

2011

Tax Newsletter Year End Issue

inthisissue

INTRODUCTION	1
YEAR END PLANNING	1
Investments	
Family Trusts	
Shareholder Loans	
Eligible Dividends Paid from GRIP	
Equipment Purchases	
Spousal Loans	
Salary to Family Members	
Charitable or Political Donations	
RESPs	
RRSPs	
IMPORTANT CHANGES TO CPP	2
PRINCIPAL RESIDENCES	2
TAX FREE SAVINGS ACCOUNTS	3
NEW POOLED REGISTERED PENSION PLANS	4
MISSED OPPORTUNITIES	4
Top 10 Missed Tax Deductions	
NEW IRS GUIDANCE FOR U.S. CITIZENS LIVING ABROAD	6
CHANGE IN TAXATION OF PERSONAL SERVICES BUSINESSES	6
MAKE THE MOST EFFECTIVE USE OF YOUR ACCOUNTANT	7
CRA LETTER CAMPAIGNS	8
PAYROLL CHANGES FOR 2012	8

INTRODUCTION

Our year end newsletter summarizes useful tax and payroll information related to the end of 2011 and the beginning of 2012.

YEAR END PLANNING

Investments

If you have capital loss carry forwards, consider selling shares to realize capital gains. If you have realized capital gains in the current year, consider selling shares to create capital losses to reduce your tax bill. Sales must occur by December 23, 2011 to qualify.

Family Trusts

Ensure any distributions from a family trust are made by December 31, 2011. If distributions are planned, ensure appropriate dividends are paid from a private company in advance. Payments by cheques deposited and distributed before the end of the year are required, unless detailed steps are completed.

Shareholder Loans

If you have a shareholder loan that has been outstanding since the December 31, 2010 year end, ensure it is repaid by December 31, 2011. Consult your tax advisor on methods of payment such as dividend or net wage compensation.



Eligible Dividends Paid from GRIP

The tax rate on eligible dividends paid from General Rate Income Pools (GRIP) will be increasing by 1.35% on January 1st, 2012.

You may want to consider paying dividends from your corporation this month instead of early in the new year if:

- You have more than \$500,000 in taxable active business income for your fiscal year ending in 2011, and/or
- You have earned more than \$500,000 in previous years and have not depleted your GRIP by paying eligible dividends.

In each of these cases Ontario residents can save \$1,350 in tax for every \$100,000 of eligible dividends that are declared before January 1st instead of in 2012.

Please contact your tax advisor if you would like to discuss whether or not you should declare dividends this month.

Equipment Purchases

If you have equipment you were planning on purchasing early next year, consider purchasing it before December 31, 2011 to get a tax deduction this year. If you have a proprietorship or company, consider this prior to your next year end.

Spousal Loans

If you have spousal loans ensure the interest is paid by January 30, 2012 by a "documented" method such as a deposited cheque.

Salary to Family Members

If you pay reasonable salaries to family members, make sure payment of net compensation is reasonable and is made before December 31, 2011. Again, deposited cheques are an appropriate method of documentation together with payment of withholdings by January 15, 2012 or the appropriate payment date if it is advanced.

Charitable or Political Donations

If you are planning to give money to a charity or political party make sure the gift is made before December 31,

2011 to ensure you can claim the tax credit on your 2011 return.

RESPs

Make any contributions to an RESP before December 31, 2011 to qualify for any 2011 grants for which you may be eligible.

RRSPs

Spousal and regular contributions may be made up to February 29, 2012. If you must repay a portion of your Home Buyers' Plan or your Lifelong Learning Plan, payments must be made by February 29, 2012 as well. Tax savings are greatest for individuals with more than \$41,500 of taxable income. If you are starting to withdraw funds from your RRSP, consider using your RRSP to purchase an annuity that will be eligible for the pension credit and income splitting.

IMPORTANT CHANGES TO CPP

CPP rules will be changing starting January 1, 2012. If you are over 18 and under 65 years of age and are earning wages, you will have to pay CPP premiums even if you are collecting CPP. If you are over 65 but under 70 years of age and earning wages, you may choose not to pay CPP premiums and forgo the resulting increased pension. To stop paying CPP premiums, you must complete and file the CPT30 form with Canada Revenue Agency and provide a copy of the completed form to your employer. If you do not file the Form by December 31, 2011, your employer will be required to deduct CPP from your wages starting January 1, 2012. Once you reach 70 and are earning wages, you cannot pay CPP premiums.

PRINCIPAL RESIDENCES

As a homeowner you are aware that the profit on the sale of your home is tax free.

You also know tax has its nuances. Just because you know the basic rules does not mean they apply to your exact situation. Consider this principal residence question:

"In early 2011 we bought a house for \$400,000. We moved in but ended up selling it a few months later

because of a work-related move. We sold our place for \$450,000. Is our gain taxable? Also, would we qualify for the First-Time Home Buyers' tax credit even though we owned the place for only a few short months'?"

Before we address this astute enquiry, here's how the tax-free principal residence rule works. The principal residence exemption eliminates the capital gains from the sale of a principal residence. So here is the big question - did you sell a principal residence?

A principal residence is a home you own and live in. For example, if you sell your home that you purchased for \$300,000, for \$500,000, the profit of \$200,000 is tax free if you lived in it throughout that period. A principal residence can be a house, condo, trailer, house boat or cabin, which you own and you, your spouse or child lives in.

If you own a house and a cabin, you could own two principal residences at the same time. Your cabin can be your principal residence if you use it occasionally and the main reason for owning the cabin is not for rental purposes.

However, you can only claim the principal residence exemption on one property in any one year. An example would be, if you bought your home in 1990 and a cabin in 2005 and sold both in 2011. The gain on the house was \$100,000 and the gain on the cabin was \$50,000. The initial reaction is to claim the entire gain on the house as tax free. If instead the exemption is claimed on the cabin for 2005 to 2011 and the house is claimed from 1990 to 2004 we actually shelter approximately \$123,000 in capital gains instead of \$100,000. The real challenge relates to time, size of its use. Did you only live on the property for part of the time or is it larger than one half hectare? Specific advice on these cases is needed as part of the property can be taxable.

So far we have only scratched at the basic principal residence exemption rules. For a full blown discussion on the topic, go to the CRA's website at: <http://www.cra-arc.gc.ca/E/pub/tp/it120r6/it120r6-e.pdf>

Back to the reader's question - the gain is tax free because they sold a principal residence – a property

they both owned and lived in. The fact they sold the property a few months after moving in is irrelevant if you can prove to the CRA (if asked) that you bought the property to live in. Conversely, if you bought the property to flip for profit – even though you did move into the property during the short period of ownership - the CRA would argue the purchase and sale of the property was a business activity and assess the profit as business income.

You also qualify for the First-Time Home Buyer's tax credit as long as either of you hadn't owned a home during the year of purchase and the past four calendar years. For example, your home purchase during 2011 will qualify for the \$750 federal tax savings if you hadn't owned a home since January 1, 2007. For more info, Google: First-Time Home Buyers' tax credit.

TAX-FREE SAVINGS ACCOUNTS

The TFSA is all about saving money but with an innovative feature. You know you can save money by leaving it in your savings account or buying investments such as stock or mutual funds. You can also invest through the tax-assisted Registered Retirement Savings Plan (RRSP); save for future schooling using a Registered Education Savings Plan (RESP) or provide retirement income for a qualifying disabled individual using a Registered Disability Saving Plan (RDSP). All the above options have tax implications. Interest earned in a savings account is taxable, as is the investment income earned from your stocks or mutual funds. Money that goes into an RRSP is tax-deductible – this is a good thing – but RRSP withdrawals are fully taxable – not so good. And the investment income in an RESP or RDSP is taxable to the recipients when withdrawn.

The TFSA is different because of its unique tax free feature. Any investment income, i.e., capital gains, dividends or interest earned in a TFSA is completely tax free. For example, the capital gain is totally tax free if your TFSA were used to purchase a speculative stock and you made a killing because your hunch worked out. To get started you go to your bank or investment broker and say the magic words – 'Open a TFSA' and it's done. Or you can set one up online more quickly through your bank or brokerage service. You have to be

aged 18 or older, and have a Social Insurance Number, to open a TFSA.

You can contribute up to \$5,000 a year into a TFSA. Because the TFSA program was created in 2009, you will have \$15,000 of TFSA contribution room in 2011, if you are aged 20 or older this year and never made a TFSA contribution. You automatically accumulate \$5,000 of TFSA contribution room since 2009, provided you were aged 18 or older in 2009, regardless if you have opened a TFSA. The Canada Revenue Agency tracks your cumulative TFSA contribution room and conveniently reports it on your Notice of Assessment.

Some parents are contributing to the TFSA's of their children who are 18 or older. The Canada Revenue Agency has made it clear that the funds must come from the person who holds the TFSA. If you would like to fund your "child's" TFSA contribution, be sure to gift him or her the funds so that they can be transferred from his or her own bank account to the TFSA. We know that this seems like an unnecessary extra step but it is important to follow the rules so that you can be certain that the TFSA will continue to be considered valid by CRA. If it is no longer considered valid then all of the income earned in the account will be considered taxable.

A big appeal and a potential problem with the TFSA is the way its contribution room is calculated. In addition to

your automatic annual \$5,000 room, any TFSA withdrawal in the previous year is added to the following year's contribution room. This amazing feature allows you to re-contribute every dollar previously withdrawn. For example, if you opened your first TFSA account today; contributed \$15,000 to it; withdraw \$15,200 (interest earned = \$200) at the end of 2011, your 2012 TFSA contribution room will be \$20,200 (\$5,000 from the 2012 annual limit + \$15,200 withdrawn in the previous year). The potential problem is that a lot of people don't understand that withdrawals don't create contribution room until the following year. If you put \$15,000 into a TFSA in June, withdraw it in July and then re-contribute it in August, you will have over-contributed from the months of August to December and will be subject to punitive penalties.

There is a lot more to the TFSA such as what happens when you die, get divorced, become a non-resident, and other issues like penalties for over-contributing. For a comprehensive review of TFSA rules, go to the CRA's website.

NEW POOLED REGISTERED PENSION PLANS

In early 2012 we expect to have more detail on the proposed large-scale, low-cost pension plans for individuals who do not already participate in a pension plan. These plans are based on current federal government proposals that have provincial support.

MISSED OPPORTUNITIES MEAN EXTRA TAXES

It appears as if thousands of Canadians like to pay income tax. In fact, they like to pay so much that they pay more than they should. By not taking full advantage of deductions, you may be one of these generous Canadians without even knowing it. Are you taking advantage of every deduction available to you? Do you file your return on time? Do you pay instalments quarterly?

Here is a subjective look at some of the more common missed opportunities that may be contributing to your tax bill.



Top 10 Missed Tax Deductions (in reverse order)

10. Tuition and Education Credit Not Transferred

Tuition and education credits can be transferred to a spouse or parent from a student who has income too low to claim the credits themselves. There are some restrictions and a few forms to sign; however, it is relatively easy to do the transfer.

9. Childcare Expenses

Subject to certain limitations, childcare expenses can be deducted from income by the lower income spouse. These expenses include day-care, babysitting, boarding school and day camps. You will have to provide the Social Insurance Number if you paid an individual in order to get the deduction. A copy of the childcare form is frequently requested by CRA when a return is e-filed.

8. Employment Expenses

Employees using their own automobile for work (other than to and from the work place) without reimbursement by their employer can deduct the business portion of their automotive expenses. If you are reimbursed and the amount is not "reasonable," you can still claim a deduction for the non-reimbursed portion. Your employer will have to complete form T2200 in order for you to get the deduction.

7. Charitable Donations

Charitable donations made by you or your spouse during the year should normally be added together and claimed on the income tax return of one spouse. A higher credit is available for donations that exceed the first \$200, so it makes more sense to aggregate the credits and use the low rate only once. If donations total less than \$200 they can be claimed on either return, either separately or jointly.

6. Medical Expenses

You may claim medical expenses for yourself, your spouse and dependent children. Either spouse can make the claim. You are not restricted to claiming on a calendar year basis; you can claim medical expenses for any 12-month period that ends in the year. The most commonly missed expenses are dental bills, eyeglasses and private medical insurance, including travel medical insurance. For certain seniors, some or all of the payments to a nursing home qualify as a medical expense.

5. Carrying Charges and Deductible Interest

Too many taxpayers do not plan properly to ensure that interest is deductible. Loans must be incurred to purchase an investment (with the intent to earn income) in order to deduct the interest. Proper documentation on the loans will ensure that the interest is eligible. Deduction is dependent on the actual direct use of funds borrowed. Carrying charges may also include investment counsel fees, accounting fees and safety deposit box charges.

4. Moving Expenses

Moving costs, real estate commissions on the sale of your former home, property purchase taxes, and legal fees qualify as moving expenses (with certain restrictions). If you are a student, it is possible to claim the moving expenses to start a job (including your summer job) or to start a business. Either way, you must earn income at the new location from a new job or a business and have moved in order to be at least 40 kilometres closer to your place of work.

3. Make Maximum Use of Your RRSP

To make maximum use of your RRSP from an income tax perspective you should start early in your life, contribute the maximum each year and consider the use of spousal RRSPs, including those for common-law spouses, to take advantage of lower income tax rates. Other ideas are to use the RRSP Home Buyer's Plan if you are a first-time homebuyer, to use the RRSP Lifelong Learning Plan if you are returning to school full time, and to roll the maximum amount of severance payments directly into your RRSP tax free.

2. Instalments

Failure to pay quarterly instalments results in interest charges and possible penalty interest. It is possible to pay catch-up payments and reduce or offset the interest charges.

1. Filing Deadlines

The normal deadline for filing an income tax return for the previous year is April 30th. This filing deadline is extended to June 15th if you are self-employed or your spouse is self-employed. However, income taxes payable are still due on April 30th. The filing of the information return for foreign investments, including foreign shares held in Canada, with a cost over

\$100,000 is subject to large penalties if not filed by these dates.

Taxpayers who do not file their tax returns on time face late-filing penalties (5% + 1% per month to a maximum of 17%) on the tax outstanding, plus interest. A "second occurrence" penalty is double the amount above and can be charged if the taxpayer has failed to file on time for a second time in three years or if a formal demand for filing has been issued by the Minister.

Interest and penalties are not tax deductible and add up quickly at the rates charged by Canada Revenue Agency. Even if you cannot pay taxes that are due, ensure you file your return on time.

This "Top Ten List" represents some of the more common deductions that are missed by taxpayers. You should discuss your particular situation with your tax advisor to ensure that you are minimizing your tax bill.

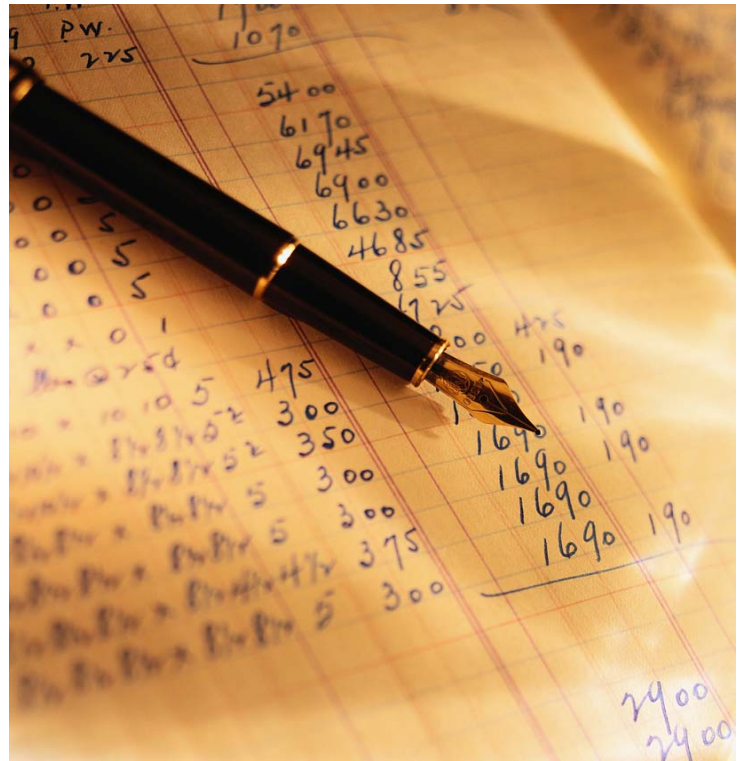
NEW IRS GUIDANCE FOR U.S. CITIZENS LIVING ABROAD

Earlier this month the Internal Revenue Service (IRS) released a Fact Sheet (FS-2011-13, December 2011) to provide guidance to U.S. citizens residing outside the U.S. who have not filed U.S. tax returns and information reports, including the Report of Foreign Bank and Financial Accounts (FBARs).

The Fact Sheet provides for some tax return penalty relief by allowing IRS examiners to consider an individual's situation.

The Fact Sheet confirms that U.S. citizens who are resident abroad and owe no U.S. tax for the prior six tax years may file U.S. tax returns for these years without the imposition of penalties related to not filing income tax returns or paying tax. This will be the case for many U.S. citizens resident in Canada because of foreign tax credits for the taxes they paid in Canada.

For U.S. citizens who owe U.S. tax, the IRS will now consider whether the failure to file or pay tax was due to reasonable cause based on consideration of the facts



and circumstances. The IRS will look at whether the taxpayer exercised ordinary business care and prudence. Other factors that will be considered include:

- Length of time between the taxpayer's failure to meet his or her tax obligations and his or her subsequent compliance
- The taxpayer's compliance history
- Reasons given for not meeting the tax obligations, and
- Circumstances beyond the taxpayer's control.

If you are a U.S. citizen who has not been filing U.S. tax returns you should contact the U.S. tax specialists in McLarty & Co's taxation services group.

CHANGE IN THE TAXATION OF PERSONAL SERVICES BUSINESSES

Please note that incorporated health professionals are not generally considered personal services businesses.

Draft legislation was released at the end of October that, if passed, would result in major changes to how personal services businesses are taxed. The tax rate on income earned in these companies would increase by 13% for fiscal years beginning after 2011 because they would not be entitled to the general rate reduction.

The shareholders of personal service businesses are sometimes described as “incorporated employees”. If they were not incorporated the shareholder would usually be considered an employee of another organization. Usually the personal services business has a long-term contract with one organization.

Personal services businesses are already ineligible for the small business deduction. The draft legislation will also deny them the general rate reduction. On top of that these businesses will continue to be limited in terms of what types of expenses are deductible for tax purposes. They are restricted to the types of expenses an employee would normally be allowed to deduct.

As a result of the proposed changes personal services businesses will generally not be effective from a tax deferral or income splitting perspective after 2011. But contractors are required to incorporate in order to work with some organizations. Care should be taken to include clauses in their contracts that are beneficial to the contractor from a taxation point of view, such as:

- The requirement for the contractor to pay for its own administrative assistance
- The requirement for the contractor to provide its own work space
- The requirement for the contractor to pay for any expenses necessary to complete the agreed upon work, outside of specifically negotiated reimbursable items, and
- To allow the contractor discretion in determining what supplies/expenses are necessary to complete the agreed upon work.

For all of these reasons we recommend that taxpayers who are earning income through incorporated personal services businesses consult with their tax advisors.

MAKE THE MOST EFFECTIVE USE OF YOUR ACCOUNTANT

Yes, we do get “shoe boxes”. Sometimes it happens for good reason, like when there’s an unexpected change in key personnel. But it always does cost more when you present your records in a disorganized fashion. Here are some tips on how to utilize your accountant effectively and to lower your accounting fees.

1. Reconcile your bank account. Once you learn how, this is actually easy to do and yet can be a very time consuming and therefore, a very costly procedure.
2. Bring your business bank statement and cancelled cheques for the month of your year end and the following month.
3. Bring in your Accounts Receivable listing, Accounts Payable listing, and an Inventory listing. The Accounts Receivable listing should include an indication of which amounts may not be collected.
4. Provide photocopies of the invoices for all fixed asset additions, such as a vehicle purchase.
5. If you have a new loan or a change in your loan, bring in the loan document.
6. Bring in a balanced set of books. Let us show you how if you do not know how to do this. We can save you money in the long run and it is not difficult to learn.
7. Whenever you visit our office, come in with a list of prepared questions and comments. Comment on the unusual events that happened during the year, especially if there are items on the Income Statement that fluctuated more than usual.
8. Come early. Our goal is to have year ends completed within 3 months of the year end. Timely information is useful information. More mistakes are made by everyone if the work is being done at the last minute.
9. Let us know about major changes or transactions before they occur or are finalized whenever possible.



During the year please telephone when things are unusually good or bad. We may be able to do some effective tax planning and/or damage control at the time rather than after the fact when it may be impossible.

10. Do not be afraid to ask questions. There are no such things as dumb questions, only items that we might miss.

11. Two things happen when you take more responsibility for your own record keeping:

- a) You learn more about your business.
- b) You can ask better questions of your accountant.

As a result, you can make better decisions and we can be more effective.

CRA Letter Campaigns

The Canada Revenue Agency has announced that it will be continuing its letter campaign again in 2012 for the third year in a row. It will be sending selected taxpayers two types of letters. The first one explains the eligibility criteria for certain deductions and encourages taxpayers to adjust their returns if appropriate. The second type includes the same information plus a notification that taxpayer's returns may be selected for audit.

The areas that CRA will be focusing on are:

- Rental properties
- Business activities
- Employment expenses, and
- Capital gains and losses from the sale of publicly-traded shares and mutual funds.

PAYROLL CHANGES FOR 2011 YEAR-ENDS AND 2012

The following changes will affect your payroll starting in January 2012:

- An EI Hiring Credit of up to \$1,000 for small businesses will be automatically calculated by CRA for eligible companies from their 2011 T4 Summaries.
- Effective January 1, 2012, employers will be required to restart CPP contributions for employees who are receiving a CPP/QPP pension, and are:
 - At least 60 but under 65 years of age; or
 - At least 65 but under 70 years of age unless they have filed an election to stop CPP contributions.

There will be no grand-fathering for employees who were receiving CPP retirement benefits and had stopped paying CPP prior to January 1, 2012. After turning 65, an employee can file an election using form CPT30, to stop contributing. This form can also later be revoked, but only one CPT-30 form can be filed per year.

- The CPP Maximum Pensionable Earnings for 2012 is \$50,100. Both the rate (4.95%) and Annual Basic Exemption (\$3,500) remain the same as 2011.
- The EI Maximum Insurable Earnings for 2012 is \$45,900. The new Employee Premium Rate is 1.83%.
- T4 Boxes 24(EI Insurable Earnings) and 26 (CPP/QPP Pensionable Earnings) will be mandatory for 2011 T4's.

This newsletter was prepared by McLarty & Co's taxation services group with content from our associates at MacKay LLP for the benefit of clients and other interested parties.

Clients are invited to contact their tax advisor or relationship manager if they have any questions about the information covered in this newsletter.

McLarty & Co
Chartered Accountants
495 Richmond Road, Suite 110
Ottawa, Ontario K2A 4B2
Phone: 613-726-1010
Fax: 613-726-9009
www.mclartyco.ca