

TAXTALK

YEAR END TAX PLANNING - 2005

If you or any of your colleagues would prefer to receive an electronic copy of TaxTalk in PDF format instead of a paper copy, please send an email to

taxtalk@mgca.com

To review previous issues of our TaxTalk, please visit our website at

www.mgca.com

As the end of 2005 approaches, this TaxTalk is a reminder to you to review your personal tax situation. Personal tax planning is important to the management of your financial affairs and should be considered throughout the year and not just late in the year.

The aim of tax planning is straightforward: minimize your tax burden or defer taxes to a later tax year. Tax planning can also include preventing events that could create unwelcome tax consequences.

This TaxTalk will assist those individuals resident in Ontario who desire to take advantage of opportunities that exist for minimizing income taxes for 2005 and subsequent years.

This TaxTalk is based on existing legislation and the current interpretation of the Income Tax Act (the Act) by Canada Revenue Agency (CRA) and by the courts. In addition, recent proposals to amend the Act have been considered and are referred to below as proposed amendments.¹ Other than these proposed amendments, this TaxTalk does not anticipate any other changes to the Act or its interpretation.

Comments related to the Goods and Services Tax (GST) are based on existing legislation, proposed amendments to the legislation and the current interpretation of the Excise Tax Act by CRA and by the courts.

CONTENTS

Important Dates and Deadlines.....	2
Highlights of Personal Tax Changes in 2005	3
Tax Deferral Plans	4
Investment Strategy	10
Family Tax Planning	15
Planning for Professionals and Owner/Managers	18
Unincorporated Professionals and Business Owners.....	21
Employees	22
Trusts	25
Other Planning Points.....	25
Social Assistance and Family Benefits.....	25

¹ With the fall of the government, the proposed amendments will need to be re-introduced by the new government.

The Registered Retirement Savings Plans (RRSPs) of an individual who attains the age of 69 in 2005 will mature by December 31, 2005, at the latest.

If you turn 69 in 2005, the RRSP contribution for 2005 must be made by December 31, 2005, rather than by March 1, 2006.

IMPORTANT DATES AND DEADLINES

Many deductions and credits are available only if payments are made by December 31, 2005 or early in 2006. Important deadlines are summarized below.

Amounts to be paid by December 15, 2005

- final personal income tax instalment for 2005

Amounts to be paid by December 31, 2005

- investment counsel fees
- carrying charges on investments
- safety deposit box fees
- professional membership and union dues
- charitable donations
- medical expenses
- moving expenses
- interest expense (if claimed on a cash basis)
- alimony and support payments
- certain legal, tax, and accounting fees
- political contributions
- tuition fees
- tax shelter investments
- employment expenses (office in home, travel expenses, etc.)
- to ensure the settlement date occurs in 2005 for dispositions of most publicly traded securities, we recommend trades be executed on or before December 23, 2005
- contributions to Registered Education Savings Plans to qualify for 2005 Canada Education Savings Grant

Information returns to be filed by January 15, 2006

- an employee must advise their employer of their intent to elect to defer benefits from stock options exercised in 2005

Amounts to be paid by January 30, 2006

- any interest owing for 2005 on loans to family members (including loans to family trusts) must be paid by January 30, 2006 so that the income attribution rules will not apply for 2005 and subsequent years
- any interest owing by an employee to his or her employer must be paid by January 30, 2006 in order to reduce the interest benefit on a low-interest or interest-free loan for 2005

Amounts to be paid by February 14, 2006

- if an employee is provided with an automobile for work and uses it for personal use, it may be appropriate for the employee to repay the 2005 personal operating costs paid by his or her employer by February 14, 2006. This repayment will reduce or eliminate the taxable benefit for the personal operating costs paid for by the employer. This benefit must be included in income at the rate of 20 cents (17 cents for an automobile salesperson) per kilometre of personal use. For more information in this regard please refer to TaxTalk 2004 Issue 1, *Automobile Benefits and Deductions*.

Information returns to be filed by February 28, 2006

- T4s, T4As, T5s and the respective summaries for 2005

Amounts to be paid by March 1, 2006

- deductible contributions to an individual's RRSP or a spousal RRSP (for 2005)
- repayments of RRSP Home Buyers Plan (for 2005)

Amounts to be paid / information returns to be filed by March 15, 2006

- first personal income tax instalment for 2006
- Employer Health Tax allocation agreement to be filed by associated companies

Amount to be paid by May 1, 2006

- balance outstanding on 2005 personal taxes payable

Other amounts to be paid

- childcare expenses² paid for services rendered in the year, even if paid after December 31, 2005

² The maximum childcare expenses for 2005 are: \$7,000 for each child under the age of 7 (at the end of the year), \$4,000 for children 7 to 16 years of age (during the year), and \$10,000 for a child eligible for the disability tax credit.

HIGHLIGHTS OF PERSONAL TAX CHANGES IN 2005

In addition to annual adjustments to tax rates, thresholds and tax credits, the February 2005 federal and the May 2005 Ontario budgets announced various changes, some of which are highlighted below.

Federal Changes

In general, there are four different income brackets for federal tax rates. Personal tax bracket income thresholds have been increased for 2005 as follows:

- the lowest federal tax bracket (at 16%)³ increases from \$35,000 to \$35,595,
- the middle income bracket levels (tax at 22%)³ will be \$35,596 to \$71,190 and (at 26%)³ \$71,191 to \$115,739,
- the top tax bracket for income over \$115,739 will continue to be taxed at a rate of 29%.³

The employee Canada Pension Plan (CPP) contribution rate remained the same for 2005 at 4.95% of pensionable earnings. However, the maximum pensionable earnings in 2005 increased to \$41,100⁴ (from \$40,500 in 2004). This results in an increase in the maximum employee contribution from \$1,831.50 in 2004 to \$1,861.20 in 2005.

The employee Employment Insurance (EI) contribution rate decreased from 1.98% to 1.95% of insurable earnings⁵ for 2005, resulting in a decrease in the maximum employee contribution from \$772.20 in 2004 to \$760.50 in 2005.

Federal Tax Credits and Deductions

Other changes in 2005 include the following increases to federal personal credits:

- basic personal from \$8,012 to \$8,149
- spouse⁶ from \$6,803 to \$6,920
- disability from \$6,486 to \$6,596
- caregiver from \$3,784 to \$3,848
- claim for infirm dependants from \$3,784 to \$3,848

³ Ontario tax rates are in addition to the federal rates.

⁴ The first \$3,500 of earnings is exempt from CPP.

⁵ The maximum insurable earnings remains at \$39,000.

⁶ For purposes of this Taxtalk all references to "spouse" include a spouse by marriage, as well as a common-law partner, of the opposite or same sex.

Disability and Medical Relief

The 2005 federal budget announced several proposals that will benefit persons with disabilities and/or high medical costs, and their caregivers. The proposals, effective for 2005 and subsequent years, include:

- broadening the eligibility for the disability tax credit,
- expanding the list of eligible expenses for the disability supports deduction and the medical expense credit,
- raising the annual maximum from \$5,000 to \$10,000 for medical expenses eligible for a tax credit when paid by the taxpayer on behalf of certain dependants,
- increasing the Canada Child Tax Benefit for disabled children,
- increasing the refundable medical expense supplement from \$571 to \$750 for 2005,⁷ and
- extending the contribution period to 25 years and lifetime period to 30 years for registered education savings plans with a beneficiary who is disabled.

Adoption Expense Tax Credit

The 2005 federal budget announced a new non-refundable tax credit for certain adoption expenses, to apply for 2005 and future years. Proposed eligible expenses, such as fees paid to a provincial or territorial adoption agency, court costs, legal fees, and reasonable travel/living expenses, will be allowed, to a maximum of \$10,000 for an adopted child.

Ontario Changes

Whereas there are four federal tax brackets, Ontario has three income brackets for its personal tax rates. The Ontario tax brackets and tax credits are fully indexed for inflation. The 2005 tax rates⁸ are as follows:

- the Ontario tax rate for the lowest tax bracket (up to \$34,010 – the federal bracket threshold is \$35,595) will remain at 6.05%,
- the tax rate for the middle tax bracket level of \$34,011 to \$68,020 (federal - \$35,596 to \$71,190) will remain at 9.15%,
- the tax rate for income over \$68,020 (federal brackets \$71,191 to \$115,739 and income over \$115,739) will remain at 11.16%.

⁷ This refundable credit is generally available to low income earners with at least \$2,857 of earnings from employment or self employment.

⁸ Federal tax rates are in addition to the Ontario rates.

Ontario levies a surtax in addition to its normal tax. For 2005, the first-tier surtax is 20% of Ontario tax over \$3,929 (generally when taxable income exceeds \$59,880). The second-tier surtax is 36% of Ontario tax over \$4,957 (generally when taxable income exceeds \$70,560).

For 2005, the top combined marginal tax rate for Ontario residents remains at 46.41%, and starts when taxable income exceeds \$115,739 (2004 - \$113,804).

The 2005 Ontario budget proposed to parallel the income tax measures announced in the 2005 federal budget with respect to disability and medical relief, as well as a tax credit for eligible adoption expenses.

The 2004 Ontario budget⁹ introduced the **Ontario Health Premium**. The “premium” starts to apply on taxable income in excess of \$20,000. The maximum premium of \$900 will apply when taxable income exceeds \$200,600 in 2005 and subsequent years.

TAX DEFERRAL PLANS

Registered Retirement Savings Plans

Deduction Limits

For 2005, your RRSP deduction limit equals the **lesser of**:

- 18% of your 2004 **earned income** (see below) (i.e. the previous year); and
- \$16,500

less:

- your “pension adjustment” for the prior year under a registered pension plan (RPP) for current or past service, and
- your net “past service pension adjustment” for the current year under an RPP

plus:

- any “pension adjustment reversal” for 2005 to restore lost RRSP deduction limit on termination of employment, and
- your unused RRSP deduction limit carried forward since 1991.

CRA provides the “2005 RRSP Deduction Limit Statement” for you as part of your 2004 Notice of Assessment. This Statement indicates your 2005 deduction limit which is the maximum you can deduct on your 2005 tax return. This Statement also indicates your

RRSP contributions from prior years that you have made but have not claimed a tax deduction for. You should verify the amounts when determining your available RRSP deduction limit for 2005.

Earned income includes: employment income, business income, rental income, disability pension income received under the Canada Pension Plan, and taxable support receipts. Earned income does **not** include: business and rental income earned through a limited partnership, interest income, dividends, capital gains, pension benefits, retiring allowances or severance, death benefits and other amounts received from an RRSP or Deferred Profit Sharing Plan (DPSP).

Earned income is **reduced by**: deductible support payments, employment expenses, and business and rental losses. Business and rental losses incurred through a limited partnership do **not** reduce earned income.

Where, in prior years, you deducted less than your RRSP deduction limit, the unused RRSP deduction limit may be carried forward indefinitely, allowing you to contribute to your RRSP in future years when you have more funds available.

On the other hand, a current year contribution does not have to be claimed as a deduction on your current tax return. Instead, you can choose to deduct it in a future year. This strategy will benefit you where, for instance, your marginal tax rate is relatively low this year and you can use the deduction to reduce higher rate income in a later year. Even if you do not deduct the amount this year, your contribution is, in the meantime, earning tax-deferred income within your RRSP.

The 2005 federal budget announced increases in the RRSP deduction limit for 2007 and future years. The limits for 2005 and subsequent years, before any pension adjustments, are as follows:

YEAR	LIMIT
2005	\$ 16,500
2006	18,000
2007	19,000
2008	20,000
2009	21,000
2010	22,000
2011	Indexed for wage growth.

⁹ For more information please refer to *TaxTalk 2005 Issue 2, 2005 Ontario Budget Highlights*.

Spousal RRSP

You can contribute all or part of your RRSP deduction limit to an RRSP of which your spouse is the annuitant (spousal RRSP). Your ability to contribute to a spousal RRSP is not limited by your spouse's RRSP deduction limit or their RRSP contributions. The advantages of a spousal RRSP include: splitting income during retirement and, where your spouse is younger than you, a longer tax-deferral period for income earned in the RRSP.

You will lose the benefits of a spousal RRSP if your spouse withdraws funds from the plan too soon. Normally, RRSP withdrawals are taxed in the hands of the recipient spouse; however, if your spouse withdraws funds from a spousal plan in the same calendar year as your contribution or in the subsequent two calendar years following your contribution to any spousal plan, the withdrawal will be taxed in your hands.

For example, for spousal RRSP contributions made in 2005, your spouse will be taxed on withdrawals made on or after January 1, 2008. On the other hand, you would include the withdrawal in your income if the withdrawal happened prior to January 1, 2008. This rule applies whether your spouse has one or many spousal RRSP accounts.

Finally, if you turned 69 prior to 2005, you can no longer contribute to your own RRSP; however, you can contribute to a spousal RRSP, for which you will receive a deduction, provided that your spouse is 69 or younger at the end of 2005.

Retiring Allowances and Severance Payments

You are generally subject to tax on any lump-sum retiring allowance or severance payment you receive. Subject to limitations, you may transfer some or all of these payments to your RRSP. The tax benefit of this planning is a reduction in your taxable income, with no impact on your RRSP contribution limit.

The maximum "eligible" amount that you can transfer to your RRSP is limited to \$2,000 times the number of full or partial years during which you were an employee **before 1996**, plus \$1,500 times the number of full or partial years of service **before 1989** for which your employer did not make vested contributions to an RPP or a DPSP on your behalf.

You must transfer the funds to your RRSP within 60 days following the year you received the eligible receipt. There is no withholding tax on the eligible amount if your employer transfers the funds directly to your RRSP. The transfer cannot be made to a spousal RRSP.

If you receive a retiring allowance in respect of employment that began after 1996 or you receive a retiring allowance in excess of the eligible amount, these amounts will not be eligible for rollover to your RRSP. However, to the extent that your RRSP deduction limit allows, you may choose to contribute the portion of your retiring allowance ineligible for rollover to your RRSP or a spousal RRSP and claim an RRSP deduction.¹⁰

The effect of this strategy is to defer income tax on your retiring allowance until such time as you withdraw funds from your RRSP.

Lump Sum Payments

Lump sum payments from an RPP or a DPSP may be transferred tax free to an RRSP provided the transfer is made directly to your RRSP (i.e. you cannot first receive the funds and then later contribute them to your RRSP). In some cases, the transfer of vested pension benefits must be made to a locked-in retirement account (LIRA) which is subject to withdrawal restrictions under the relevant provincial and federal pension legislation.

Borrowing to Contribute

Interest incurred on funds borrowed to make an RRSP contribution is not tax-deductible. If you want to borrow to contribute, it is generally advisable that the borrowing be for a short-term period (i.e. a few months). In general, it is best to use available cash to make RRSP contributions and borrow to fund other income earning activities (such as acquiring non-RRSP investments) where the interest will be tax-deductible.

Non-Cash Contributions

Your RRSP contribution need not be limited to cash. You can, if you so choose, contribute certain non-cash property (e.g. publicly traded shares) to an RRSP for you or your spouse.

¹⁰ If your former employer has reasonable grounds to conclude that your RRSP deduction limit is sufficient to allow you to deduct the RRSP contribution in the current year, then your employer can contribute the retiring allowance **directly** to your (or a spousal) RRSP and no tax would be withheld.

For tax purposes, when you contribute non-cash property to your RRSP, or to a spousal RRSP, you are deemed to have disposed of the property at its fair market value at the time of the transfer. As a result, the contribution may trigger a capital gain or a capital loss. While only 50% of such a capital gain would be taxable in your hands, you would be denied any benefit should there be a capital loss on the transferred property, as the capital loss is deemed to be nil.

The best approach to take, with property that would create a capital loss, is to sell the property in the open market (i.e. a third party), and then contribute the cash proceeds to your RRSP. In this way, the loss may be recognized subject to the stop loss rules discussed below under "Investments with Accrued Losses" on page 11.

Timing of Contributions

Subject to your 2005 RRSP deduction limit, RRSP contributions you make by March 1, 2006 will be deductible for 2005.

If you turn 69 in 2005, your RRSP contribution for 2005 must be made by December 31, 2005. For further planning, please refer to the discussions on "Spousal RRSP" and "Over-Contribute before Maturity".

Consider making your 2006 RRSP contribution as early as possible in 2006. In doing this, you will benefit from a longer period during which your retirement fund can grow tax deferred.

If you wish to increase your RRSP deduction limit to the maximum of \$18,000 for 2006, you will need earned income of \$100,000 in 2005.

Over-Contribute Before Maturity

If you have earned income in the current year and you are required to collapse your RRSPs by the end of the year (i.e. if you turn 69 in 2005), you should consider "prepaying" your 2006 RRSP contribution before the end of the current year. The contribution you make in late 2005 will be deductible in 2006 when the new deduction limit (based on your 2005 earned income) becomes available.

This strategy will allow you to transfer a higher amount to your Registered Retirement Income Fund (RRIF). Although this "premature" contribution is an over-contribution subject to a 1% penalty for each month that it is in the RRSP in 2005 (subject to the \$2,000 over-contribution that is allowable - see below), your ultimate

future after-tax income on this over-contribution may outweigh the penalty.

You will benefit the most from this strategy where your marginal tax rate in 2006 is expected to exceed your marginal tax rate(s) in the year(s) that the RRSP contribution is to be ultimately withdrawn.

\$2,000 Over-Contribution

You could consider making a lifetime (not annual), non-deductible over-contribution of \$2,000 to your RRSP. Since the over-contribution is not deductible, the amount contributed is from your after-tax dollars.

Unless you limit your RRSP contributions before the last year in which you are eligible to contribute to an RRSP, the \$2,000 over contribution will be subject to double taxation. Double taxation would occur since the initial \$2,000 came from after-tax dollars and will be taxed again when you withdraw it from your plan. However, even if you are subject to double taxation you may realize a benefit if the funds are allowed to grow tax free in your RRSP for a considerable period of time.

You could also consider making an over-contribution for any of your children who are 18 or older. This over-contribution will be deductible by your child in a future year when your child has earned income, creating an RRSP deduction limit.

Building Unused RRSP Deduction Limit for Children

If you have a child who has earned income in a particular year, your child should file a personal tax return and report his or her earned income, even if your child is not required to file a return because his or her income is too low. In this way, with each year's tax return filed, your child will build up his or her unused RRSP deduction limit. The end result of this strategy is that your child will have a larger RRSP deduction limit available for future years.

Equity Investments in RRSPs

Although income and capital gains earned within your RRSP accumulate tax free, the income will eventually be taxed at your full marginal tax rate in the year you withdraw funds from your RRSP.

While you only pay tax on 50% of your capital gains on property you hold *outside* your RRSP: if you earn capital gains *inside* your RRSP, you will be taxed on 100% of the gain in the year of withdrawal. As a result, from a tax standpoint, it may be better to hold growth equity shares outside of your RRSP.

RRSP Investments in Small Businesses

Your RRSP may, subject to certain restrictions, invest in shares of **private companies**.¹¹ Some of the specific rules and restrictions that apply are summarized below:

- Your RRSP cannot own shares of any corporation¹² that you control. In addition, anybody who is related to you (i.e. spouse, children, siblings or parents) is also precluded from owning shares in their RRSP of a company that you control.
- Where you own, together with a related group, 10% or more of the issued shares of a private company,¹² inside and outside RRSPs, and you deal at arm's length with the company, your (combined) cost of the investment in the company must be less than \$25,000.
- Where you, together with a related group, own less than 10% of the shares of any class of a private company,¹² you may invest RRSP funds in this private company, **without limit**, provided that the shares held, inside or outside of the RRSP, after the investment, do not cause you, and the related group together, to own 10% or more of the issued shares of any class of the company.

Foreign Content

For 2004, the foreign property content of your RRSP was limited to 30% of the cost amount of its qualified investments. Effective January 1, 2005, there is no longer a restriction on the foreign property content in an RRSP.

Early Withdrawals

If your income for 2005 is unusually low, consider making a withdrawal from your RRSP in 2005 in order to raise your taxable income to \$35,595. This income amount is the maximum for the lowest federal tax bracket. Please keep in mind, however, that RRSP

¹¹ The company must either be an "**eligible corporation**" or a "**small business corporation**". While the definitions for these terms are not the same, in general, the company must be a Canadian controlled private corporation that carries on an active business in Canada.

¹² Including shares of related companies.

withdrawals do not re-generate your deduction limit. You may only "re-contribute" to an RRSP to the extent your "earned income" has created additional RRSP deduction limit.

Using the Pension Income Credit

You are entitled to claim a non-refundable tax credit on the first \$1,000 of qualifying pension income. Qualifying pension income would include most types of retirement income received on a periodic basis, such as:

- life annuity payments out of a superannuation or pension plan, regardless of your age,
- if you are 65 years or older, annuity payments from an RRSP or DPSP and payments from a RRIF, or
- if you are under 65 years of age, annuity payments from an RRSP or DPSP and payments from a RRIF, if these payments are received by virtue of the death of your spouse.

If your income will be taxed above the lowest tax bracket, you will have some net tax payable on the first \$1,000 of pension income since the \$1,000 non-refundable tax credit is computed at the lowest tax rate.

RRSP Home Buyers' Plan

If you are a "**first-time**" home buyer,¹³ consider using the RRSP Home Buyers' Plan (HBP). The HBP allows you and, if applicable, your spouse to withdraw up to \$20,000 each from your existing RRSPs tax-free, to purchase a home.

Certain rules and restrictions apply. First, before making an HBP withdrawal, the funds must have been in your RRSP for at least 90 days before the withdrawal. Secondly, the home must be purchased by October 1st of the year following the year of the withdrawal. Thirdly, you must repay the withdrawn funds over time or you will pay tax on the withdrawal.

¹³ A first-time home buyer includes any individual if neither that individual nor his or her spouse, have owned a home as a principal residence within 5 calendar years preceding the new HBP withdrawals. An individual may participate in the HBP more than once, provided that all HBP withdrawals have been repaid. Also, the "first-time buyer" prerequisite does not apply to individuals who qualify for the disability tax credit, and to individuals who support disabled individuals and who purchase a home that is better suited to the needs and care of the disabled individual.

The amount you withdraw under an HBP is treated like an interest-free loan from your RRSP and must be repaid annually over a maximum period of 15 years,¹⁴ beginning in the second year after the withdrawal. An HBP repayment is made by making a regular RRSP contribution and designating an amount of your contribution as an HBP repayment rather than a regular RRSP contribution in your income tax return for each year of repayment.

As a result, the HBP repayment does not reduce your taxable income. If this designation is not made, then no repayment would be recognized and the required repayment amount would be included in your income and be subject to tax. CRA will advise you of the minimum amount you must repay each year.

If you plan to withdraw funds from your RRSP under an HBP late in 2005, you should consider delaying the withdrawal until early in 2006. This strategy will: (i) extend the deadline for purchasing a home from October 1, 2006 to October 1, 2007, and (ii) delay the start of the required repayments by one year from 2007 to 2008.

When you withdraw funds from your RRSP to purchase a home under an HBP, you will forego the tax-deferred growth in the RRSP of income on the funds. Whether an HBP makes sense for you will depend, in part, on what you intend to do with the cash savings that result from having a higher down payment and a lower mortgage. If you invest the savings by either paying down your mortgage or by increasing your RRSP contributions, then the HBP can be effective for you.

Lifelong Learning Plan (LLP)

Under an LLP, you can withdraw funds from your RRSP tax-free, if the funds are used to finance full-time (or part-time if the student has a mental or physical impairment) post-secondary education for you or your spouse. Certain other rules and restrictions may apply.

First, annual withdrawals are limited to \$10,000, with a four-year maximum limit of \$20,000. Secondly, the funds must have been in the RRSP for at least 90 days before the withdrawal. Thirdly, you must repay the withdrawn funds over time or you will pay tax on the withdrawal.

¹⁴ Repayment of the HBP withdrawals will be accelerated if the taxpayer (i) passes away (unless the deceased's spouse elects otherwise), or (ii) ceases to be a resident of Canada.

Like an HBP, the amount you withdraw under an LLP is treated like an interest-free loan from the RRSP and must be repaid in equal instalments over 10 years, with the first repayment due no later than 60 days following the fifth year after the first withdrawal.¹⁴ Any unpaid amounts will be included in income in the year that the repayment is missed (similar to the HBP). Future withdrawals can be made from your RRSP for education, provided all your previous withdrawals have been fully repaid.

Transferring Out of an RRSP by Age 69

If you were older than 69 at the start of 2005, you can no longer contribute to your RRSP. **If you turn 69 this year, you must mature (i.e. collapse) your RRSP accounts by December 31, 2005.**¹⁵

In collapsing your RRSPs, your choices are to:

- convert your RRSP into a fixed term or a life annuity (a tax deferred transaction),
- convert your RRSP to a RRIF (a tax deferred transaction), and/or
- be taxed on the value of your RRSP (a taxable event).

A RRIF allows you to manage your investments in much the same manner as a self-directed RRSP. You must make annual minimum withdrawals from your RRIF. These withdrawals are included in income in the year withdrawn.

The minimum annual withdrawal is not subject to withholding tax and may be based on your age or your spouse's age. If you wish to minimize your annual withdrawal (perhaps to defer tax) you should use the younger spouse's age. If you would rather maximize your minimum annual withdrawal you should use the older spouse's age. You can increase the withdrawals from your RRIF over the annual minimum required amount to perhaps meet cash requirements; however, withholding tax will apply to the excess amount withdrawn.

Source Deductions on RRSP Contributions

If you are an employee or owner-manager who receives a salary/annual bonus,¹⁶ you can choose to contribute all or a portion of your remuneration (subject to your RRSP

¹⁵ You do not have to wait until you are 69 to collapse the plan.

¹⁶ This would include bonuses paid to owner/managers by companies who "bonus down" to the income level eligible for the special low rate of tax available to small businesses.

deduction limit) directly to your RRSP provided your employer agrees to the direct transfer.

Your employer is not required to withhold income tax provided they make the contribution directly to your RRSP and the amount contributed does not exceed your RRSP deduction limit for the current year. Furthermore, you are not required to obtain a letter of authority from CRA to do this.

Subject to your RRSP deduction limit, this rule may enable you to immediately contribute 100% of your salary/bonus into an RRSP instead of a tax reduced salary/bonus contribution (i.e. gross versus net). However, your gross salary/bonus will still be subject to CPP and EI premiums, if you have not reached the maximum contributions required for the year.

With this strategy, you will benefit from the fact that more of your money will be invested in your RRSP earlier, thereby creating a longer period for tax deferred compounded growth.

Reduction in Source Deductions

You may ask CRA for authorization to have withholding tax on your salary reduced based on your own RRSP contribution(s). Once your employer receives the authorization, the amount of income tax your employer will deduct from your pay cheque will be reduced. Evidence of the RRSP contribution must be provided to CRA (i.e. the RRSP contribution receipts) before they will allow your employer to reduce the tax withholdings.

CRA will generally provide advance authorizations to allow reduced withholdings if you are making monthly pre-authorized RRSP contributions, and you provide them with suitable documentation (e.g. a copy of the pre-authorized RRSP contribution contract).

Rollover of RRSP and RRIF Upon Death

In general, when a taxpayer dies, the fair market value of his or her RRSPs and RRIFs is included in their final income tax return (i.e. terminal return) and is subject to tax.

There are exceptions to this rule. In general, where the RRSP/RRIF funds are transferred to a spousal RRSP/RRIF or to an RRSP for the benefit of financially dependant children or grandchildren, the funds will not be taxed on the terminal return.

The mechanics to obtain a rollover can be complex and will depend on the facts of the situation. For instance, the procedures differ depending on whether the spouse is a beneficiary under the will or directly under the

RRSP/RRIF, and whether or not the RRSP has matured at the time of death. In some cases, elections need to be filed with CRA in order for the transfer to be tax deferred. You should discuss this matter with your professional advisor.

Individual Pension Plans

If you are a high-income individual, you may be able to have your employer make contributions to a special registered pension plan called an Individual Pension Plan (IPP). Contributions to an IPP can significantly exceed the normal RRSP deduction limits. The amount of the IPP contributions depends, in part, on your age - the older you are, the higher the allowed contributions.

In general, an IPP may be suitable for a key executive and/or an owner/manager who is over 45 years old, is earning a base salary of more than \$100,000, and has worked for the company for several years (back to 1990).

The rules regarding IPPs are complex. As well, there are set-up, administrative and compliance costs.¹⁷ Compliance costs include costs to maintain records, file tax and information returns etc., as applicable.

Registered Education Savings Plans

A Registered Education Savings Plan (RESP) is a contract between you and an issuer under which you make current payments toward the future post-secondary education of a designated beneficiary¹⁸ (for say your child or children). The contributions are not deductible, that is, you **do not receive a tax deduction** for your contributions. However, income earned in the plan is not taxable until it is distributed. Upon distribution, the *income* element is taxed in the hands of your child, and may, therefore, attract minimal tax if your child is a student subject to low marginal tax rates with a tax credit for tuition fees.

The annual limit for RESP contributions is \$4,000 per child, with a lifetime contribution limit of \$42,000 per child.

¹⁷ The costs to set up an IPP may range from \$3,000 to \$5,000. Annual administrative costs may range from \$500 to \$600, with an additional triennial fee of \$1,000 to \$2,000 for an actuarial report.

¹⁸ The single beneficiary of an RESP plan may be a child or grandchild of the subscriber, but need not be, i.e. your niece/nephew could be the sole beneficiary of an RESP that you contribute to. In the case of a "family plan", however, each beneficiary must be related by blood or adoption (as defined in the Act) to the subscriber.

The federal government provides a Canada Education Savings Grant (CESG) equal to 20% (30% on the first \$500 for low income families) of the first \$2,000 of the annual RESP contribution, to a maximum grant of \$400 per year for each child under age 18. If a \$2,000 contribution is not made in a year, the grant entitlement will carry forward to a subsequent year (keep in mind that the annual RESP contribution limit is \$4,000 per child, and thus the grant for a particular year cannot exceed \$800). The maximum grant of \$7,200 per child can be obtained by contributing a total of \$36,000 to the RESP over an 18-year period. The grant is paid directly into the RESP and must be repaid to the government if your child does not pursue higher education.

Subject to the terms and conditions of the RESP, all contributions made to the RESP by you can be returned to you when the contract ends or at any time before. Since RESP contributions (capital) are not deductible when made, they are not taxable when returned.

If your child does not pursue a post-secondary education,¹⁹ you may be eligible to receive the income element of the RESP under certain circumstances. To receive the income element that would otherwise be forfeited, all the intended children of the plan must be at least 21, not be pursuing a qualified educational program, and the plan must have been running for 10 years. You may transfer the income element to your RRSP (to a maximum of \$50,000) to the extent of your RRSP deduction limit at that time. Any income not transferred to your RRSP will be subject to a special 20% tax, which would be in addition to the regular income tax that will apply to the investment income.²⁰

Exempt Life Insurance

An exempt life insurance product can provide insurance coverage together with retirement income that has benefited from tax-deferred growth. These products allow you to pay insurance premiums and, at the same time, make deposits to a tax sheltered investment account. The insurance premiums are generally not tax deductible when made, but the ultimate insurance receipt on death is tax free.

¹⁹ RESP properties (capital and income) can, in most cases, be transferred to another sibling's RESP, provided the sibling is under 21 years of age.

²⁰ The additional 20% tax is to ensure that the RESP is not used to unduly defer tax.

This type of tax-sheltered investment is usually appropriate if you have maximized your RRSP contributions.

INVESTMENT STRATEGY

Return on Investments

As part of year-end tax planning, you should review your investment mix to ensure that you receive the best possible **after-tax** return on your portfolio.

Each type of investment income is taxed differently:

- interest income is accrued annually and fully taxed;
- dividends from taxable Canadian corporations receive preferential tax treatment. They are taxed as received and are eligible for a dividend tax credit;
- capital gains are not fully taxed (50% inclusion rate), and some capital gains are exempt from tax.

The table below shows the after-tax amount on \$100 of investment income earned by an individual who is in the top tax bracket in Ontario. The 2006 rates may change with future federal and Ontario budgets.

Type of Income	After-tax Amount of \$100 in 2005/2006
Interest ²¹	\$53.59
Dividends	\$68.66
Capital Gains–Non-exempt	\$76.79
Capital Gains–Exempt	\$100.00

Based on the different tax treatment for each type of investment, where possible, it is preferable to:

- hold interest-yielding investments inside an RRSP (to defer tax on the higher-taxed interest), and
- hold equity investments, which yield dividends and capital gains, outside an RRSP.

Income trusts have become a significant investment alternative to traditional investments such as shares and bonds. Although there is an element of risk (the risk will vary dependent on the trust), income trusts are generally highly tax efficient and potentially provide investors with a greater after tax return than more traditional investments in Canadian public companies.

²¹ Also applies to foreign source investment income (such as interest and dividends).

If you hold units in an income trust, please be aware that the cash distribution you receive may be a combination of income, subject to tax, and a return of capital which you receive tax free.²² As result, when you calculate your return on investment or yield, you need to exclude the capital receipt.

If you are considering acquiring an interest in a mutual fund or income trust which is expected to make a taxable distribution at the end of 2005, consider waiting until early 2006, thereby saving yourself the tax on the distribution.

Accrual of Interest Income

In general, you must include interest income annually on your tax return, based on the anniversary date of the investment contract, whether you receive the interest in cash or the interest is accrued, as is the case with a compound interest investment.

If you plan on purchasing an interest-bearing investment near the end of 2005, you may want to consider whether delaying your purchase until 2006 will defer the forced accrual/ recognition of interest income until 2007. Keep in mind that interest will accrue on the anniversary date of the investment contract, which will not necessarily coincide with the anniversary date of your purchase.

Interest Expense

Where you have fully paid investments and are also paying non-deductible interest related to the purchase of other assets, you should discuss the situation with your professional advisor to determine whether your financial affairs can be structured to make the interest payments tax-deductible.

When paying down debt, you will be better off if you reduce debts with non-deductible interest (e.g. personal mortgages and personal credit-card balances) before debts on which interest is deductible.

²² The return of capital will, however, reduce the tax cost of your investment and thus increase your gain (or decrease your loss) on sale, redemption, etc.

If you purchased an investment using debt, subsequently sold this investment at a loss, and the proceeds were insufficient to pay off the debt, you can continue to reduce your income for interest paid on this remaining debt, provided the debt is not related to real estate or other depreciable property.²³

Capital Gains and Losses

Only one-half of your capital gains for the year are included in your income and subject to tax (i.e. the capital gains inclusion rate is 50%). Your selling costs reduce your capital gain or increase your capital loss.

To the extent that you realize capital losses in the year, these losses can reduce your taxable capital gains but cannot reduce any other type of income.²⁴ The inclusion rate for capital losses is the same as for capital gains - 50%.

If you cannot use all of your capital losses in the current year, the capital losses can be carried back three years and carried forward indefinitely. As is the case with applying losses in the current year, capital losses carried over to other years can only reduce capital gains.

Investments with Accrued Losses

When you are deciding which investments to sell, you should consider the following tax planning points:

- If you have realized capital gains in 2005, you should consider selling investments with accrued losses before the end of 2005²⁵ to offset your taxable gains.
- Further, you should consider triggering a capital loss if you paid tax on capital gains in any of the **preceding three years**.
- If you realize a capital loss in 2005, the “superficial loss” anti-avoidance rule will deny your loss to the

²³ The interest restriction applies where the real estate assets or other depreciable property is earning income from property (i.e. passive rental income). Where the property was used to earn income from a business, interest will remain deductible after the sale.

²⁴ In the year a taxpayer dies, capital losses can reduce other income on his/her terminal return or his/her return for the immediately preceding taxation year, not just capital gains. However, to the extent that the deceased claimed the capital gains exemption during his/her lifetime, the amount of capital losses deductible against other income will be reduced.

²⁵ To realize a capital loss in 2005, we recommend security trades be executed on or before December 23, 2005.

extent the same investment is acquired by a person that is affiliated²⁶ with you within (i.e. before or after) 30 days of the sale. The denied loss is added to the cost of the investment acquired by the affiliated person, and reduces their gain or increases their loss on a subsequent disposition of the investment. This rule effectively defers the recognition of the loss until the investment is sold to a non-affiliated person.

Foreign Spin-Offs

If you own shares of a foreign corporation and the company distributed shares it owned of a subsidiary to you as part of a spin-off, the distribution is generally considered to be a dividend in Canada and is taxable as foreign source income (i.e. no preferential tax treatment). If however, the spin-off meets certain criteria, you may **elect**²⁷ to exclude the dividend from your income.

Once you elect, the cost of your original shares is split between your original shares and the spin-off shares based on the relative fair market value of those shares at the time of the spin-off. As a result, Canadian income tax on the spin-off:

- will be deferred until you dispose of the shares, and
- may be reduced if the deferral election converts what otherwise would have been a dividend to a capital gain which is currently subject to a lower tax rate.

\$500,000 Capital Gains Exemption

You can exclude from your income a **lifetime maximum of \$500,000** of capital gains realized on the disposition of shares of a qualified small business corporation and/or qualified farm property.

The exemption will provide you with significant tax savings. If you are at the top tax rate and you are able to shelter \$500,000 of capital gains, your potential tax savings would be approximately \$116,000 in 2005.²⁸

While the exemption is designed to shelter up to \$500,000 of gains on a sale of qualifying corporations

²⁶ A person affiliated with you includes you, your spouse, your RRSP, your spouse's RRSP, a company controlled by persons affiliated with you, and certain trusts where more than 50% of beneficial ownership of the income interest or capital interest is held by you and/or persons affiliated with you. This restricted loss rule does not apply to sales made to, or repurchases by parents, children, nieces or nephews.

²⁷ The election should be filed with your tax return.

²⁸ The lifetime limit is \$500,000. Thus, a current or future claim will be reduced by any previous exemption claimed.

(and/or farm property) to third-parties, it is possible to access the exemption without selling the shares to an “outside” party.

You should consider triggering a gain eligible for the exemption for two reasons: (i) the federal government may eliminate the exemption, and (ii) the exemption is only available under certain circumstances and you may have to plan to access the exemption.

You should be aware of the following:

- you can only claim the exemption in respect of certain shares of Canadian controlled private corporations or farm properties that meet specific criteria (i.e. not all shares or farm property will qualify for the capital gains exemption),
- you can only claim the exemption to the extent that your taxable capital gains in the year (net of allowable capital losses) exceed your Cumulative Net Investment Loss amount (see the discussion below),
- capital gains are preference items for the Alternative Minimum Tax (AMT) (see the discussion below) and, therefore, recognizing a gain which is exempt from regular tax may create an AMT liability,
- if you claimed an Allowable Business Investment Loss (ABIL) after 1984, the ABIL reduces your eligible exemption,
- if you claimed pre-1985 capital losses to reduce income (other than capital gains) after 1984, these losses reduce your eligible exemption, and
- to the extent that you have used some or all of your capital gains exemption (including your general \$100,000 exemption), your access to the \$500,000 exemption is reduced.

Cumulative Net Investment Loss (CNIL)

Your use of the capital gains exemption is reduced to the extent of your CNIL balance in the year that the capital gain is recognized. Your CNIL is the cumulative excess of your investment expenses over your investment income after 1987. For example, interest expenses and limited partnership losses increase your CNIL while interest and dividend income reduce it.

To the extent you have a positive CNIL (i.e. more expenses than income), your capital gains exemption²⁹ is

²⁹ The CNIL amount reduces the taxable capital gains eligible for the capital gains exemption, i.e. the 50% taxable portion

reduced by the CNIL. Your capital gains exemption is not affected if your CNIL is negative (i.e. more investment income than investment expense).

While the CNIL impact is not necessarily permanent, it does delay your ability to use the exemption until such time that your taxable capital gains exceed your CNIL. To minimize the effect of a positive CNIL balance, you should consider the following:

- defer the payment of investment expenses to a subsequent year or accelerate the receipt of investment income to the current year to offset the CNIL,
- if you are an owner/manager of a private corporation, you could receive dividends rather than salary, or earn interest on amounts that you lend to the company, to reduce your CNIL,
- maximize your borrowings for business purposes and use your savings for investment purposes, and
- realize eligible capital gains early if you anticipate a CNIL “problem” in the future.

Alternative Minimum Tax (AMT)

AMT is calculated on your “adjusted taxable income” which is your taxable income excluding “preference items”. Preference items include: losses from limited partnerships and other tax shelters, the non-taxable portion of capital gains, and certain allowable deductions,³⁰ including carrying charges related to investments in limited partnerships, tax shelters and rental properties (to the extent of rental losses).

AMT operates in a limited range of circumstances to reduce or eliminate the current tax savings otherwise generated by preference items. You are liable for AMT if your AMT is greater than your regular taxes payable.

Other than the observation that an individual with gross income of less than \$40,000 is generally not subject to AMT, it is difficult to develop a rule of thumb with respect to when AMT will apply. If you have significant amounts of “preference items”, you should speak with your professional advisor before you invest in a limited partnership (or other tax shelter), or realize capital gains.

If you pay AMT in one year, the amount is recoverable to the extent that your regular taxes payable exceeds your

of the gain. The maximum exemption is \$250,000 (1/2 of a \$500,000 gross capital gain).

³⁰ RRSP deductions are no longer required to be added back to compute taxable income for AMT purposes.

AMT in any of the next seven years. If you paid AMT in a previous year, you could discuss steps to generate a refund of this AMT with your professional advisor.

Small Business Capital Gains Deferral

In addition to the small business capital gains exemption discussed above, you can defer tax on capital gains realized on the sale of qualifying shares of a “small business corporation” **if you reinvest** the proceeds of disposition in shares of another eligible small business corporation or corporations.

The deferral is only available if you own the shares directly (i.e. not in a corporation or trust). The proceeds of disposition must be reinvested within 120 days after the year of disposition to be eligible for the deferral. To illustrate, for dispositions occurring in 2005, the reinvestment must occur prior to April 30, 2006.

Tax Shelters

Tax shelters are effectively tax-assisted investments in real estate, oil and gas, and other operating businesses. Although tax shelters can reduce and defer tax, **you should examine them first and foremost for their investment potential.** Your net worth will not increase if there is little chance of earning a return or recovering the after-tax cost of your investment. **The tax benefits should be a secondary consideration.** Consider the following tax issues when evaluating tax shelters:

- significant deductions from a tax shelter can create AMT (i.e. additional taxes),
- most tax-shelter deductions are added to your CNIL balance,
- the “at-risk rules” limit the available deductions to the amounts you invested or earned,
- a negative adjusted cost base in a limited partnership creates a capital gain.

If you will have significant tax shelter deductions for 2006, you should consider filing a request for a reduction of income tax withholdings from employment income in 2006, rather than waiting until 2007 to file your 2006 personal tax return to receive your tax refund.

In general, before you consider an investment in a tax shelter, you should be in the highest tax bracket **after** contributing the maximum to your RRSP or RPP.

An investment in a tax shelter must be made by December 31, 2005 in order to obtain a tax deduction for 2005.

For investments, other than flow-through shares, an investor should ensure that the shelter has a Tax Shelter Identification Number issued by CRA. Tax shelters, including charitable donation shelters, are required to register with CRA and obtain a Tax Shelter Identification Number. CRA will deny deductions or credits if a tax shelter does not have an identification number.

Certain “gifting” arrangements are considered tax shelters and must be registered by the promoter. For this purpose, gifting arrangements include plans where it is reasonable to expect that a person will make a gift to a qualified donee or incur a limited recourse debt related to the asset acquired and subsequently gifted.

The tax rules for tax shelter investments have become more complex in recent years. Rules have been introduced to significantly curtail certain types of shelters³¹ (e.g. computer software and film tax shelters). Buy-low, donate-high donation shelters, involving the purchase and donation of items, such as multiple works of art, have effectively been eliminated by legislative changes made in 2003. CRA continues to aggressively pursue donation plans arranged prior to the legislative changes, where the value of tax saved by the donors exceeded the cash cost of the asset purchased and then gifted to a charity.

The income tax implications (risks, etc.) of tax shelters can be complex. Therefore, you should speak with your professional advisor prior to purchasing a tax shelter.

Investment Holding Corporations

In general, there is no tax deferral benefit to holding investments (public stocks, bonds, etc.) in an investment holding corporation. Nonetheless, you may benefit from using an investment holding corporation, in certain circumstances.

For example:

- the use of a holding corporation may lower your income which may create higher personal tax credits and eliminate the Old Age Security clawback,

³¹ On October 31, 2003, the Department of Finance released far reaching draft legislation, effective for taxation years commencing after 2004, which, if implemented, could have applied to deny loss and interest expense claims. In response to concerns raised by the public, the draft proposals have been withdrawn. In the 2005 federal Budget, the Department of Finance indicated that it will develop a “more modest legislative initiative” which will address concerns raised. Please refer to TaxTalk 2004 Issue 4, Cases of Interest for a more detailed discussion of this draft legislation.

- it may be possible to use a holding corporation to convert non-deductible interest to deductible interest,
- if you own certain property in a holding corporation, you may reduce or eliminate probate fees and/or U.S. estate tax.

If you own an investment holding corporation, but are not benefiting from it, you should consider winding up the company. In doing so, the benefits of winding up the corporation should be weighed against the potential costs, including any income tax to be paid on the wind-up either by the company on a deemed disposition of its assets, and/or by its shareholder(s) on the deemed dividend that could result.

Foreign Investment Entities

Proposed tax rules³² will allow CRA to “attack” offshore investment plans.

To the extent that you hold an investment which meets the definition of a “foreign investment entity” you may have to include certain amounts in income, even if you do not actually receive any income from the particular investment. The new rules are intended to stop Canadian residents from deferring income tax on investment income earned outside Canada through investments in foreign entities.

If you have foreign holdings, you should speak with your professional advisor to determine the effect of these new rules on you.

Non-Resident Trusts

Recent legislative proposals³² expand the rules for determining when an offshore trust is **deemed to be a resident of Canada** for income tax purposes and, therefore, subject to tax in Canada. The new rules will deem more offshore trusts to be resident in Canada than was the case under previous legislation. If you are a trustee or beneficiary of an offshore trust, you may wish to seek professional advice to determine the implications of these new rules.

³² As drafted, the proposals are generally to be effective retroactively on January 1, 2003.

FAMILY TAX PLANNING

Charitable Donations

The first \$200 of your charitable donations in 2005 will reduce your taxes payable at a rate of 25.4%³³ of the donation amount. This is a combined federal and Ontario rate. Your donations in excess of \$200 will reduce your taxes payable by 46.41%³⁴ of the donation amount.

In order to claim a donation in 2005, your donations must be made by December 31, 2005. To obtain a higher overall tax credit, donations made by both spouses should be claimed by only one spouse.³⁵

Your total allowable donation claim is limited to 75% of your net income for the year. This limit increases to 100% in the year of death and the year before death.

Further, the limit increases to 100% for gifts of:

- capital property with an unrealized capital gain, to the extent you do not shelter the gain from tax by claiming the capital gains exemption,
- depreciable property with potential recapture of capital cost allowance,
- gifts to Her Majesty in the right of Canada, or a province (i.e. Crown gifts),
- certified cultural property to designated institutions or public authorities, and
- ecologically sensitive land to Canada, a province or municipality in Canada, and certain charities.

If you choose not to use a donation to reduce your taxes in the current year, or the above restrictions limit your donations, your unused donations can be carried forward 5 years.³⁶

If you own shares or certain debt of a public company with unrealized capital gains, and you plan on making a cash contribution to a registered charity, your after-tax cost of the gift is lower if you donate the shares instead of donating cash. For such gifts, the capital gains inclusion rate is 25% instead of 50%.

³³ For those taxpayers who are subject to the maximum Ontario surtax. For those who are not subject to the surtax, the tax saving on the first \$200 of donations is 22.05%.

³⁴ For those taxpayers who are subject to the maximum Ontario surtax. For those who are not subject to the surtax, the tax saving for donations exceeding \$200 is 40.2%.

³⁵ It is CRA's administrative policy to allow either spouse to claim donations made.

³⁶ To the extent donations cannot be utilized in the year of death, they can be claimed in the immediately preceding year.

Donations of funds from your RRSPs, RRIFs or proceeds from life insurance, in the year of death, are treated as donations for tax purposes.

Child Support and Alimony

You cannot deduct child support payments that you made pursuant to an agreement or court order entered into or altered after April 30, 1997. These payments are also not taxed in the hands of the recipient. The amount payable for child support is determined using prescribed rates and depends on the income of the payor. In certain instances, it may be beneficial for you to change a pre-May 1997 agreement to the new rules. This can be done where both parties make a request in writing to CRA.

However, where the supporting spouse is in a higher tax bracket than the recipient spouse, the application of the new rules would result in increased combined taxes. In this case, it may be beneficial to preserve agreements entered into before May 1997.

Alimony (i.e. spousal support) payments remain deductible under the new rules; however, if there are payments in arrears, the payments apply first for child support and secondly for alimony. As a result, your ability to deduct alimony may be restricted if the payments are re-characterized to be non-deductible child support.

Legal fees paid to establish, enforce or increase spousal or child support are deductible for income tax purposes regardless of whether the support is taxable to the recipient.

Qualifying Retroactive Lump Sum Payments

If you receive a lump sum payment of over \$3,000 relating to prior years, this receipt can be included in income in the prior year(s) instead of in the year received. This measure is intended to relieve you of the higher tax liability that may result if the entire lump sum is taxed in the year you receive it, rather than year-by-year as the right to receive the payments arose.³⁷

³⁷ A notional income tax liability is calculated, as if such income had been included in each prior year to which it relates. A notional interest component, using prescribed interest rates, is also computed, and must also be considered to determine the better alternative with respect to income recognition.

The qualifying payments include wrongful dismissal and other employment related payments arising from a court order or similar judgment, arbitration awards, superannuation and pension benefits, and spousal or child support payments.

Income Splitting

Benefits

The primary technique of income splitting is to remove income from a higher-tax-bracket individual and add it to the income of a lower-tax-bracket family member (spouse, child or parent). The benefits of income splitting are:

- lower taxes on income, and
- access within a family to multiple \$500,000 capital gains exemptions to reduce taxes on any future sale of shares.

Opportunities for Income Splitting

There are a number of “attribution rules” that prevent income splitting. For example, where one spouse earns interest income from property received as a gift from the other spouse, the attribution rules would require the income be included in the taxable income of the transferor spouse (i.e. attributed back).

The attribution rules are complex. While there are opportunities for income splitting, you will only benefit through careful planning.

Subject to the income splitting tax (the “kiddie tax”) (see discussion below), you should consider the following opportunities for income splitting and family tax planning:

- Where your minor child earns income from property (e.g. interest or dividend income) and the funds to earn this income came from you as the child’s parent by way of a gift or loan, the income will be taxed in your hands unless your child pays you interest on the capital amount.³⁸ The interest must be paid by January 30th of the following year, is taxable in your hands and is deductible by your child. Further, the interest on the loan must be at least equal to the lesser of CRA’s prescribed rate at the time of the loan, and the interest rate that would have been charged to an

³⁸ This attribution rule also applies to loans or gifts from grandparents.

arm's length party.³⁹

- The above attribution rule on income from property to minor children does not apply to: capital gains,⁴⁰ business income, or income earned on reinvested income (i.e. the compound income portion). That is, any capital gains earned by your child on money you gave him or her would be taxed in your child's hands and not in yours.
- There is no attribution on gifts to children 18 years of age or older.⁴¹ The funds can be used for any purpose including contributions to their RRSP.
- There is no attribution of income on gifts or loans made by a non-resident of Canada to a resident of Canada.
- In 2005, an individual who has little or no other income can receive approximately \$31,750 in dividends from Canadian corporations without paying income taxes.⁴²
- You can make a low-interest or interest-free loan to your adult children to assist them to acquire a principal residence.
- You can deposit the child tax benefit cheques you receive into a bank account in your child's name. The income earned in the account will be taxed in your child's hands and not in yours.
- If you and your spouse both earn income, but one of you is taxed at a higher tax rate than the other, the higher income spouse should pay all or most of the "non-deductible" family expenses, including income taxes, while the lower income spouse should invest all or most of his or her earnings to generate investment income which would be taxed at the lower tax rate.
- The higher income spouse can contribute to a spousal RRSP (see Tax Deferral Plans above).
- You can contribute to an RESP for your child (see Tax Deferral Plans above).

³⁹ Since interest rates are currently at low levels, **consider an income-splitting arrangement using a loan to your spouse or minor child.** The loan recipient must pay interest to you as creditor at the prescribed interest rate in effect at the time the loan is made. The rate is 3% for the period October 1 to December 31, 2005. Please refer to TaxTalk 2002 Issue 3, Tax Matters of Note for a more detailed discussion.

⁴⁰ Consider buying securities with high capital gains potential in the names of minor children.

⁴¹ Gifts of assets with unrealized capital gains will give rise to a capital gain to the transferor. There is no "gift" tax in Canada.

⁴² Assuming that the "kiddie tax" does not apply.

- You can assign half of your CPP benefits to your spouse, provided that both of you are over 60 years of age.
- You can create multiple testamentary trusts in your will. Each trust would be taxed separately resulting in multiple lower-tax-rate brackets.
- The charitable donation credit is generally maximized by having either you or your spouse claim all donations.
- In general, unless net income for both you and your spouse exceeds \$61,465,⁴³ the lower income spouse should claim all medical expenses to maximize the medical expense credit.

Subject to the possible application of the "kiddie tax", the following opportunities for income splitting may be available:

- Your spouse or your children can participate in your incorporated business through share ownership if they purchased the shares with their own funds.
- If you are a professional carrying on your practice in your own name, you could consider setting up an entity to provide either management or technical services to your practice.⁴⁴

Income Splitting Tax

The income splitting tax (the "kiddie tax") is intended to discourage high-income taxpayers from splitting certain types of income with **minor children**.

The tax applies to:

- taxable dividends from private corporations to minor children, received either directly or through trusts;
- income from a service partnership or trust arrangement where fees are derived from a professional practice of a parent or a related corporation; and
- income⁴⁵ from a partnership or trust⁴⁶ derived from

⁴³ Medical expenses must be reduced by 3% of net income to a maximum amount, which for 2005 is \$1,844.

⁴⁴ However, if the management company provides services to a professional who provides GST tax-exempt services, there will be a GST cost that may exceed the income splitting benefits of the plan.

⁴⁵ Pursuant to proposed legislation, income from property [e.g. rent, interest] earned from a business carried on by a related individual would also be subject to the kiddie tax.

the business of providing goods or services to a business carried on by a relative of the minor or a business in which the relative participates.

The “kiddie tax” does **not** apply to:

- income from employment or personal services of a minor,
- capital dividends,
- dividends⁴⁷ received on public stocks, including mutual fund corporations, or,
- income from property acquired on the death of a parent.

Under this provision, the minor child is subject to tax at the **highest income tax rate**⁴⁸ on the first dollar of “split income” and every dollar thereafter (i.e. no graduated rates). As a result, the benefits from some income splitting techniques have been reduced significantly.

Salaries to Spouse and Children

One form of tax planning that is permitted is the deduction of *reasonable* salaries paid to spouses and children by sole proprietors, partnerships and corporations. This technique allows your spouse or your children:

- to make CPP and RRSP (subject to their RRSP limits) contributions, and
- to contribute to EI, in certain situations.

The salary must be reasonable in relation to the services performed. To the extent a portion of the salary is unreasonable, your business will be denied this deduction, yet, at the same time, your spouse or child will pay tax on this income, which will result in double taxation.

Further, as an employer, you must withhold and remit income taxes, CPP and EI as required. Their salaries would be included in your company’s Ontario Employer Health Tax (EHT) calculation. You may also be required to pay premiums to the Workplace Safety and Insurance Board in respect of the “family” salaries.

⁴⁶ If structured properly, and depending on your specific circumstances, there are still advantages to income splitting using family trusts.

⁴⁷ Other attribution rules could apply to this income.

⁴⁸ In Ontario for 2005, the highest rate is 40.2% before application of Ontario surtax, which starts to apply when Ontario tax payable exceeds \$3,929. The surtax starts to apply when taxable income exceeds \$59,880 (for taxpayers who do not receive Canadian-source dividend income).

PLANNING FOR PROFESSIONALS AND OWNER/MANAGERS

Incorporated Business Owners

Remuneration

There are several factors that you should consider when determining how best to carry on business in your corporation and how to receive profits from it.

A Canadian controlled private corporation (CCPC) is taxed in **2005** on active business income (ABI) at the following rates (*assuming a December 31 fiscal year end*):

Income	Federal Rate %	Ontario Rate %	Total %
ABI up to \$300,000	13.12	5.50	18.62
ABI from \$300,001 to \$400,000	22.12	5.50	27.62
ABI from \$400,001 to \$1,128,519 **	22.12	18.67	40.79
ABI > \$1,128,519	22.12	14.00	36.12
ABI > \$1,128,519 with M & P ***	22.12	12.00	34.12

* includes surtax of 1.12%

** includes clawback of Ontario small business deduction

*** M & P – manufacturing and processing

The low rate of tax in 2005 (i.e. 18.62%) applies to active business income of \$300,000 per associated group. There are federal and Ontario rules that “clawback” the low rates of tax in certain cases (see discussion below for clawback rules).

A CCPC with ABI over \$400,000 should generally reduce its income to \$400,000 through the use of year-end bonus accruals.⁴⁹ If income is not bonused down⁵⁰ to \$400,000, an overall tax burden (combined corporate and individual, at the top marginal rate) of approximately 56.1% (instead of a top rate of 46.4% applicable to

⁴⁹ If you (and the other owner/managers) are likely to withdraw corporate earnings in the near future, additional consideration should be given to reducing taxable income to the federal low rate income level of \$300,000. If the income in excess of \$400,000 is eligible for the manufacturing and processing tax credit, the decision to bonus income down to \$400,000 depends on how long the funds (after corporate tax) would otherwise remain in your company before being distributed to the owner/managers as dividends.

⁵⁰ There are alternatives to a “bonus down” strategy, including the potential use of an employee profit sharing plan or a retirement compensation arrangement.

individuals) could be incurred by the time dividends are ultimately distributed to you.

If your corporation's income fluctuates from year to year, you could consider paying tax (in the corporation), at the high rate in one year if the high rate tax can be recovered by future loss carrybacks.⁵¹

A bonus accrual can also result in a tax deferral since payment of the bonus (and any related taxes) can be delayed for up to 179 days from the end of the company's taxation year. For example, July 31, 2005, fiscal year bonus accruals can be paid as late as January 26, 2006. In this case, the corporate deduction would be in the 2005 fiscal year, and the related income would not be taxed in your hands until the year 2006.⁵²

Where the ABI in your corporation that is eligible for the low rate of tax is below \$300,000, the combination of salary and/or dividends to you and the owner/managers of your company is dependent on a number of other factors.

Advantages of Paying a Salary

- provides a source of earned income to maximize CPP, RRSP and RPP contributions
- is not subject to AMT
- does not create a personal instalment base due to tax withheld at source
- some or all of the salary may be eligible for the SR&ED⁵³ credit

Advantages of Paying a Dividend

- an overall tax savings to a top rate taxpayer of about 3.3% of the pre-tax corporate income
- provides investment income to reduce your CNIL account
- dividend payments are not subject to EHT
- dividend payments may trigger a refund of refundable dividend tax on hand in the company

The cash requirements of your company and its owner/managers, and other income sources of the owner/managers should also be considered when deciding the salary/dividend mix.

⁵¹ Losses may be carried back up to three years.

⁵² In this example, source deductions on the bonus, including income tax, would need to be remitted in February 2006.

⁵³ Scientific Research and Experimental Development.

Interest in Lieu of Salary

If you are a shareholder and lend money to your corporation, you should consider charging interest on the loan, instead of receiving a salary. Any interest paid on a shareholder loan should be deductible by the company, would not be subject to EHT, and would reduce your CNIL account balance, if any.

Federal Clawback of the Low Corporate Rate

The lower federal tax rate of 13.12% available on the first \$300,000 of active business is limited if the prior year's taxable capital⁵⁴ (including the taxable capital of associated corporations) exceeded \$10 million. The amount of income eligible for the low rate of tax is eroded when taxable capital exceeds \$10 million, and is reduced to zero when the taxable capital of the company (and the associated group) equals or exceeds \$15 million.

As a result of the federal clawback, it may be prudent to bonus your company's income down to the amount of income, if any, eligible for the low rate of tax.

Retirement Compensation Arrangement

A Retirement Compensation Arrangement (RCA) can be a valuable retirement and estate planning tool that, in some circumstances, can also lead to reduced taxes. In appropriate circumstances, an RCA can be used as an alternative to paying a bonus to a shareholder/manager, and can be attractive for higher income owners and executives who are looking for a retirement benefits in line with their present and future income.

RCAs are a useful means of providing for the retirement of a key employee, including the owner-manager of a business. Tax savings may be realized where the employee expects to be taxed at lower marginal rates after retirement.

An RCA is a trust arrangement between an employer and an employee. Contributions are made by the employer⁵⁵ to an RCA trust, under which the employee is the beneficiary. The trust is then required to make payments to an employee (or an employee's beneficiary) on, after, or in contemplation of the employee's retirement or loss of office.

⁵⁴ Taxable capital includes debt and equity invested in a company, net of investments in other corporations..

⁵⁵ Contributions made by the employer are based on actuarial calculations, and are deductible to the employer on a paid basis.

The RCA pays a 50% refundable tax on (i) contributions made to it and (ii) any income earned or gains realized by the RCA. When distributions are made from the RCA to the beneficiary, this 50% refundable RCA tax is recovered by the RCA at a rate of \$1 for every \$2 distributed to the retired employee.

Since the RCA is subject to the 50% tax on contributions to it and on its income, the employee is not taxable in respect of employer contributions to the plan or the income earned in the RCA. Instead, the employee pays tax on distributions from the RCA on or after retirement, and in this way may be able to take advantage of the lower graduated tax rates. This may be of particular benefit after retirement if the key employee has few other sources of income, or plan to retire in a lower-taxed jurisdiction, so that lower tax rates will apply to amounts received from the RCA.

Other potential benefits of an RCA include:

- it can be used as a vehicle to raise funds for the operating business, and
- its assets can be creditor-proofed — since RCAs are established within a trust, the RCA assets are separated from the operating business assets.

As with any planning vehicle, it is necessary to consider the pros and the cons. Some pros have been outlined above. The cons include the added complexity and the initial and on-going costs to set-up and administer the RCA. In addition, a prepayment of income tax occurs since the 50% RCA tax rate is currently higher than the highest income tax rate that applies to a bonus in Ontario in 2005 [46.41%, rising to 47.44% when the Employer Health Tax is payable on the bonus].

Ontario Clawback of the Low Corporate Rate

A surtax is imposed in Ontario on corporate taxable income (including the taxable income of associated corporations) between \$400,000 and \$1,128,519. This “clawback” gradually eliminates the Ontario tax rate benefit of the portion of the lower tax rates on the first \$400,000 of active business income for Ontario.

A company with taxable income (including the taxable income of the associated group) over \$400,000 and earning both active and investment income should consider transferring the investment income earning assets outside the associated group to avoid the Ontario clawback. However, there may be tax implications associated with the transfer that would need to be considered.

Capital Tax Reductions

Pursuant to the 2004 Ontario budget, the capital tax exemption will increase in increments of \$2.5 million over four years until the exemption reaches \$15 million as detailed in the following chart:

Year	Exemption (\$Millions)
January 1, 2005	7.5
January 1, 2006	10.0
January 1, 2007	12.5
January 1, 2008	15

Also, the 2004 budget proposed that, the current capital tax rate of 0.3% will be reduced annually by 0.075%, commencing January 1, 2009, until the rate reaches zero in 2012.

It should be noted that based on current legislation, the federal large corporations (capital) tax will be eliminated by 2008.

Research and Development

The federal and Ontario governments have a number of tax incentives to encourage Scientific Research and Experimental Development (SR&ED). The incentives are very attractive to private companies engaged in SR&ED, and can significantly reduce the after-tax cost of SR&ED. Taxpayers should review their operations to determine if they are performing SR&ED. Measures were introduced to simplify and streamline SR&ED claims. Please refer to TaxTalk 2003 Issue 5, *Research and Development* for more information with respect to SR&ED.

Shareholder Loans

If your corporation lends you money in your capacity as a shareholder, you and your professional advisor should review the loan annually. The general rules with regard to these loans are as follows:

- loans made to you as a shareholder, whether or not they bear interest, received from the company must generally be repaid before the end of the first taxation year of the company following the year in which the loan was made to you.⁵⁶ Otherwise, the amount of the unpaid loan is treated as income in your hands in the calendar year that you received the loan.
- certain loans (such as qualifying housing, share purchase or automobile loans) may be exempt from this “one year” repayment rule.

In this case, a taxable benefit is required to be included in your income to the extent that the interest rate on the loan is less than the prescribed interest rate. However, you can offset the benefit by a deduction of the same amount if the low-interest loan is used by you for income-producing purposes.

A loan to you or an individual “connected” to you⁵⁷ is exempt from the repayment rule only if it is received in the capacity of employee and is available to other similar employees. This rule significantly restricts the ability of a shareholder to receive a housing, share purchase or automobile loan that is exempt from the “one year” repayment rule.

- if the loan is included in your income, and you subsequently repay it, then the amount repaid may be a deduction to you in the year of repayment.

Review Shareholder Agreements

Shareholder agreements should be reviewed periodically. As a shareholder, it is important to have a shareholder agreement to protect your estate in the event of death or disability. It is common for the agreement to provide for the purchase of shares of the deceased by the remaining shareholders and/or a buy-back directly by the corporation.

⁵⁶ These payments cannot be a series of loans and repayments.

⁵⁷ A person is connected with a shareholder of a particular corporation if he or she does not deal at arm's length with that shareholder.

In certain circumstances, a life insurance policy can be purchased on the life of a shareholder to help fund the purchase and/or buy back of the deceased shareholder's shares.

Specific provisions in the Act dealing with share redemptions and life insurance proceeds may result in negative tax consequences and/or restrict tax planning opportunities. You should discuss the preferred wording and structure of a shareholder agreement with your professional advisor in order to access tax planning opportunities and avoid tax pit falls.

Employer Health Tax (EHT)

EHT is payable on remuneration paid to employees in Ontario. The first \$400,000 of the annual payroll is exempt from EHT.

Associated employers must share the \$400,000 EHT exemption. An allocation agreement to share the exemption must be filed with the EHT return, and is due by March 15 of the following calendar year. If the agreement is not filed, all employers in the associated group will be denied the exemption for the year.

EHT is calculated on all payroll amounts, including bonuses and lump sum payments made to former employees. Stock option benefits received by current and former employees are also included in the EHT base.⁵⁸

UNINCORPORATED PROFESSIONALS AND BUSINESS OWNERS

Unincorporated businesses and partnerships with individuals, as members, cannot defer income taxes by having a business year-end of other than December 31. A taxpayer commencing business operations is required to either adopt a December 31 business year-end or make certain calculations to include in income an estimated amount of business income being deferred by the non-calendar year-end (i.e. by electing to use the “alternative method”). This election must be made in the year you commence your business even though you may not need to report business income until the following year.

⁵⁸ The EHT exemption will continue to be available with respect to stock options granted before May 18, 2004 by research-intensive employers and exercised by December 31, 2009.

You may switch your business from a non-calendar year-end to a December 31 year-end in any year. However, once you have switched the business to the December 31 year-end, you cannot switch it back to the non-calendar year-end. As a general rule, if your business income is increasing each year, keeping the non-calendar year end will provide some income tax deferral.

Extended Tax Return Filing Date

The filing deadline for the income tax returns of a self-employed individual (and his or her spouse) is June 15 of the following year.⁵⁹ However, the balance of income tax is still due and payable on April 30 of the following year, and should be paid at this time to avoid interest charges.

Incorporation of Professionals

Laws allowing professionals to incorporate in Ontario came into effect as of November 1, 2001. The regulations or by-laws of the professional governing body must allow for incorporation of its members' practices. If you are a professional, who does not require all the profits of your business for personal living, and/or want to potentially access the small business capital gains exemption on the sale of your practice, you may wish to consider incorporating to take advantage (to the extent possible) of favourable corporate tax rates available to an active small business.

If you are interested, please contact us to obtain a copy of TaxTalk 2002 Special Issue 1, *Professional Corporations* for a detailed discussion of this topic. It should be noted that the incorporation of a professional practice will not limit your professional liability.

Current legislation does not allow dividend splitting with family members, unless they are members of the same profession as you. However, the Ontario government proposes to relax the share ownership rules for doctors and dentists. Specifically, a doctor or dentist may allow family members to hold non-voting shares in their Professional Corporation (PC), effective January 1, 2006.

It will be necessary for the governing bodies to ensure the legal and regulatory changes have been made to allow for non-professionals to hold shares. Presumably there will be pressure to allow for expanded ownership of shares of PCs of other professions.

⁵⁹ GST returns are also due on June 15 of the following year, however, any GST balance payable is due on March 31 of the following year.

Home Office

If you are a self-employed individual who uses an office in your home:

- as your principal place of business; **or**
- exclusively for earning business income **and** on a regular and continuous basis for meeting clients, customers or patients,

you may deduct home expenses related to the office space. These expenses⁶⁰ include the business portion of rent, mortgage interest, property taxes, utilities, home insurance, repairs, cleaning materials, and telephone. However, no capital cost allowance on the home may be claimed.

Canada Pension Plan (CPP) Premiums on Self-Employed Income

As a self-employed individual, you are allowed to deduct from income, one half of the CPP premiums paid on income from self-employment. The remaining half will continue to qualify for a non-refundable personal credit.

GST - Quick Method of Accounting

Certain self-employed individuals and small businesses may elect to use the "Quick Method" to simplify their GST record keeping. The Quick Method can be used by certain businesses (excluding lawyers, accountants, actuaries, financial consultants and bookkeepers) with annual revenues of \$200,000 or less (including GST).

Under the Quick Method, you would charge GST on sales in the normal manner but remit GST to CRA based on a fixed percentage of revenues (including GST) that is lower than the 7% GST rate. You will not be entitled to claim Input Tax Credits (ITCs) with respect to on-going expenses; however, you will still be eligible to claim ITCs on capital expenditures.

The Quick Method can simplify reporting of GST, and can lead to lower GST remittances if your business has few expenses subject to GST.

⁶⁰ It is important to obtain receipts and document the expenses in your records, noting the date, purpose and GST paid in order to substantiate the deductions.

EMPLOYEES

Employee Benefits

Non-Taxable Benefits

Certain employee benefits are not subject to tax such as: employer contributions to RPP, DPSP, group sickness or accident insurance plans, private health care premiums, subsidized meals, social or athletic club memberships (when used primarily to promote the employer's business), certain training courses, relocation expenses and reimbursements of economic losses as a result of job transfers,⁶¹ as well as reasonable allowances based on a per kilometre charge for the use of an employee's automobile for employment purposes.

Your employer may provide you with **non-cash** gifts (no more than two in a calendar year) for special occasions. If the aggregate annual cost of the two non-cash gifts does not exceed \$500, the gifts are not taxable to you and your employer is entitled to deduct the cost of the gifts. If the cost of the gift exceeds \$500, the entire fair market value of the gift must be included in your income. Your employer may also give you non-cash awards for achievement with the same annual \$500 limit and conditions applying. If the gift or award offered is cash or near cash, the full amount of the gift must be included in your income.

Taxable Benefits for Employer-Provided Vehicles

Where your employer provides you with an automobile for personal use or employment use, you will be taxed on the following:

1. **"Standby charge."** The standby charge is a notional benefit based on the cost of the automobile, or lease payments, for providing the automobile to you, the employee.

The standby charge is 2% per month⁶² (whole or partial month) of the original cost of the vehicle. Where your employer leases an automobile, the standby charge is two-thirds of the lease payments.

⁶¹ One-half of employer-paid amounts in respect of eligible housing losses in excess of \$15,000 is treated as an employment benefit received by the taxpayer.

⁶² If you are an employee of an automobile dealership, the 2% rate may be reduced to 1.5%.

The standby charge is reduced if two conditions are met: (i) your total personal use of the automobile, in a calendar year, is less than 20,004 kilometres, **and** (ii) your personal use is less than 50% of total use.

The fact that an automobile depreciates in value does not reduce the standby charge. As a result, if the fair market value of a used vehicle is substantially less than its original cost, it may be prudent for you to purchase the vehicle from your employer.⁶³ Subsequent to your purchase, your employer could reimburse you for the employment use of the vehicle as discussed below.

2. **"Operating costs."** The operating costs benefit relates to your personal use of your employer's automobile.

If your annual employment-related use exceeds 50% of total use, the operating cost benefit can be calculated as one-half of the standby charge, less reimbursements made by you to your employer. You must notify your employer in writing by December 31, 2005 if you wish to have the operating cost benefit calculated as one-half of the stand-by charge.

If your employment-related use is less than 50%, or you choose not to have the operating cost benefit calculated as one-half of the standby charge, the operating cost benefit is calculated at 20 cents per kilometre of personal use (17 cents for automobile salespersons).

You can avoid an operating cost benefit, if you reimburse your employer for your personal-use operating costs. The reimbursement must be made by February 14, 2006. This topic is discussed in more detail in TaxTalk 2004 Issue 1, *Automobile Benefits and Deductions*.

You should review your personal use of your employer-provided automobile before December 31 to determine how close you are to the 50% employment-use threshold. It may be prudent to reduce personal use between now and the end of the year to reduce the stand-by charge and/or the operating cost benefits.

In addition to the taxable benefits to you, an employer-provided automobile creates a GST liability for your employer. The GST liability is 6/106 of the standby charge and 5% of the operating-cost benefit. Your employer is required to compute and self assess GST on the benefits.

⁶³ Alternatively, the standby charge would be reduced if your employer sells the car and then repurchases it based on the current value of the car.

Employee-Owned Vehicles

As indicated above, an allowance received by you for an employee-owned or leased vehicle can be received tax free if the allowance is computed based solely on employment related kilometres.

An allowance received for employment-related use of your (owned or leased) automobile, which is **not** based on a per kilometre rate, is **not** considered reasonable and must be included in your income. If an allowance is included in your income, then you may deduct the portion of your automobile expenses that relates to employment use⁶⁴ to reduce or eliminate the impact of the income inclusion.

Stock Option Benefits

If you are an employee of a **public company** and you acquire shares under an employee stock option plan (ESOP), the difference between the fair market value of the shares on the date you exercise the option and the amount you pay for the shares is included in your income in the year you acquire the shares.

This income inclusion may, however, be deferred to the year in which either the shares are sold, or an individual dies or becomes a non-resident. This deferral is subject to an annual ceiling of \$100,000.⁶⁵ You must notify your employer in writing by January 15, 2006 in order to obtain the deferral in respect of option benefits arising in 2005.

If you are an employee of a **Canadian controlled private corporation** (CCPC) with which you deal at arm's length and acquire shares of the CCPC under an ESOP, the stock option benefit is included in income, as employment income, in the year in which **you sell the shares**, rather than the year you exercise the option.

If you acquired shares under an ESOP and either:

- the exercise price was at least equal to the fair market value of the shares on the date the option was granted, or
- they were shares of a CCPC (with which you deal at arm's length) acquired subsequent to May 22, 1985, and you have held them for at least two years,

⁶⁴ To deduct automobile expenses on your tax return, you must receive a duly-completed form T2200 - Declaration of Conditions of Employment - from your employer.

⁶⁵ The application of the \$100,000 annual limit to specific taxpayers can be complex. Professional advice should be sought before options are exercised.

you may deduct 50% of the stock option benefit in the year you must recognize the stock option benefit. This deduction effectively treats the increase between the exercise price and the fair market value of the shares on the date the option is exercised, similar to a capital gain (i.e. only 50% taxed).

Ontario Research Employee Stock Option Credit

Certain research employees of eligible research and development intensive companies who exercise eligible stock options qualify for an Ontario tax credit. The credit, which is subject to certain limitations, applies to stock options granted after December 21, 2000 and before May 18, 2004, provided the options are exercised and shares are disposed of before January 1, 2010.

Employee Loans

The taxable benefit that arises in 2005 from a low-interest loan by your employer to you is reduced by interest paid by you to the company by January 30, 2006. An interest deduction can be claimed by you to offset the taxable benefit for the imputed interest benefit, to the extent you used the borrowed funds to earn income from a business or property.

Employee Deductions

Employment Expenses

Certain expenses incurred by you to earn employment income are deductible against that employment income. It is important to retain receipts and document the expenses in your records, noting date, purpose and GST paid in order to substantiate the deductions. Employees are not entitled to claim capital cost allowance (CCA - depreciation for tax purposes), with the exception of CCA with respect to an automobile, airplane or musical instrument used to perform their employment duties. The types of expenses eligible for deduction differ if you earn commission income.

If you are a non-commission employee, you are restricted to deducting employment-related items, such as travel costs, automobile expenses, supplies, office rent and salary paid to an assistant.

If you are a commission employee and certain conditions are met, you are not restricted to the expenses noted above for non-commissioned employees. You are entitled to deduct a greater variety of expenses to the extent they are incurred to earn commission income. Cellular phones, computers and fax machines should be leased in order to obtain tax deductions for the lease

expenses since CCA on these capital expenditures would not be deductible. For any year, the amount deductible is limited to the amount of commission income earned.

Office in Home

If you are required by your employer to maintain a home office, you may be able to deduct some expenses related to the office space.⁶⁶ For home office expenses to be deductible, you must either:

- perform principally (i.e. more than 50%) of your employment duties at home, **or**
- use the area exclusively in respect of earning income from your office or employment **and** used on a regular and continuous basis for meeting customers, clients, patients, etc.

In order to deduct office in home and other employment expenses from income, form *T2200 - Declaration of Conditions of Employment* - must be completed and signed by your employer, and retained by you with your records.

GST Rebate

A GST rebate is available to an employee or a partner who incurs GST on employment-related or business expenses. The expenses, net of any allowance or reimbursement received, must be deductible from employment income or business income. The rebate is intended to parallel the input tax credit mechanism available for a GST registered business.

To receive a rebate, you should complete a GST rebate application form (Form GST 370) and file it with your personal income tax return. Alternatively, you have up to four years to claim the rebate. The rebate must be included in your income in the year in which it is received. For rebates related to CCA claims, the rebate will not be included in income, but instead will reduce the undepreciated capital cost of the related asset.

⁶⁶ Home office expenses that are deductible for employees include a prorated portion of rent, utilities, repairs, and cleaning materials. CCA insurance, property taxes and mortgage interest are **not** deductible. However, if you earn commission income you may also deduct a prorated amount of insurance and property taxes.

TRUSTS

Potential Deemed Disposition

With the introduction of tax on capital gains in 1972, rules were established to deem certain types of trusts to dispose of their capital assets at their market value every 21 years. Accordingly, trusts established in 1984 and 1985 may be subject to this 21 year deemed disposal rule in 2005 and 2006 respectively. There may be significant tax costs associated with the deemed disposition to the extent that the assets of the trust have appreciated in value, albeit planning options do exist to reduce, defer or eliminate income tax on the accrued gains.

In appropriate circumstances, trusts can be a valuable vehicle to meet estate, tax and probate planning objectives. Alter ego and joint partner trusts provide some unique planning opportunities for individuals over 65 years of age.

If you are a trustee of a trust which may in the near future be affected by the deemed disposition rules, or wish to explore the benefits of a trust, you should contact your professional advisor to discuss your options.

If interested, please contact us to obtain a copy of TaxTalk 2000 Special Issue 1, *Family Trusts* for a detailed discussion of trusts.

Preferred Beneficiary Election

A preferred beneficiary election allows a trust to retain income but allocate this income to a "preferred" beneficiary who pays tax on it, rather than the trust. This election can only be made for a beneficiary of a trust who is mentally or physically impaired.

OTHER PLANNING POINTS

Personal Tax Instalments

You can avoid interest charges (compounded daily) and penalties if you pay the minimum required personal income tax instalments, and any final balance of tax, by their due dates. Tax instalments in respect of a taxation year are due in quarterly payments and must be received by CRA no later than March 15, June 15, September 15, and December 15.⁶⁷

⁶⁷ When the 15th of the month falls on a weekend or statutory holiday, the instalment is due the next business day.

You are required to pay instalments if the difference between your combined federal and provincial income tax payable and the amount deducted or withheld at source is greater than \$2,000 in both the current year and either of the two preceding years.

Based on their records, CRA will send you a notice indicating your minimum required instalments. As long as you pay the required instalments, no interest or penalties will be charged. If you make late instalments, you can make future instalments before their due date to create an interest offset to reduce or eliminate interest and penalties.

CRA charges interest on overdue taxes at “prescribed” interest rates which are based on current treasury bill rates and are adjusted quarterly. The rate for the last quarter of 2005 is 7%. The interest is not deductible, compounds daily, and equates to a pre-tax rate of approximately 13% for a taxpayer in the top tax bracket. Since, in most instances, commercial interest rates are lower, you will be better off borrowing from your financial institution to pay off any CRA debt.

In addition to interest on late payments, CRA assesses a penalty for late or deficient instalments equal to 50% of the interest payable where the instalment interest payable exceeds \$1,000 in any year. As a result, where this additional penalty would apply, you will be further ahead if your payments are applied first to your instalment account for the current year instead of applying them to your prior year taxes.

Since interest and penalties paid to CRA, or on money borrowed to pay amounts owing to CRA, is not deductible, you may wish to seek professional advice to determine if you can re-arrange your debt to convert non-deductible interest into deductible interest.

SOCIAL ASSISTANCE AND FAMILY BENEFITS

Old Age Security Clawback

If your net income in 2005 is over \$60,806, you are required to repay some or all of your Old Age Security (OAS) benefits. The clawback amount is the lesser of your OAS benefits and 15% of your net income that is over the threshold amount of \$60,806. The OAS clawback is calculated solely on your net income and is not affected by your spouse’s income.

If your net income is \$98,850 or greater in 2005, you are required to repay all of your OAS benefits; therefore, you should consider steps to reduce your 2005 income to below this threshold.

For example, if you receive OAS and earn significant investment income which you do not require for day-to-day expenses, you may want to consider holding these investments through a corporation. The objective of this strategy is to reduce your net income and minimize your OAS repayments.

OAS benefits are subject to withholding tax. The amount the government withholds is based on your prior year’s income. Any excess or deficiency in current year withholdings will be determined and adjusted when your tax return for the current year is filed.

Federal Child Tax Benefits

A qualifying family may be eligible to receive a non-taxable **child tax benefit**. The benefit is paid monthly and is based on:

- your family income (i.e. you and your spouse) of the prior year,
- the number of minor children you have, and
- your child care expense deduction in the prior year.

A memorandum of this nature cannot be all encompassing and its purpose is to highlight tax-planning possibilities and identify areas the contents or to make any comments or suggestions about this Tax

Offices 10 Bay Street, Suite 900
(Bay Street and Queen’s Quay)
Toronto, Ontario M5J 2R8
Phone: 416-362-0515
Fax: 416-362-0539

TaxTalk is prepared by our Tax Group (taxtalk@mgca.com)

You may also be eligible for the National Child Benefit Supplement (NCBS). You are eligible for the full benefit if your family income (i.e. you and your spouse) in 2004 was below \$21,480. When your family income is above this threshold, the payment is reduced. At a family income of \$35,595, the payment is eliminated. The NCBS benefits are: \$1,722 for one-child families, \$3,224 for two-child families, and \$3,224 plus an additional \$1,420 per child for the third and subsequent child.

In addition, there is a Child Disability Benefit which is \$2,000 per child, as of July 2005.

Ontario Child Tax Supplement

The annual maximum Ontario Child Care Supplement for each child under age 7 for single parent families is \$1,310. For two parent families the amount is \$1,100. For 2005, the benefits begin to be phased out when the family net income for 2004 exceeded \$20,000.