefits or the new Universal Child Care Benefit. Therefore you can invest these funds for the benefit of a child and the income is taxable in the child's hands and does not attribute back to the parent.

TAX TIP

If you are selling investments in 2010 because you want to trigger a capital loss to offset gains, make sure that you sell early enough for the loss to fall into 2010. The 2010 deadline for selling investments listed in Canada is December 23 and December 28 for investments listed on a U.S. exchange.

SALARY VS DIVIDENDS

The proper mix of salaries and dividends will always depend on the situation at hand. In the past the standard rule has been to pay bonuses to bring active business income down to a corporation's small business limit. This limit is \$500,000 for federal purposes for a corporation with a December 31, 2010 year end. The provincial rules are not always consistent with the federal rules. This means every bonus decision is based on the particular facts of the situation, and wherever possible the planning should be started prior to the corporate year end.

An additional factor to consider is the Enhanced Dividend Tax Credit. The impact of the credit is that an individual should be tax neutral (i.e. the same amount of total tax is paid) whether receiving income out of a corporation as a wage or dividends out of after-tax corporate income. However, there is now a tax deferral benefit to be gained

when corporate income is left in excess of the small business limit (income is not bonused down to the small business limit). The deferral is achieved because the general corporate tax rate on business income is less than the highest marginal individual tax rate. In some provinces the deferral could exceed 10%. *The impact of this deferral is that owner-managers of private corporations may be less inclined to declare year end bonuses to reduce corporate income (unless they otherwise require the cash).* There are additional benefits to not reducing corporate income: more cash is available in the corporation to be reinvested into the business and the value of the company is increased, meaning more value may be achieved upon a sale of shares that could be eligible for the capital gains exemption or the lower capital gains tax rate.

It should be noted that not bonusing down will result in an increased corporate tax installment requirement for the corporation. The impact of this on cash flow should be taken into consideration.

The following points should be considered when tax planning with respect to salaries or dividends:

- a. Ensure salaries are sufficient in 2010 to allow for CPP coverage.
- b. Weigh the payment of salaries against the increased costs thereon, such as:
 - i. Provincial (Territorial) employer health tax (EHT);
 - ii. CPP and EI payments;
 - iii. Increased surtax for high income earners
- c. If saving in a RRSP is preferred to saving in a corporation, ensure the full usage of RRSP contribution limits in 2011. The 2011 contribution limit will be \$22,450 which means an individual must have a salary of at least \$124,722 in 2010 to generate the maximum contribution room for 2011.

In certain cases, salaries will be more advantageous than dividends to avoid or reduce an AMT liability. Salaries will also reduce corporate tax installments.

Dividends might be considered:

- a. to decrease a taxpayer's CNIL balance;
- b. to permit losses of a corporation to be utilized;
- c. to obtain a refund of refundable dividend tax.

Another point to consider is the payment of interest on a shareholder's loan account. The major advantages of paying interest as opposed to salary are a reduction in the CNIL account and the avoidance of provincial payroll taxes. Interest, however, does not qualify as earned income for

RRSP purposes. If interest or dividends are to be paid, the individual should determine whether personal tax installments will be required.

INVESTMENT INCOME

Interest Income

Interest income earned from investments acquired after 1989 must be accrued annually.

Dividend Income

As a result of the dividend gross up and tax credit mechanism, the top marginal tax rates on non-eligible dividends (see discussion below regarding the new **Enhanced Dividend Tax Credit**) received in 2010 is 32.57% in Ontario.

The Enhanced Dividend Tax Credit

Starting in 2006, investors may receive dividends eligible for the Enhanced Dividend Tax Credit. This credit provides additional tax relief on dividends that have been paid out of corporate active business income that was not subject to the small business tax rate. Generally the credit will apply to dividends received from public corporations and to dividends received from private corporations that have had business income in excess of the small business limit.

The highest marginal individual tax rates on eligible dividends for 2010 will be 26.57% in Ontario.

The majority of dividends received from public corporations will be eligible dividends. The T5 slip indicates whether dividends are eligible or ineligible.

Income from Trust Units

A common misconception is that all information necessary to calculate investment income and capital gains/losses is included on the T3/T5 slips received from investment firms. While the T3/T5 slips report any income earned on investments they do not disclose information necessary for determining capital gains and losses for the year.

Your accountant will require additional information such as a summary of gains and losses from the investment firm. In some cases this information will not be sufficient as the investment firm may not have a record of the cost base of the investment being sold. This often occurs when an individual transfers their investments from one firm to another.

One type of investment that involves more work when calculating capital gains or losses is trust units. With many trust unit investments the annual cash payout that an investor receives is made up of a number of different components. It can include interest, dividends, capital gains and a return of capital ("ROC"). ROC is the investment returning some of the investor's initial investment and is not taxable to the investor at the time of receipt. ROC reduces the cost base of the investment and therefore increases the capital gain (or decreases the capital loss) at the time of sale.

Often ROC is not reflected on the monthly brokers' statements and so the amount shown as "book value" is not the cost base of the investment for tax purposes.

INVESTMENT INCOME AND CORPORATIONS

Refundable Tax

Several years ago CRA believed that some individuals were receiving an unfair tax deferral by holding assets producing investment income in a corporation rather than holding them personally. To combat this perceived inequity, an additional refundable tax of 6 $\frac{2}{3}$ % is levied on the investment income (other than deductible dividends) of Canadian-controlled private corporations (CCPC).

Dividend Refund Rate

The basis for a corporate dividend refund is \$1 of refund for every \$3 of taxable dividends paid. This dividend refund rate will apply to all refundable tax accumulated in the Refundable Dividend Tax on Hand (RDTOH) pool.

Planning Tips

- i. Where a CCPC has a significant investment portfolio, consideration should be given to acquiring investments which produce dividends rather than interest, since the maximum corporate tax on dividends equals 33 $\frac{1}{3}$ % compared to almost 50% on interest. However, a change of this nature should be discussed with your investment advisor prior to implementation.
- ii. Other uses of an investment holding corporation may include inter-generational transfer of a business, income splitting, changing the characterization of investment income, holding foreign investments, protection against the Old Age Security claw back and maintaining eligibility of shares of an operating company for the enhanced capital gains exemption.

Mandatory Electronic Filing

For taxation years that end after 2009, all companies with gross revenues in excess of \$1 million will have to file their income tax returns via the Internet using CRA approved commercial software, with the exception of insurance corporations, non-resident corporations, corporations reporting in functional currency, and corporations that are exempt from tax payable under section 149 of the *Income Tax Act*.

For purposes of the mandatory Internet filing rules, gross revenues will include "total revenue" and "total farm revenue" as reported in the company's General Index of Financial Information - on line 8299 and line 9659, respectively.

- Taxpayers will be required to file electronic income tax information returns, such as T4, T5, T5013, when the number of these returns is more than 50. This is a reduction from the current 500 returns.
- Although these requirements apply to returns filed after 2009, no penalties will be introduced for failing to comply until 2011.
- The penalty for not filing corporate income tax returns in electronic format will be set at \$250 for taxation years that end in 2011, \$500 for taxation years that end in 2012 and \$1,000 for subsequent tax years.

Penalties for filing information returns late or in the incorrect format will be reduced. The penalty for late-filed returns will be based on the number of late returns and the number of days late (maximum 100 days). The penalties range from \$10 per day to \$75 per day.

TAX TIP

When donating publicly traded securities to a charity, and if you have a choice of securities that you can donate, consider contributing the ones with the highest inherent capital gain.

CAPITAL GAINS

Income Inclusion

Capital gains realized are included in taxable income at a rate prescribed by the *Income Tax Act*. The inclusion rate for dispositions is 50%.

For individuals in the top marginal tax bracket, the effective tax rate on capital gains in 2010 is 23.2% in Ontario.

Donation of Publicly Traded Securities

Effective May 2, 2006 a donation of publicly traded securities to a registered charity (now includes private foundations effective for donations made after March 18, 2007) will result in no taxable capital gain. Prior to this date the capital gains inclusion rate was 25% (as opposed to the general inclusion rate of 50%). The benefit of this to taxpayers is significant. Now individuals wishing to donate significant amounts to a charity should consider whether or not they have suitable securities that could be donated instead of making a cash donation. The following example illustrates the advantage that can be realized.

	Sell first donate cash	Donate securities
Value of securities	\$10,000	\$10,000
ACB	(2,000)	(2,000)
Capital gain	8,000	8,000
Taxable capital gain	4,000	0
Tax on gain*	(1,800)	0
Tax savings from donation*	4,500	4,500
Net tax savings	2,700	4,500
Net cost of donation	\$7,300	\$5,500

* Assumes a 45% combined federal/provincial marginal tax rate. (Ontario's is 46.4%)

As the example illustrates, the additional tax savings from donating securities worth \$10,000 is an additional \$1,800 when compared to selling the securities first and donating the cash. Another way to look at this example is that if you originally paid \$2,000 for the securities and get \$4,500 of tax savings you actually net an advantage of \$2,500!

Capital Gains Exemption

The enhanced capital gains exemption has been increased to \$750,000 from \$500,000 for dispositions after March 18, 2007. The enhanced exemption is available on the disposition of qualified farm or fishing property and shares of a qualified small business corporation. As future access to the enhanced exemption may not be available, it may be prudent for individuals with qualifying property to take steps to use the exemption as soon as possible. The planning points mentioned below are more important than ever before with the increase to the exemption.

Planning Tips

- i. Owners of private companies should ensure that access to the enhanced capital gains exemption remains untainted. Steps may be taken to “purify” corporations which are ineligible for the exemption as a result of a buildup of non-business assets.
- ii. Owners of unincorporated businesses may consider incorporating their business to gain future access to the exemption.
- iii. Consideration should be given to corporate reorganizations whereby shareholdings are redistributed in order to take advantage of additional capital gains exemptions of family members.
- iv. Alternative minimum tax (AMT) must be considered when entering into transactions designed to utilize the enhanced capital gains exemption.
- v. The effect of cumulative net investment losses, business investment losses, certain allowable capital losses claimed in prior years and previous capital gains exemptions must be considered when claiming the enhanced capital gains exemption.

Cumulative Net Investment Losses (CNIL)

The CNIL account has no effect on a taxpayer’s net income. Its only purpose is to restrict the use of the capital gains exemption. Even though the \$100,000 Capital Gains Exemption is gone, the CNIL account is still important to those individuals who have not yet utilized their enhanced Capital Gains Exemption. The allowable capital gains exemption in the year is reduced by the balance in the taxpayer’s CNIL account.

Where investment expenses have exceeded investment income, this amount is reflected in the CNIL account and, in effect, a tax liability is created on a capital gain through the reduction of the allowable exemption.

The CNIL account is a cumulative lifetime account made up of the excess of investment expenses over investment income after 1987.

Investment expenses include the following:

- deductions in computing income from property, including interest, carrying charges, etc.
- limited partnership losses
- 50% of resource deductions
- rental losses

The above expenses increase the CNIL account. It may be reduced by investment income, including:

- income from property, including interest, dividends (grossed up), and rental property
- limited partnership income
- 50% of recovery of any resource deductions

TAX TIP

Remember you have until March 1, 2011 to contribute to your RRSP and still be able to claim the contribution as a deduction on your 2010 income tax return.

DEFERRED INCOME PLANS

There are number of deferred income plans contemplated in the income tax act. Following is a summary of the ones that individuals or their family may be members of.

Registered Retirement Savings Plans (RRSP)

i. Contribution Limits

An individual who has “earned income” may make a tax-deductible contribution to a RRSP. The dollar limit for RRSP contributions is based on earned income of the previous year and is subject to maximum dollar limits.

For 2010, the maximum amount that an individual may contribute to a RRSP is the lesser of \$22,000 and 18% of 2009 earned income plus any unused contribution room from prior years. You may carry forward the deduction room indefinitely.

If you are a member of a company pension plan or a deferred profit sharing plan, your RRSP deduction limit will be reduced by your prior year’s “pension adjustment” which appears on your T4 slip annually. The pension adjustment represents the registered pension plan and deferred profit sharing plan benefits which have accrued on your behalf.

On assessment, the Canada Revenue Agency (CRA) will issue a statement to every individual that will show the RRSP deduction available for the year, based on the individual’s previous years’ returns and the aforementioned pension adjustment.

ii. Spousal Plans

It may be beneficial to contribute to a “Spousal RRSP” in order to split future RRSP receipts upon plan termination. The definition of a spouse includes a common-law spouse which is defined for tax purposes as a person

who is cohabiting with the taxpayer in a conjugal relationship throughout the preceding 12 months, or two cohabiting individuals who are the parents of the same child.

Contributions to RRSPs are available to December 31 of the year in which the contributor turns 71 (increased from age 69 in the 2007 Federal Budget) or, in the case of a contribution to a spousal RRSP of a younger spouse, to December 31 of the year in which the spouse turns 71.

Effective March 6, 1996, amounts paid for administration fees for RRSPs and RRIFs are no longer deductible.

iii. Home Buyers' Plan

First-time home buyers will be able to withdraw a maximum of \$25,000 from a Registered Retirement Savings Plan (RRSP) under the Home Buyers' Plan, an increase of \$5,000. Also, a non-refundable tax credit based on the amount of \$5,000 was introduced for those first-time home buyers who acquire a qualifying home after January 27, 2009. Individuals eligible for the Disability Tax Credit can claim this credit when a home that is purchased is more suited to their personal care needs. Also, the individual's spouse or common-law partner can claim any unused portion of the Credit. Note that a husband and a wife may each withdraw the maximum permitted.

Individuals will be required to repay the RRSP withdrawal in equal installments over a 15-year period. The first repayment must be made no later than 60 days after the end of the second calendar year following the first withdrawal. Any amount not repaid as required will be treated as a permanent withdrawal from the RRSP and included in the individual's income.

Since this measure is intended to provide access to existing RRSP funds, contributions made less than 90 days before the withdrawal will not qualify as a deduction to the extent the amount withdrawn exceeds the RRSP balance before contributions made in the past 90 days.

The Home Buyers' Plan was revitalized by a change, effective in 1998, which allows an individual to participate in the program again as long as they have repaid all amounts previously received under the Home Buyers' Plan and no home had been owned in the previous five years. Note the amount withdrawn does not have to actually be used for the house purchase; you just need to be buying a qualifying home at the time of withdrawal.

Registered Retirement Income Funds (RRIF)

Since 1993, it has not been necessary to deplete a RRIF by age 90. Plans are now available for life. The minimum payments will be fixed by formula until age 94 and, from that time on, the minimum withdrawal will be equal to 20% of the balance in the plan annually.

The 2007 Federal Budget increased the age at which a RRSP must be converted to an annuity or a RRIF. The conversion must now occur before the end of the year in which the individual turns 71 (previously 69).

Retiring Allowances

A retiring allowance is an amount paid to an employee upon retirement in recognition of long service or as severance upon termination. Although such a payment is taxable to the employee in the year received, a qualifying portion may be deductible if paid to an RRSP within 60 days of the end of the calendar year. To avoid deductions at source on the qualifying portion of a retiring allowance, arrangements should be made with the employer to transfer the qualifying portion directly to the employee's RRSP.

The portion of a retiring allowance which qualifies for the rollover into an RRSP is equal to \$2,000 for each year or part year of employment up to the end of 1995. An additional \$1,500 per year of employment up to 1988 is available for employees who were not members of a registered pension plan or Deferred Profit Sharing Plans (DPSP). These amounts are in addition to your normal RRSP contribution limits.

Registered Pension Plan (RPP)

The limits for RPP contributions for 1996 and subsequent years depend on whether the plan is a money purchase plan or a defined benefit plan.

Individual Pension Plan (IPP)

An IPP is a defined benefit RPP designed for one person. The IPP holds a theoretical advantage over an RRSP for a high income individual who begins the plan after age 40. Since a defined benefit RPP is based on a promise to pay a certain amount of retirement benefit, it requires a large contribution if started in later years.

The virtues of the IPP are based on models that make assumptions about the age and life expectancy of the individual, salary level, interest rates, etc. The IPP must be

compared to the maximum RRSP contributions to determine the best option.

An IPP requires maximum contributions from both the individual and the corporation and is more restrictive than an RRSP with respect to the withdrawal of funds. Those interested in beginning such a plan should proceed with care and obtain professional advice.

Deferred Profit Sharing Plans (DPSP)

Under a DPSP, an employer contributes part of the company's pre-tax profit to a plan for the benefit of the employees. The employer receives an immediate tax deduction for the contribution and the employee will be taxed only on receipt of the funds from the plan.

Employer contribution limits are currently the lesser of 18% of the employee's remuneration and one-half of the total dollar limits for money purchase plans. Employee contributions are not permitted.

Registered Education Savings Plans (RESP)

Under an RESP, a taxpayer makes contributions to a plan for the benefit of designated parties who use the funds to pay for a portion of post-secondary education costs. The contributions are not tax deductible and the income portion of the withdrawals is taxable. The income that accumulates in the plan accumulates without annual taxation and forms part of the withdrawals.

Effective for contributions made after 2006, there is no maximum annual contribution limit to a RESP (the annual contribution limit was \$4,000 for 2006 and previous years). There is a maximum lifetime contribution limit which was increased to \$50,000 effective 2007 (previously \$42,000).

In 1999, the government introduced a Canada Education Savings Grant that gives parents and other contributors even greater incentive to utilize Registered Education Savings Plans. The grant is 20% on the first \$2,500 for 2007 and subsequent years for children up to age 17 with a maximum annual grant of \$500 per child (previously \$400). There is a lifetime maximum grant, per child, of \$7,200. The Canada Education Savings Grant is provided directly to the investment organization managing the Registered Education Savings Plan and is invested in the contributor's plan. The grant itself is not a factor in determining the annual and lifetime Registered Education Savings Plan contribution limits.

If your child does not pursue higher education, most Registered Education Savings Plans give the contributor the option of designating another child. If no other child is named, or the other child is not connected by blood relationship or adoption, the Canada Education Savings Grant will be returned to the government. Contributors are allowed to transfer up to \$40,000 of the income from the Registered Education Savings Plan into their own Registered Retirement Savings Plan if there is contribution room available. If there is not, or if the contributor chooses to receive the investment income directly, the income will be subject to a charge of 20% in addition to regular income taxes calculated in that taxation period. In all cases, principal contributions are returned tax free.

New Registered Tax-Free Savings Account (TFSA)

Beginning in 2009, individuals over the age of 18 will be able to contribute \$5,000 annually to a TFSA. The limit will be indexed annually and any unused contribution room will be carried forward to future years. Unlike an RRSP, any amounts withdrawn from the TFSA will increase the contribution room carry forward.

Contributions will not be tax deductible, but any withdrawals from the plan will also not be taxable.

The advantage of the TFSA is that no tax is payable on income, including capital gains, earned on investments in the plan.

Any interest on amounts borrowed to fund contributions to the plan is not deductible and there are rules governing the type of investments eligible (generally the same investments as an RRSP can make). However, investments in non-arm's length entities are not permitted.

Income from Registered Disability Savings Plans (RDSP)

Effective January 1, 2009, income from an RDSP is excluded from income for purposes of determining eligibility for the BC Sales Tax Credit. This income will also be excluded for purposes of eligibility for the Medical Services Plan premium assistance.

TAX TIP

The federal pension credit has been increased to \$2,000 from \$1,000 for 2006 and subsequent years. If you are at least 65 and are not otherwise receiving qualified pension income, consider converting your RRSP to a RRIF early so that you can receive payments from your RRIF that qualify for the pension credit.

TAX TIP

To receive the maximum Canada Education Savings Grant you have to contribute at least \$2,000 annually starting in the year of birth. Alternatively you must start contributing at least \$2,500 annually in the year the child turns 3. In both cases you must continue contributing the maximum up to and including the year the child turns 17.

TAX TIP

Consider holding speculative investments in a TFSA and not in your RRSP. Should you hit the jackpot and the stock value soars, there will be no tax hit when you cash out. Such gains in an RRSP would eventually be fully taxable as ordinary income.

TAX SHELTERED INVESTMENTS

Over the past few years, the federal government has introduced measures that reduce the attractiveness of many “tax-driven” shelters. *It is, therefore, more important than ever to consider the investment attributes and to place less emphasis on the income tax features of these shelters.*

Some of the more popular tax sheltered investments have included exploration partnerships, farming partnerships, film partnerships, and mutual fund partnerships. Before investing, you should consider two tax measures- the at-risk rules and the alternative minimum tax-as they could have a profound effect on any investment decision.

“At-Risk” Rules

The “at-risk” rules provide that a taxpayer (who is a limited partner) may claim deductions in respect of an investment only up to the amount of money actually at risk.

For each limited partnership investment, a taxpayer must calculate annually the at-risk amount. This amount represents the maximum deduction allowable in respect of the partnership for the year. The at-risk amount is basically the amount invested, and income allocated to the investor, less deductions previously taken and cash distributions received.

The amount invested must actually be put at risk by the taxpayer. Therefore, amounts owing to the partnership, or guaranteed returns from the partnership, will generally reduce the amount at risk.

The total of partnership losses, investment tax credits and resource deductions flowed through the partnership may be

deducted by the limited partner only to the extent that this total does not exceed the at-risk amount in respect of the partnership. Any non-allowable excess becomes a “limited partnership loss” that may be carried over to future years and deducted to the extent of any future increase in the at-risk amount.

Alternative Minimum Tax (AMT)

The AMT is a separate tax calculation applied to taxpayers who reduce their taxes through the deduction of “preference items”. Such preference items are added back to the taxpayer’s income through a separate calculation to determine an alternative taxable amount. The AMT rate is applied to the recalculated amount and compared to taxes otherwise payable. The AMT rate is currently set at 15% federally. In 2010, the combined federal and provincial rate is approximately 20% to 22%.

If the AMT exceeds taxes otherwise payable, the higher amount must be paid. Subject to certain conditions, the excess AMT paid may be recovered over the next seven years.

The list of preference items which are included in the AMT calculation is extensive. It includes some of the non-taxable portion of capital gains and deductions in respect of tax shelters mentioned above. No decision to invest in a tax shelter should be made before giving due regard to the effect of the AMT.

TAX TIP

Donations receive federal tax credits of 15% on the first \$200 donated each year and 29% on amounts donated in excess of \$200. Taxpayers can claim donations made by a spouse and so it may be beneficial for spouses to combine their donations and claim them all on one return.

INVESTMENT LOSSES

Many people find themselves as guarantors of business loans or as investors in fledgling businesses. Often this support is given to family members and friends without requesting compensation in return. Often such ventures fail, and taxpayers are surprised to hear that their losses may not be allowable for tax purposes.

The rules in this area are very complex and a detailed review is beyond the scope of this publication. However, in order to ensure that the loss incurred with respect to a loan made or a debt guaranteed becomes allowable for tax purposes if it proves to be unrecoverable, one of two sets of

circumstances must exist. *The most reliable way to ensure protection from a tax perspective is to demand some reasonable consideration such as interest on the loan or a fee for a guarantee.*

If you provide a loan or a guarantee to a corporation in which you are a shareholder, and the corporation is not in a position to borrow such funds on similar terms without your help, your loss may also qualify for a tax deduction.

Before making any such loans or guaranteeing debts, be sure to consult your advisor to ensure that the tax relief will be available should the investment fail.

OTHER MATTERS

Medical Expense Tax Credit

The medical expense tax credit provides a non-refundable tax credit of 15% of the eligible unreimbursed medical expenses in excess of the lesser of \$2,024 and 3% of net income. An expense is generally eligible if it is directly related to a disability or medical condition.

Under the 2010 Federal Budget provisions, *expenses incurred after March 4, 2010 for purely cosmetic procedures (including related services and other expenses such as travel) will be ineligible under the medical expense tax credit regime.* Such expenses include surgical and non-surgical procedures aimed at enhancing a taxpayer's appearance (i.e. liposuction, hair replacement procedures, botulinum toxin injections and teeth whitening).

However, a cosmetic procedure that is required for medical or reconstructive purposes (i.e. surgery to improve upon a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or a disfiguring disease) will continue to qualify as an eligible medical expense.

Quarterly Tax Installments

Under existing rules, individuals do not have to calculate the amount of their quarterly tax installments. Instead, CRA informs the affected taxpayer of the exact amount of the required installment payments. Taxpayers using this method will not be subject to interest charges or penalties, even if these payments fall short of their total tax liability for the year.

Individuals are required to make quarterly installment payments if the difference between tax payable and amount

withheld at source is greater than \$3,000 in both the current year and either of the two preceding years.

There are two other options available to calculate installment payments. They are:

- i. the prior year option whereby you pay one-quarter of your prior year's taxes by each due date;
- ii. the current year option whereby you pay one-quarter of your estimated current-year taxes by each due date.

Interest and Penalties

The CRA now charges interest at 4% above the prescribed rate (set at 1% effective April 1, 2009) on insufficient installments and late income tax payments. In addition, a penalty of 50% of the interest charged will be levied on installment interest owing in excess of \$1,000. This can result in a very high after-tax cost where required installments are not made.

It is strongly recommended that installments be paid on a timely basis in order to avoid non-deductible interest and penalties.

Employment of Spouses

The employment of a spouse will not necessarily be insurable for EI purposes. For the employment to be insurable, the employer must show that the employment would have existed if they had been dealing with each other at "arm's length". The services must also be performed under a valid contract of service.

Social Benefits Claw Back

The social benefits repayment is equal to the lesser of:

- i. the aggregate of Old Age Security and Net Federal Supplements;
- ii. 15% of the amount by which the individual's income exceeds approximately \$66,000.

This "claw back" of benefits is based on the income level of an individual. Therefore, income over \$66,000 should be split with a spouse, if possible (see **Pension Income Splitting**).

Taxpayer Relief Provisions

Under the Taxpayer Relief Provisions (formerly the Fairness Package) the CRA has the discretion to be lenient with taxpayers in certain circumstances.

This discretion applies to 1985 and subsequent taxation years and is related to situations where taxpayers who, because of circumstances beyond their control, are unable to meet deadlines or comply with certain rules. The Taxpayer Relief Provisions include the following:

- i. Tax refunds may be paid even though the return is filed more than three years late.
- ii. Penalties and interest may be waived where there are extraordinary circumstances.
- iii. Late filed, amended or revoked elections may be accepted.

Recent changes to the legislation now restrict relief claims to the 10 years prior to the current year (instead of being able to go back to 1985).

INCOME TAX FILING REQUIREMENTS ON DEATH

It is important to note the different filing requirements in the case of an individual who passes away during the year. Following is a summary of the various returns that must be considered in an estate situation.

Terminal Return

This is the deceased's final personal income tax return. The return reports income for the year of death for the period from January 1st to the date of death. All regular income (i.e. pensions, employment income, interest, etc.) earned during this time period will be reported. In addition, the return will report any gains resulting from deemed dispositions on death. This return has the normal filing deadline of April 30th of the following year. When the individual has died in November or December this filing deadline is extended to six months after the date of death.

Additional Separate Returns

It is possible to report certain types of the deceased's income on a separate return for the year of death, known as

a "Rights or Things" return. The benefit of this separate return is that the individual is then able to make a second claim for tax credits. In effect, they get to claim personal tax credits twice for the same year. The reporting period and the filing deadlines are the same as for the terminal return. The following is a brief list of the types of income that can be reported on a separate return.

- Dividends declared but unpaid at the date of death.
- Income from another person's estate.
- Income for the stub period of a business.
- Vacation pay from an employer.

Estate Return

The estate return reports any income earned **after** the date of death. A typical example is the CPP death benefit. Other types of income include interest on an investment or bank account or any gains on the sale of assets by the estate. This return is filed annually within 90 days of the selected year end which can be no longer than the anniversary date of death. The final estate return is filed once the Executor is prepared to wind up the estate and distribute any remaining assets to the beneficiaries. This final estate return is due within 90 days of the proposed wind-up date.

Once the final estate return has been filed and assessed, a **Request for a Clearance Certificate** would be prepared and filed. A Clearance Certificate protects the Executor from any future liability for income taxes.

Information Required to Prepare the Returns

- A copy of the deceased's prior year's Income Tax Return and Notice of Assessment,
- A copy of the Death Certificate,
- A copy of the Last Will and Testament,
- A copy of the Statement of Assets and Liabilities (from the Probate documents), and
- All income information slips, including T4s and T5s.

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