

TAXTALK

YEAR END TAX PLANNING - 2009

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As the end of 2009 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: to minimize your tax burden or to 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 want to take advantage of planning opportunities that exist for minimizing income taxes for 2009 and subsequent years.

This TaxTalk is based on existing legislation and the current interpretation of the Income Tax Act (the Act) by the 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 amendments¹. 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.

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¹ Certain proposed amendments to the Income Tax Act have not received Royal Assent as of the date of this TaxTalk.

For those turning 71 in 2009, Registered Retirement Savings Plans (RRSPs) mature on December 31, 2009 and contributions to these plans must be made by December 31, 2009.

The 2009 RRSP contribution deadline is March 1, 2010.

IMPORTANT DATES AND DEADLINES

Many deductions and credits are available only if payments are made by December 31, 2009 or early in 2010. Important deadlines are summarized below:

Amounts to be Paid by December 15, 2009

- final personal income tax instalment for 2009

Amounts to be Paid by December 31, 2009

- 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 (home office expenses, travel expenses, etc.)
- to ensure the settlement date occurs in 2009 for dispositions of most publicly traded securities, we recommend trades be executed on or before December 24, 2009
- contributions to Registered Education Savings Plans to qualify for 2009 Canada Education Savings Grant
- contributions to Registered Retirement Savings Plans for those reaching 71 years of age in 2009

Information Returns to be Filed by January 15, 2010

- an employee must advise their employer of their intent to elect to defer benefits from stock options exercised in 2009

Amounts to be Paid by January 30, 2010

- interest owing for 2009 on loans to family members (including loans to family trusts) must be paid by January 30, 2010 so that the income attribution rules will not apply for 2009 and subsequent years
- interest owing by an employee to his or her employer must be paid by January 30, 2010 in order to reduce the interest benefit on a low-interest or interest-free loan for 2009

Expenditures to be made by January 31, 2010

- work must be performed or goods acquired by January 31, 2010 to qualify for the 2009 Home Renovation Tax Credit

Amounts to be Paid by February 14, 2010

- an employee can reduce or avoid an operating cost benefit related to an employer provided automobile, if he or she reimburses the employer for personal-use operating costs by February 14, 2010

Information Returns to be Filed by March 1, 2010

- 2009 T4s, T4As, T5s and the respective summaries

Amounts to be Paid by March 1, 2010

- deductible contributions to an individual's RRSP or a spousal RRSP (for 2009)
- repayments of RRSP Home Buyers Plan (for 2009)

Amounts to be Paid / Information Returns to be Filed by March 15, 2010

- first personal income tax instalment for 2010
- Employer Health Tax allocation agreement to be filed by associated companies

Amount to be Paid by April 30, 2010

- balance outstanding on 2009 personal taxes payable

Other Amounts to be Paid

- childcare expenses² paid for services rendered in the year, even if paid after December 31, 2009

² The maximum childcare expenses for 2009 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 2009

In addition to annual adjustments to tax rates, thresholds and tax credits, the 2009 federal and Ontario budgets³ announced several changes, some of which are highlighted below:

Federal Changes

Personal Income Tax Rates

The following table summarizes marginal tax rates (on regular income, i.e., salary, interest, etc.) that apply to the income tax brackets for 2009.

Taxable Income*	Federal Rate %	Ontario Rate %	Total %
\$ 10,320 to \$ 36,848	15.00	6.05	21.05
\$ 36,849 to \$ 40,726	15.00	9.15	24.15
\$ 40,727 to \$ 63,421	22.00	9.15	31.15
\$ 63,422 to \$ 72,040	22.00	10.98	32.98
\$ 72,041 to \$ 74,728	22.00	13.39	35.39
\$ 74,729 to \$ 81,452	22.00	17.41	39.41
\$ 81,453 to \$126,264	26.00	17.41	43.41
\$126,265 and over	29.00	17.41	46.41

* Slight differences in the tax brackets for Ontario purposes have not been taken into account in the table

For 2009, the top tax rate remains at **46.41%**, and will apply when taxable income exceeds \$126,264⁴.

For 2009, the amount on which the age credit is based will increase from \$5,408 to \$6,408 and indexed thereafter. The income level at which this credit is fully phased out will increase from \$68,365 to \$75,032.

The federal dividend tax rates are scheduled to increase in 2010 to 2012 as a result of the decreases scheduled in the corporate tax rates. The chart on following page summarizes the scheduled increases.

Home Renovation Tax Credit³

A temporary 15% federal non-refundable Home Renovation Tax Credit (HRTC) will apply in 2009 for eligible renovations or alterations made in respect of

³ Several federal and Ontario budget proposals have been passed into law in 2009. The home renovation tax credit and the first-time home buyers' tax credit are included in Bill C-51 which has been tabled and is currently waiting for Senate approval.

⁴ In general, the tax brackets are indexed for inflation to protect taxpayers from automatic tax increases that would otherwise result. For 2009, the brackets have increased by 2.5%. As a result, the top tax rate will apply in 2009 when taxable income exceeds \$126,264 (2008 - \$123,184).

eligible dwellings. The credit can be claimed on eligible expenditures between \$1,000 and \$10,000 and the maximum credit available is \$1,350 (\$9,000 x 15%) per family. Work must be performed or goods acquired between January 28, 2009 and January 31, 2010 and agreements must be entered into after January 27, 2009.

Home Buyers' Plan

The maximum eligible withdrawal for eligible home buyers permitted from an RRSP has been increased from \$20,000 to \$25,000 after January 27, 2009.

First-Time Home Buyer's Tax Credit³

First-time home buyers who acquire a qualifying home after January 27, 2009, may also claim a new non-refundable tax credit. The tax credit is 15% of \$5,000 (or \$750 for 2009) and is claimable in the year in which the home is acquired. The home must be intended to be the principal residence of that individual within one year after its acquisition.

The credit will also be available for a home acquired by, or for the benefit of, an individual who is eligible for the disability tax credit to enable the individual to live in a more accessible dwelling or in a better suited environment.

Registered Retirement Plans

Where there is a decrease in the value of investments held in a Registered Retirement Savings Plan (RRSP) or a Registered Retirement Income Fund (RRIF), after the death of an annuitant and before the final distribution of the property, a new measure allows a deduction for the decrease in value to be carried back and reduce the RRSP/RRIF income inclusion that was reported in the year of death of the annuitant. This new measure applies where the final distribution from an RRSP or RRIF occurs after 2008.

Flow-Through Shares

The mineral exploration tax credit available to individuals has been extended to flow-through share agreements entered into by March 31, 2010, which support eligible exploration until the end of 2011. The program was otherwise intended to expire on March 31, 2009.

Ontario Changes

Tax Treatment of Dividends

As a result of the proposed reductions in the corporate tax rates effective July 1, 2010, the budget proposes to reduce the Ontario dividend tax credit on both eligible⁵ and non-eligible dividends effective January 1, 2010, resulting in increases in the dividend tax rates.

Combining the federal and Ontario changes, the top marginal rates for *eligible dividends* in Ontario will be as follows:

Year	Federal %	Ontario %	Total %
2009	14.6	8.5	23.1
2010	15.9	10.7	26.6
2011	17.7	10.5	28.2
2012	19.3	10.2	29.6

Combining the federal and Ontario changes, the top marginal rates for *non-eligible dividends* in Ontario will be as follows:

Year	Federal %	Ontario %	Total %
2009	19.6	11.7	31.3
2010 & forward	19.6	13.0	32.6

Reduction in Lowest Marginal Tax Rate in 2010

To reduce some of the impact of the harmonized sales tax, effective January 1, 2010, Ontario's lowest marginal tax rate is to be reduced to 5.05% from 6.05%. The lowest rate currently applies to the first \$36,848 of taxable income. This threshold is indexed annually.

Property and Sales Tax Credits in 2010

Ontario also proposes to increase the provincial tax relief by replacing the existing combined property tax and sales tax credits with two new credits, effective for the 2010 tax year.

The Ontario Sales Tax Credit (OSTC) will provide for a maximum of \$260 for each adult and child while the new Ontario Property Tax Credit (OPTC) will provide for a maximum of \$900 for non-seniors and \$1,025 for seniors.

Tax-Free Savings Accounts (TFSA)

Ontario proposes to change the Succession Law Reform Act to allow direct beneficiary designations on TFSAs, similar to those for RRSPs and life insurance. The impact of this proposal is to allow TFSAs to pass outside a will

⁵ In general, eligible dividends are dividends that are paid from corporate business income that has been taxed at the high corporate federal income tax rate.

thereby avoiding Estate Administration Tax (probate fees).

Locked-in Pension Accounts

Enhanced access to locked-in funds will be provided by changes to the Pension Act that will allow 50% unlocking (increased from 25%) on purchase from new Life Income Funds (LIF), effective January 1, 2010. Existing LIF and Locked-in Retirement Income Fund owners will be able to unlock an additional 25% of their accounts in order to bring them on side with the new rules. In addition, there will be a temporary two-year waiver of financial hardship application withdrawal fees for applications approved on or after April 1, 2009.

Harmonized Sales Tax (HST)

It is proposed that, effective July 1, 2010, Ontario's RST be replaced with the HST. The HST will have a combined tax rate of 13% - combining the existing 5% federal Goods and Services Tax (GST) and an 8% Ontario component.

In general, a single sales tax rate of 13% will apply to all goods and services that are currently subject to GST.

Please refer to TaxTalk 2009 Issue 5, *Ontario Harmonizes Sales Tax ("HST") – Transitional Rules* for a detailed look at the HST and the transitional rules.

TAX DEFERRAL PLANS

Registered Retirement Savings Plans

Deduction Limits

For 2009, your RRSP deduction limit equals the **lesser of**:

- 18% of your 2008 **earned income** (see below) (i.e. the previous year) and
- \$21,000

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 2009 to restore lost RRSP deduction limit on termination of employment and
- your unused RRSP deduction limit carried forward since 1991.

CRA included a “2009 RRSP Deduction Limit Statement” as part of your 2008 Notice of Assessment. This Statement indicates the maximum you can deduct on your 2009 tax return and any RRSP contributions you made in prior years that you have not claimed a tax deduction for. You should verify these amounts prior to making any RRSP contributions.

Earned income includes: employment income, business income, rental income, disability pension income received under the Canada Pension Plan, and taxable support payments received. 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.

When you contribute less than your RRSP deduction limit, the unused RRSP deduction limit carries forward indefinitely, allowing you to contribute to your RRSP in future years when you have more funds available.

You can choose to claim all or part of your current year contributions as a deduction on your current tax return subject to your deduction limit. Any amount you do not claim this year can be carried over and deducted in a future year. This strategy will benefit you if 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 limits for 2009 and subsequent years, before any pension adjustments, are as follows:

Year	Limit	Earned Income ⁶
2009	\$21,000	\$116,667
2010	\$22,000	\$122,222
2011	Indexed for wage growth	Indexed for wage growth

⁶ The amount of earned income must be earned in the previous year.

Spousal RRSP

You can contribute all or part of your RRSP deduction limit to a “spousal” RRSP of which your spouse⁷ is the annuitant. Your ability to contribute to a spousal RRSP is limited to your own RRSP deduction limit. It is not limited by your spouse’s RRSP deduction limit or their RRSP contributions. The advantages of a spousal RRSP include: splitting income and a longer tax-deferral period for income earned in the RRSP where your spouse is younger than you.

Generally, RRSP withdrawals from a spousal RRSP 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 2009, your spouse will be taxed on withdrawals made on or after January 1, 2012. However, you would be taxed on the withdrawal if the withdrawal happened prior to January 1, 2012. This rule applies whether your spouse has one or many spousal RRSP plans.

Finally, if based on your age, you can no longer contribute to your own RRSP; you can still contribute to a spousal RRSP, for which you will receive a deduction, provided you have deduction limit and your spouse is 71 or younger at the end of 2009.

Timing of Contributions

RRSP contributions you make by March 1, 2010 may be deducted in your 2009 tax return, subject to your 2009 RRSP deduction limit.

The maximum age for holding an RRSP is 71. **If you turn 71 in 2009, your RRSP contribution for 2009 must be made by December 31, 2009.** For more planning ideas, please refer to the discussions on “Spousal RRSP” and “Over-Contribute before Maturity”.

By making your 2010 RRSP contribution as early as possible in 2010, you will benefit from a longer period during which your retirement fund can grow tax deferred.

To contribute the maximum RRSP of \$22,000 for 2010, you will need earned income of \$122,222 in 2009.

⁷ For purposes of this TaxTalk, references to “spouse” include a spouse by marriage, as well as a common-in-law partner, of the opposite sex or same sex.

Borrowing to Contribute

Interest incurred on funds borrowed to make an RRSP contribution is not deductible for tax purposes. Generally, 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. If you want to borrow to contribute to your RRSP, it is generally advisable that the borrowing be for a short-term period (i.e. a few months).

Non-Cash Contributions

Your RRSP contribution is not restricted to contributions of cash. You can also contribute certain non-cash property (e.g. publicly traded shares) to your RRSP or spousal plan.

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. Only 50% of a capital gain would be taxable in your hands, however, any capital loss is deemed to be nil.

If you anticipate that you may incur a capital loss on property you want to transfer to your RRSP or a spousal plan, you should consider first selling the property in the open market (i.e. a third party), and then contributing the cash proceeds to your RRSP. Any losses actually incurred may be recognized, subject to the stop loss rules discussed below under "Investments with Accrued Losses".

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 71 in 2009), you should consider "prepaying" your 2010 RRSP contribution before the end of the current year. The contribution you make in late 2009 will be deductible in 2010 when new deduction limit (based on your 2009 earned income) becomes available.

Although this "excess" contribution is subject to a 1% penalty for each month that it is in the RRSP in 2009 (excluding the \$2,000 over-contribution that is allowable - see below), your ultimate future after-tax income on this over-contribution may outweigh the penalty. This strategy will allow you to transfer a higher amount to your Registered Retirement Income Fund (RRIF).

You will benefit the most from this strategy if your marginal tax rate in 2010 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 might 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. The younger you are when you make the \$2,000 over-contribution, the longer the funds can grow tax-free in your RRSP.

However, 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. 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 should 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 he or she has earned income to create 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, even if there is no tax payable. 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 in future years.

Equity Investments in RRSPs

Although all income earned within your RRSP accumulates tax-free, the income will eventually be taxed as pension income at your full marginal income tax rate in the year that you withdraw funds from your RRSP.

You only pay tax on 50% of your capital gains on property you hold *outside* your RRSP. However, if you earn capital gains *inside* your RRSP, you will be taxed on 100% of the gain (as pension income) in the year of withdrawal, not as a capital gain. From a tax standpoint, therefore, it is better to hold equity shares that you expect to grow in value outside of your RRSP.

RRSP Investments in Small Businesses

Subject to certain restrictions, your RRSP can invest in shares of **private companies**⁸. Some of the specific rules and restrictions that apply are summarized below:

- Your RRSP cannot own shares of any corporation⁹ 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.
- You may invest RRSP funds in a private company, where you, together with a related group, own 10% or more of the issued shares of the private company⁹, inside and outside RRSPs, only if you deal at arm's length with the company and your (combined) cost of the investment in the company is less than \$25,000.
- Where you, together with a related group, own less than 10% of the shares of any class of a private company⁹, 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.

Source Deductions on RRSP Contributions

If you are an employee or owner-manager who receives a salary/annual bonus¹⁰, you can choose to contribute all or a portion of your remuneration (subject to your RRSP 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.

⁸ 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.

⁹ Including shares of related companies.

¹⁰ 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.

Subject to your RRSP deduction limit, this rule may enable you to immediately contribute 100% of your gross salary/bonus into an RRSP instead of an after-tax contribution. However, your gross salary/bonus may 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 the 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 is required to 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).

Retiring Allowances and Severance Payments

Lump-sum retiring allowances or severance payments are generally taxable when received, however, you may transfer some or all of these payments to your RRSP on a tax deferred basis. Eligible amounts transferred to your RRSP would not impact on your RRSP deduction 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 lump-sum payment. 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.

A retiring allowance in respect of employment that began after 1996 or any retiring allowance you receive in excess of the eligible amount will **not** be eligible for rollover to your RRSP. However, to the extent that your RRSP deduction limit allows, you may choose to contribute any ineligible portion of your retiring allowance to your RRSP or to a spousal RRSP and claim an RRSP deduction¹¹.

This strategy allows you to defer income tax on your retiring allowance until such time as you withdraw funds from your RRSP.

Lump Sum Payments

If you receive lump sum payments from an RPP or a DPSP you can transfer the funds tax-free to an RRSP provided the transfer is made directly by the payor to your RRSP. 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.

Early Withdrawals

If your income for 2009 is unusually low, consider making a withdrawal from your RRSP in 2009 in order to raise your taxable income to \$40,726. This income amount is the maximum for the lowest federal tax bracket. Please keep in mind, however, that RRSP withdrawals do not regenerate your deduction limit. You may only “re-contribute” to an RRSP to the extent your “earned income” has created additional RRSP deduction limit.

Transferring Out of an RRSP by Age 71

If you were older than 71 at the start of 2009, you can no longer contribute to your RRSP¹². **If you turn 71 this year, you must mature (i.e. collapse) your RRSP accounts by December 31, 2009¹³.**

In collapsing your RRSP, your choices are to:

- convert your RRSP into a fixed term or a life annuity (a tax deferred transaction),

¹¹ 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 transfer the retiring allowance **directly** to your (or a spousal) RRSP and no tax would be withheld.

¹² But you can continue to contribute to a spousal RRSP if your spouse is under the age 71 in 2009.

¹³ You do not have to wait until you are 71 to collapse your RRSP.

- 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.

Pension Income Splitting

Beginning in 2007, Canadian residents can allocate up to one-half of their pension income that qualifies for the pension income credit (see discussion below) to their Canadian resident spouse or common-law partner when filing their annual tax return. Canada Pension Plan (CPP)¹⁴ and Old Age Security (OAS) payments do not qualify for splitting.

You and your spouse must jointly elect¹⁵ to split pension income each year. Any tax withheld at source on the pension income will be allocated to each spouse in the same ratio as the pension income is split.

Tax benefits and credits that are based on the combined net income of both spouses, such as the GST credit and Ontario property tax credit will not be affected by splitting the pension income. However, credits based on each spouse’s net income may be impacted, such as the age and spousal amounts. The OAS clawback and the Ontario health premium, which are determined by each spouse’s net income, may reduce the tax savings of pension income splitting. Their impact should be considered when determining the amount of pension income that will be allocated to each spouse.

¹⁴ Spouses have already been able to “share” CPP benefits to achieve income splitting. To share CPP benefits, an application must be made to Services Canada.

¹⁵ Form T1032, Joint Election to Split Income, must be filed with each spouse’s tax return each year.

Using the Pension Income Credit

You are entitled to claim a non-refundable tax credit on the first \$2,000 of qualifying pension income. Qualifying pension income includes 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.

The \$2,000 non-refundable tax credit is computed at the lowest tax rate [combined federal and Ontario rate is 21.05%]. If your income is greater than the lowest tax bracket, your marginal tax rate on income will be higher than 21.05%, and consequently you will pay some tax on the first \$2,000 of pension income.

Transferring Rollover of RRSP and RRIF Upon Death

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

There are exceptions to this rule. Where 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.

Decline in Value of RRSP or RRIF After Death

In the absence of a spousal or dependant rollover, the fair market value of investments held in an RRSP or an RRIF at the time of an annuitant's death is fully included in the income of the deceased for the year of death.

In 2009 new measures were introduced to allow a deduction for a decrease in value of the investments held in an RRSP or RRIF subsequent to the annuitant's death and before the final distribution of the property. This deduction would be carried back and deducted against the year-of-death RRSP/RRIF income inclusion. This measure will apply where the final distribution from the RRSP or RRIF occurs after 2008.

RRSP Home Buyers' Plan

If you are a "first-time" home buyer¹⁶, consider using the RRSP Home Buyers' Plan (HBP). The HBP allows you and, if applicable, your spouse to withdraw up to \$25,000¹⁷ 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.

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 years¹⁸, 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.

¹⁶ 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.

¹⁷ The HBP maximum withdrawal limit increased from \$20,000 to \$25,000 for withdrawals made after January 27, 2009.

¹⁸ Repayment of the HBP and LLP withdrawals will be accelerated when the taxpayer dies (unless the deceased's spouse elects otherwise), or ceases to be a resident of Canada.

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 2009, you should consider delaying the withdrawal until early in 2010. This strategy will extend the deadline for purchasing a home from October 1, 2010 to October 1, 2011, and delay the start of the required repayments by one year from 2011 to 2012.

When you withdraw funds from your RRSP to purchase a home under an HBP, you 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.

In addition to the HBP, a new First-Time Home Buyer's tax credit of 15% of \$5,000 (or \$750 for 2009) will be available for first-time home buyers acquiring a home after January 27, 2009.

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 post-secondary education for you or your spouse (or part-time education if the student has a mental or physical impairment). 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.

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 withdrawal¹⁷. 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.

Individual Pension Plans

Individual Pension Plans (IPPs) were introduced to compensate high-income earners disadvantaged by the RRSP rules. With many executives seeking retirement benefit packages that meet their individual needs, IPPs are becoming more popular in today's business world.

They are primarily suited for incorporated businesses looking to add benefits for their owner/managers and high net worth individuals. IPPs can offer a better retirement funding solution for individuals 45 years of age or older, with employment earnings of more than \$100,000 and who have historically maximized their RRSP contributions.

Any contributions made by the company to an IPP are **tax deductible** to the company¹⁹. Contributions to an IPP can significantly exceed 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.

An IPP is a **defined benefit** plan tailored for retirement where the benefits to be paid during retirement are actuarially determined based on your age, your career employment earnings, and other actuarial assumptions. Once the retirement benefits are estimated, the company, as plan sponsor, **must** fund the annual IPP contributions needed to create the benefits required for retirement.

Contributions to the IPP are tax deductible to the employer and are based on the following:

1. Funding for **current service** must be done annually with the yearly limit based on your earnings and age.
2. **Past service** may also be funded by the company. The past service contribution is computed from the *later of* (i) January 1, 1991 and (ii) the date of incorporation of the employer/employment of the employee. To make past service contributions, it is generally necessary to transfer RRSP assets related to the time of your past service to the IPP.
3. **Additional funding** is required if the IPP does not maintain an annual compounded net rate of return of 7.5%. An actuarial valuation must be done every 3 years to determine if the IPP is underfunded or overfunded²⁰.

¹⁹ To be deductible, contributions must be made to the IPP within 120 days after the corporate year-end.

²⁰ If the plan is over funded, the employer may be restricted from making current contributions.

The annual rate of return of 7.5% ensures that the plan will be adequately funded so that you receive a defined benefit on retirement.

Assets accumulating in the IPP are locked-in, and can generally only be withdrawn during retirement. Like an RRSP, the age at which the funds in the IPP must be withdrawn from the plan has been increased to 71.

The following table compares the current contributions that can be made to an IPP (setup in 2009 at age 50) and an RRSP at various ages:

Year	Age	IPP Contribution (\$)	RRSP * Contribution (\$)	IPP Advantage (\$)
2009	50	27,778	21,000	6,778
2014	55	39,879	27,254	12,625
2019	60	57,251	35,620	21,631
2024	65	82,191	46,554	35,637

* After 2010, RRSP limits are indexed. In the above chart, the index factor is assumed to be 5.5%

As the IPP is not an asset of the company²¹, it is not available for corporate creditors to attack. Also, pension legislation provides creditor protection to you personally in respect of the IPP - your IPP retirement assets are held by a trust, not you personally.

As with any tax or retirement planning vehicle, there are disadvantages to weigh against the benefits of an IPP.

- The rules regarding IPPs are complex, and are governed by applicable pension legislation.
- There is little flexibility regarding annual funding requirements, which are mandatory pursuant to pension legislation.
- You can no longer make spousal RRSP contributions. Thus, the ability to split income using your retirement assets is not available with an IPP.
- Assets inside an IPP are locked in, as opposed to RRSP funds, which can be liquidated should there be an emergency cash need.

²¹ Not being a corporate asset, an IPP is not available to secure corporate debt.

- There are costs including set-up, administrative and compliance fees to consider²². Compliance costs include fees to maintain records, file tax and information returns etc., as applicable. The 'good news' about these costs is that they are tax deductible²³.

In conclusion, an IPP may be suitable for a key executive and/or an owner/manager who:

1. is over 45 years old,
2. earns a base salary of more than \$122,222 and expects to continue to do so,
3. has worked for the company for several years,
4. has maximized RRSP contribution, and
5. has no foreseeable need to access the funds set aside for retirement (i.e. the retirement funds will *not be needed* for an emergency).

In addition, the company should have a stable cash flow such that it will be able to comfortably afford the requisite annual IPP contributions.

The key advantage of an IPP, compared to an RRSP, is the ability to make past, current and future service contributions in excess of normal RRSP contribution limits. IPPs are becoming an attractive option for high net worth individuals and should be considered as a viable retirement planning vehicle.

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.

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

²² The costs to set up an IPP may range from \$800 to \$2,500. Annual administrative costs may range from \$500 to \$1,000, with an additional triennial fee of \$750 to \$1,250 for an actuarial report.

²³ Management expenses of an RRSP are not tax deductible.

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;
- both eligible and ineligible dividends from taxable Canadian corporations receive preferential tax treatment. They are taxed as received and qualify for a dividend tax credit; and
- 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 2010 rates may change with future federal and Ontario budgets²⁴.

Type of Income	After-tax Amount of \$100	
	2009	2010
Interest ²⁵	\$53.59	\$53.59
Ineligible Dividends	68.66	67.43
Eligible Dividends	76.94	73.43
Capital Gains–Non-exempt	76.79	76.79
Capital Gains–Exempt	100.00	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.

Taxation of Dividends

The top marginal rate in Ontario for *eligible* dividends is 23.06% in 2009 whereas the top marginal rate for *ineligible* dividends remains at 31.34%. In 2010, the top marginal rate in Ontario for eligible dividends is scheduled to increase to 26.57% and the top marginal rate for ineligible dividends is scheduled to increase to 32.57%.

²⁴ The top marginal rate in Ontario for eligible dividends is scheduled to increase to 23.7% in 2010, to 28.2% in 2011, and 29.26% in 2012.

²⁵ Also applies to foreign source investment income (such as interest and dividends).

Eligible dividends are most dividends paid by public corporations resident in Canada and certain Canadian controlled private corporations (CCPCs) on their business income subject to the high rate of corporate tax²⁶.

For 2009, eligible dividends are grossed up to 145%²⁷ for tax reporting whereas ineligible dividends continue to be grossed up to 125%.

Although the taxes on eligible dividends will be lower, your net income will increase due to the 145% gross-up and tax benefits and credits that are income based, such as the age and spousal credits and GST credits, may be reduced. In addition, the gross-up of eligible dividends received may trigger alternative minimum tax, OAS clawback and increased Ontario health premiums.

In 2009, if you are single and have no other source of income, you may receive a maximum of \$50,320 eligible dividends or \$37,511 ineligible dividends tax-free²⁸.

In general, those CCPCs that earn solely active business income eligible for the small business rate or investment income can only pay ineligible dividends to their shareholders (top tax rate remains at 31.34%).

As a result of these changes, further planning may be required in order to optimize tax efficiency with respect to executive compensation (i.e. salary/bonus and/or dividends etc.)

Income Trusts

Income trusts are flow-through tax entities and have potentially provided investors with a greater after-tax return than more traditional investments in Canadian public companies. To address concerns about the unbalanced income tax treatment that applied to “specified investment flow-through” (SIFT) trusts or SIFT partnerships and their investors, compared to public corporations, a “Distribution Tax” was introduced by the federal government in 2006. This tax applies for taxation years ending in 2007 and onward, for new SIFT entities. However, this tax is deferred until 2011 for SIFTs that were publicly traded as of October 31, 2006.

²⁶ For CCPCs, eligible dividends can also be paid out of corporate business income that has been taxed at the high corporate tax rate since 2001.

²⁷ Eligible dividends are scheduled to be grossed up by 144% in 2010, by 141% in 2011 and by 138% in 2012.

²⁸ There will be Ontario Health premiums payable of \$600 on eligible dividends of \$50,320 and \$450 on ineligible dividends of \$37,511.

Despite its name, the Distribution Tax is not a direct tax on distributions. Instead, certain distributions will not be deductible to a trust or partnership that is a SIFT. As such, the SIFT will pay tax on their non-deductible distributions at a rate comparable to the general combined federal/provincial corporate income tax rate. These distributions will be taxed as taxable dividends to investors. Any such dividends paid to Canadian resident individuals will be deemed to be "eligible dividends", thereby qualifying for the lower tax rate on dividends.

Certain Real Estate Investment Trusts (REITs) may be excluded from the Distribution Tax. Generally, REITs that earn passive income meet the criteria for exclusion. Hotel REITs and retirement-resident REITs may not qualify for the exclusion.

Distributions from a SIFT affected by the new rules will decline due to the Distribution Tax. Given the availability of the dividend tax credit, most taxable Canadian individual unit holders should be indifferent to the new tax. However, the reduced distributions will be an absolute cost to non-residents, tax exempt entities (i.e. pension funds), and lower-income Canadians who are unable to fully use the dividend tax credit to reduce their taxes.

If you currently 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-free²⁹. As result, when you calculate your return on investment or yield, you need to exclude the capital receipt.

Recent legislative proposals in respect of income trusts are relieving in nature. These proposals will make it easier for certain entities to own trust and partnership units without causing them to be SIFTs. A number of other exclusions from the SIFT rules are also proposed, as well as further clarifications which will make it easier to qualify as a REIT.

Even more recently, new draft legislation was released to allow for tax deferred conversions of SIFTs into corporations. This will allow SIFTs to convert into taxable Canadian corporations without any undue tax consequences to investors or the SIFT itself.

²⁹ The return of capital will, however, reduce the tax cost of your investment and thus increase your gain (or decrease your loss) on any disposition of the trust units.

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 2009, you may want to consider whether delaying your purchase until 2010 will defer the forced accrual/recognition of interest income until 2010. 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.

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 property³⁰.

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.

³⁰ 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.

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 income³¹. 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 2009, you should consider selling investments with accrued losses before the end of 2009³² to offset your taxable gains.**
- Given the foreign currency fluctuations that we are currently experiencing, you may have accrued capital losses in investments held in foreign currencies that should be realized at this time.
- **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 2009, the “superficial loss” anti-avoidance rule will deny your loss to the extent the same investment is acquired by a person that is affiliated³³ 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.

³¹ 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.

³² To realize a capital loss in 2009, we recommend security trades be executed on or before December 24, 2009.

³³ 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.

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 elect³⁴ 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.

Lifetime Capital Gains Exemption

You can exclude from your income a **lifetime maximum of \$750,000** 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 \$750,000 of capital gains, your potential tax savings would be approximately \$174,000 in 2009³⁵.

While the exemption is designed to shelter up to \$750,000 of gains on a sale of qualified corporations (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),

³⁴ The election should be filed with your tax return.

³⁵ Any current or future claim will be reduced by any previous exemption claimed.

- 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 \$750,000 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 exemption³⁶ is 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,

³⁶ The CNIL amount reduces the taxable capital gains eligible for the capital gains exemption (i.e. the 50% taxable portion of the gain). The maximum exemption is \$375,000 (1/2 of a \$750,000 capital gain).

- 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, 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 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 2009, the reinvestment must occur by April 30, 2010.

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, and
- a negative adjusted cost base in a limited partnership creates a capital gain.

If you will have significant tax shelter deductions for 2010, you should consider filing a request for a reduction of income tax withholdings from employment income in 2010, rather than waiting until 2011 to file your 2010 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, 2009 in order to obtain a tax deduction for 2009.

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 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 to be tax shelters and as such they 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 gift the asset. One of the features of a gifting arrangement involves receiving a donation tax credit in excess of the cash expenditure made by the individual.

The tax rules for tax shelter investments have become more complex in recent years. Rules have been introduced to significantly curtail certain types of shelters³⁷ (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, 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 allow you to lower your income which may create higher personal tax credits and eliminate the Old Age Security clawback,
- it may be possible to use a holding corporation to convert non-deductible interest to deductible interest, and
- 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 corporation. 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 corporation on a deemed disposition of its assets, and/or by its shareholder(s) on the deemed dividend that could result.

³⁷ In 2003, the Department of Finance released far reaching draft legislation which, if implemented, could have applied to deny loss and interest expense claims. In response to concerns raised by the public, the draft proposals were withdrawn. In the 2005 Federal Budget, the Department of Finance indicated that it would develop a “more modest legislative initiative” which would address concerns raised. As yet, no new draft legislation has been introduced. Please refer to TaxTalk 2004 Issue 4, Cases of Interest for a more detailed discussion of the 2003 draft legislation.

Foreign Investment Entities

Proposed tax rules³⁸ 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 proposals³⁷ expand the rules for determining when an offshore trust is **deemed to be a resident of Canada** and, therefore, subject to income tax in Canada. The new rules will deem more offshore trusts to be resident in Canada. 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.

FAMILY TAX PLANNING

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 beneficiary³⁹ (e.g. 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.

³⁸ As drafted, the proposals are generally effective back to January 1, 2007. Many draft versions have been introduced since 2001. Bill C-10 was expected to be enacted during the 39th Parliament, which ended on September 7, 2008. This outstanding bill has not been reintroduced into Parliament.

³⁹ 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.

For 2007 and subsequent taxation years there is no annual contribution limit to any RESP and the lifetime contribution limit to all RESPs is \$50,000 per child.

The federal government provides a Canada Education Savings Grant (CESG) based on the annual RESP contribution. The maximum annual RESP contribution per child qualifying for the 20% CESG⁴⁰ is \$2,500, thus, the maximum education savings grant is \$500 per year. If a \$2,500 contribution is not made in a year, the grant entitlement carries forward to a subsequent year, however, the maximum grant for any year cannot exceed \$1,000.

The maximum lifetime grant of \$7,200 per child is reached by contributing a total of \$36,000 to the RESP over a 15-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.

The maximum Educational Assistance Payment (EAP) that can be for the first 13 consecutive weeks of full time studies is \$5,000. Once these 13 consecutive weeks have been completed, there is no limit to the EAP amount that can be paid. The rules for part-time programs require 12 hours per *month*. The EAP limit is \$2,500 for each 13-week semester of qualifying part-time study.

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.

Under certain circumstances, if your child does not pursue a post-secondary education⁴¹, you may be eligible to receive the income element of the RESP. To receive the income element that would otherwise be forfeited, all the intended children of the plan must be at least 31, 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 would apply to the RESP investment income⁴².

⁴⁰ In 2009, for taxpayers with family net income of less than \$77,664, the CESG rate is increased to 30% on the first \$500 of contributions per child or to 40% if the family net income is less than \$38,833.

⁴¹ RESP investments (capital and income) can, in most cases, be transferred to another sibling’s RESP, provided the sibling is under 21 years of age.

⁴² The additional 20% tax is to ensure that the RESP is not used to unduly defer tax.

Tax-Free Savings Account

Starting January 2009, Canadian residents age 18 and over are eligible to open a Tax-Free Savings Account (TFSA). Income (interest, dividends, capital gains etc.) earned in a TFSA is *not taxable* as it is earned nor is it taxable when withdrawn from the account.

Contributions to a TFSA are *not tax deductible*. For 2009, the maximum contribution is \$5,000⁴³. Contribution limits are not affected by income (although annual tax returns must be filed with CRA in order to generate contribution room), and any unused TFSA contribution room may be carried forward indefinitely.

Your TFSA contribution is not related to your RRSP contribution and therefore does not impact on your annual RRSP contribution limit. Also, contributions to your spouse's TFSA will not affect the contribution room of your own TFSA. In addition, the attribution rules do not apply to funds you gift to your spouse to invest in a TFSA, which makes the TFSA ideal to split income with a lower-earning spouse, common-law partner or adult child.

When you contribute non-cash property to your TFSA, you are deemed to have disposed of the property as its fair market value at the time of the transfer. As a result, the contribution may trigger a capital gain or a capital loss. Only 50% of a capital gain would be taxable in your hands, however, any capital loss is deemed to be nil.

Similar to the RRSP over-contributions, there will be an over-contribution penalty of 1% per month, on any excess contribution amount.

Most RRSP eligible investments such as cash deposits, GICs, mutual funds, stocks and bonds are eligible TFSA investments. However, holding investments in "non-arm's length" entities⁴⁴ or loans to the holder of the TFSA are prohibited.

You can withdraw funds at any time and for any purpose without incurring any tax liability. The funds withdrawn will not affect your eligibility for income tested benefits such as Old Age Supplement, Canada Child Tax Benefit or Guaranteed Income Supplement. The amount you withdraw from your TFSA will be added to your unused contribution room and therefore the funds withdrawn may be re-contributed back to a TFSA in a subsequent year.

⁴³ The annual contribution limit after 2009 will be indexed to inflation in \$500 increments.

⁴⁴ Non-arm's length entities includes any company in which you, your spouse and any other related persons, either individually or collectively own more than 10% of the shares.

Interest on money borrowed and fees incurred to invest in the TFSA are not tax deductible.

However, unlike an RRSP, the TFSA may be used as collateral for a loan.

Capital losses realized with the TFSA cannot be applied against capital gains realized outside the TFSA.

Please refer to TaxTalk 2009 Issue 3, *The Tax-Free Savings Account* for a more detailed discussion.

RRSP vs. TFSA vs. Mortgage

Deciding whether contributions to an RRSP are better than contributions to a TFSA largely depends on two variables - the tax rate at which RRSP contributions are made, and the tax rate at which RRSP withdrawals are taxed. When the two tax rates are identical, the TFSA is the better option because it is more flexible and withdrawals do not affect income-tested benefits, i.e. Old Age Security repayments.

If you expect your marginal tax rate to be lower in retirement than now, RRSPs are preferred. On the other hand, if you expect your effective marginal tax rate to be higher in your retirement years than in the contribution years, the TFSA is the better option.

The TFSA versus mortgage payment decision depends on the implicit rate of return in the TFSA. If the earnings rate in the TFSA is higher than the after-tax mortgage interest rate, then it is better to invest in the TFSA than to make additional mortgage payments.

TFSA vs. RESP

When saving for a child's education, the RESP appears to be the better option for contributions that are eligible for the maximum CESG annual grant of \$500 (20% on \$2,500). Unlike the TFSA withdrawals which will be tax-free, the withdrawals of RESP income is taxable to the student recipient, however, students frequently pay little or no tax on the RESP withdrawals if their income is nominal.

Once the child turns 18, the CESG is no longer available and the TFSA becomes a more viable investment vehicle.

Registered Disability Savings Plan (RDSP)

The Registered Disability Savings Plan (RDSP) is intended to help provide long-term financial security for disabled individuals who are eligible for the disability tax credit (DTC).

The mechanics of the RDSP are similar to that of the RESP. The plan may be set up for a disabled child who is eligible for the DTC. Contributions to the plan may be made by the beneficiary, a parent or other family member of the beneficiary, or by other authorized contributors. Contributions to the plan are not tax-deductible and are limited to a lifetime maximum of \$200,000 with no annual limit.

Investment income earned on the contributions is not subject to tax as earned; however it will be included in the beneficiary's income when paid out of the RDSP. Contributions can be made until the end of the year in which the disabled beneficiary turns 59. Payments from the RDSP must begin by the end of the year in which the beneficiary turns 60.

There are currently two programs in place to enhance the funds that have been contributed to the RDSP: The Canada Disability Savings Grant Program (CDSG) and

The Canada Disability Savings Bond Program (CDSB). Under the CDSG the government provides grants which are income based up until December 31 of the year the beneficiary turns 49. For individuals with family income less than \$77,665, the government will contribute \$3 for every \$1 contributed on the first \$500 and then \$2 per \$1 contributed on the next \$1,000. This results in the maximum government contribution of \$3,500 for the year. For those family's making in excess of \$77,664 the government will contribute \$1 to \$1 for the maximum of \$1,000 contributed. The lifetime grant limit for an individual is \$70,000.

The CDSB is a program where the government helps low income families by contributing income-tested bonds directly into the RDSP up until the year in which the beneficiary turns 49 to a lifetime maximum of \$20,000. For families earning less than \$21,816, the yearly amount is \$1,000. Above this amount the \$1,000 is reduced based on the Canada Disability Savings Act until the income reaches \$38,832 at which point no further amount will be paid.

Charitable Donations

The first \$200 of your charitable donations in 2009 will reduce your taxes payable at a rate of 24.44%⁴⁵ of the donation amount. This is a combined federal and Ontario

⁴⁵ 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 21.05%.

rate. Your donations in excess of \$200 will reduce your taxes payable by 46.41%⁴⁶ of the donation amount.

In order to claim a donation in 2009, your donations must be made by December 31, 2009. To obtain a higher overall tax credit, donations made by both spouses should be claimed by only one spouse⁴⁷.

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 years⁴⁸.

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 these types of gifts (and ecologically sensitive land) the capital gains tax has been eliminated. The capital gains tax has also been eliminated for donations of shares of public corporations to private foundations.

⁴⁶ 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%.

⁴⁷ It is CRA's administrative policy to allow either spouse to claim all donations made.

⁴⁸ To the extent donations cannot be utilized in the year of death, they can be claimed in the immediately preceding year.

The following table compares selling shares with a fair market value of \$10,000 and a cost base of \$5,000 and then donating the cash versus donating the shares directly to a charity.

	Sell Shares and Donate Cash	Donate Shares
Donation	\$10,000	\$10,000
Net Tax Savings ⁴⁹	3,481	4,641
Net Cost of Donation	6,519	5,359

If you exercise employee stock options and donate these shares to a registered charity or a private foundation, there is no income inclusion with respect to the benefit you received on exercising the options⁵⁰.

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

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 arose⁵¹.

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.

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

⁴⁹ The chart assumes the donor is at the top marginal tax rate of 46.41%. If the donor sells the shares and then donates the cash, the estimated tax on the capital gain of \$5,000 would be \$1,160.

⁵⁰ Generally, there is an income inclusion equal to 50% of the difference between the fair market value of the shares at the time that you exercise your options and the price that you pay for the shares.

⁵¹ 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.

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 are deductible; 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.

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 multiply the \$750,000 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). As discussed earlier, income earned on funds gifted to your spouse for contribution to their TFSA does not attribute back.

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

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 amount⁵². 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 arm's length party⁵³.
- The above attribution rule on income from property to minor children does not apply to: capital gains⁵⁴, 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 older⁵⁵. The funds can be used for any purpose including contributions to their RRSP or to their TFSA.
- There is no attribution of income on gifts or loans made by a non-resident of Canada to a resident of Canada.
- In 2009, an individual who has little or no other income can receive approximately \$37,511 of actual **ineligible** dividends from Canadian corporations without paying income taxes⁵⁶.

⁵² This attribution rule also applies to loans or gifts from grandparents.

⁵³ 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 1% for the period October 1 to December 31, 2009. Please refer to *TaxTalk 2002 Issue 3, Tax Matters of Note* for a more detailed discussion.

⁵⁴ Consider buying securities with high capital gains potential in the names of minor children.

⁵⁵ Gifts of assets with unrealized capital gains will give rise to a capital gain to the transferor. There is no "gift" tax in Canada.

⁵⁶ Assuming that the income splitting tax ("kiddie tax") and AMT do not apply. However, the Ontario health premium of \$450 would be payable. Please note that receiving a dividend may reduce or eliminate the tuition and education credits that may be transferred to the parent.

- In 2009, an individual who has little or no other income can receive approximately \$50,320 of actual **eligible** dividends from Canadian corporations without paying income taxes.⁵⁷
- 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 and up to 50% of pension income can now be split between spouses (see Tax Deferral Plans discussion above).
- You can contribute to an RESP for your child (see Family Tax Planning discussion above).
- 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 \$67,033⁵⁸, the lower income spouse should claim all medical expenses to maximize the medical expense credit.

⁵⁷ Assuming that the "kiddie tax" and AMT do not apply. However, the Ontario health premium of \$600 would be payable. Please note that receiving a dividend may reduce or eliminate the tuition and education credits that may be transferred to the parent.

⁵⁸ Medical expenses must be reduced by 3% of net income to a maximum amount, which for 2009 is \$2,011 for federal purposes.

Subject to the income splitting tax (see discussion below), 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 practice⁵⁹.
- In addition, doctors and dentists who incorporate can have other family members own shares to allow for income splitting (as discussed on page 26 – Incorporation of Professionals).

Income Splitting Tax

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

Under the “kiddie tax” rules, the minor child is subject to tax at the **highest income tax rate**⁶⁰ 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.

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*
- income⁶¹ from a partnership or trust⁶² derived from 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.

⁵⁹ 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.

⁶⁰ For 2009, the highest rate is 40.2% without the Ontario surtax, which starts to apply to “kiddie tax” income over \$52,933, excluding dividends. After this income threshold, the top marginal rate is 46.41%.

⁶¹ 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”.

⁶² If structured properly, and depending on your specific circumstances, there are still advantages to income splitting using family trusts.

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

- income from employment or personal services of a minor;
- capital dividends;
- dividends⁶³ received on public stocks, including mutual fund corporations; *or*
- income from property acquired on the death of a parent.

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 contributions (subject to their RRSP deduction limits) 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 still 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.

The maximum salary that can be paid on which there will be no income taxes payable (assuming no other income) for 2009 is \$11,995

PLANNING FOR PROFESSIONALS AND OWNER/MANAGERS

Incorporated Business Owners

Salary vs. Dividends

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.

⁶³ Other attribution rules could apply to this income.

A Canadian controlled private corporation (CCPC) is taxed in 2009 on active business income (ABI) at the following rates (assuming a December 31 fiscal year end):

Income	Federal Rate %	Ontario Rate %	Total Rate %
ABI up to \$500,000	11.00	5.50	16.50
ABI from \$500,001 to \$1,500,000 *	19.00	18.25	37.25
ABI > \$1,500,000	19.00	14.00	33.00
ABI > \$1,500,000 with M&P **	19.00	12.00	31.00

* includes clawback of Ontario small business deduction

** M&P – manufacturing and processing tax credit

The low rate of tax in 2009 (i.e. 16.50%) applies to active business income of \$500,000⁶⁴ 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 \$500,000 should generally reduce its income to \$500,000 through the use of year-end bonus accruals⁶⁵. As indicated in the chart following, the total corporate and personal income tax [for a top-rate taxpayer] is 42.67%. This rate is less than the top rate on bonuses of 46.41% (effectively 47.44% if the bonus is subject to employer health tax).

	ABI < \$500,000	Ontario Clawback **	High Rate Tax
Corporate income	\$100.00	\$100.00	\$100.00
Corporate tax	16.50	37.25	33.00
Retained earnings	83.50	62.75	67.00
RE: Dividends paid:			
Personal tax (31.34%)*	26.17	-	-
Personal tax (23.06%)*	-	14.47	15.45
After-tax cash	\$57.33	\$48.28	\$51.55
Total tax rate	42.67%	51.72%	48.45%

* Personal tax rate is highest marginal rate, which applies when taxable income exceeds \$126,265 in 2009.

** Ontario corporate tax clawback applies when corporate income exceeds \$500,000 as discussed below.

⁶⁴ The federal small business deduction threshold increased from \$400,000 to \$500,000 effective January 1, 2009.

⁶⁵ If the income in excess of \$500,000 is eligible for the manufacturing and processing tax credit, the decision to bonus income down to \$500,000 depends on how long the funds (after corporate tax) would otherwise remain in your company before being distributed to the owner/managers as dividends. There are alternatives to a “bonus down” strategy, including the potential use of an employee profit sharing plan or a retirement compensation arrangement.

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 carrybacks⁶⁶.

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, a July 31, 2009 fiscal year bonus accrual can be paid as late as January 26, 2010. In this case, the corporate deduction would be in the 2009 fiscal year, but the related income would not be taxed in your hands until the year 2010⁶⁷.

Where the ABI in your corporation is eligible for the low rate of tax (i.e. below \$500,000), the combination of salary and/or ineligible dividends to you and to the other owner/managers of your company are 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&ED⁶⁸ credit

Advantages of Paying an Ineligible Dividend

- an overall tax savings to a top rate taxpayer of approximately 4.8%⁶⁹ of the pre-tax corporate income if the corporation pays EHT on salaries
- dividend payments are not subject to EHT
- provides investment income to reduce your CNIL account
- dividend payments may trigger a refund of refundable dividend tax on hand in the company

⁶⁶ Losses may be carried back up to three years.

⁶⁷ In this example, source deductions on the bonus, including income tax, would need to be remitted in February 2010.

⁶⁸ Scientific Research and Experimental Development.

⁶⁹ There is a 3.7% after-tax savings if the corporation does not pay EHT on salaries.

Paying an Eligible Dividend

A private corporation can pay eligible dividends out of its corporate income that is subject to the high rate of corporate income tax, which applies when taxable income exceeds \$500,000. Eligible dividends are subject to a lower rate of income tax than are ineligible dividends - in 2009 the top tax rate on eligible dividends is 23.06% and the top tax rate on ineligible dividends is 31.34%.

The ability to pay eligible dividends means that it is no longer a given that private corporations should bonus down to their small business limit, especially when the combined federal and Ontario corporate tax rate on the business income over \$500,000 is 33%.⁷⁰

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.

Consider Paying Dividends in 2009

We are currently in a period of changing tax rates that is complicating owner-manager remuneration strategies. There will be significant reductions in the federal corporate tax rate on general business income over the next few years that will reduce the rate from 19% this year to 15% by 2012 (note that many provinces are reducing their general corporate tax rate as well). The personal tax rate on ineligible dividends is increasing from 31.34% in 2009 to 32.57% in 2010.

At the same time, **the personal tax rate on eligible dividends is being increased**, to take into account the corporate tax rate reductions and to ensure that integration will still work on business income that is taxed at the top corporate tax rates. In Ontario, the total tax rate on dividends will increase as follows [top rate]:

Top Marginal tax rate on Dividends				
Year	2009 %	2010 %	2011 %	2012 %
Eligible	23.06	26.57	28.19	29.54
Ineligible	31.34	32.57	32.57	32.57

⁷⁰ 33% is the corporate rate, if there is no Ontario clawback of the small business deduction. If the Ontario clawback applies, then the corporate tax rate is 37.25% in 2009 (refer to tables on the previous page).

As a result, it is very important over the next few years to take into account when eligible dividends are expected to be paid. **If, in the next few years you are planning to pay an eligible dividend from your corporation, it may make sense to accelerate payment of that dividend a year or two in order to pay tax on the dividend at a lower tax rate.**

If the company has an RDTOH account and can pay an eligible dividend, serious consideration should be given to paying eligible dividends in 2009. The recovery of the RDTOH by the corporation [which would be up to 1/3 of the dividend] will be more than 10% higher than the personal tax paid, even if the eligible dividend is taxed at the top marginal rate for 2009 - 23.06%.

Note that there are other considerations that need to be taken into account before making this decision - for example, you will need to assess the impact that accelerating the payment of a dividend will have on your personal tax instalments. If there is no RDTOH account and you have no plans to pay a dividend in the near future and you retain the income in the corporation for an adequate period of time, the deferral of personal tax on the dividend will more than likely outweigh the integration cost that may be caused by the increasing tax rate on eligible dividends.

Although the increase on the ineligible tax rate for 2009 to 2010 is not as significant as the increase on the eligible, accelerated payments of ineligible dividends in 2009 may also make sense.

Employee Profit Sharing Plans

Under certain circumstances, an **Employee Profit Sharing Plan** (EPSP) can be used as an alternative to the traditional salary/dividend remuneration strategies to potentially defer tax or split income with other family members. An EPSP is an arrangement whereby an amount is paid to a trustee for the benefit of certain employees, which could include yourself and any family members employed by your company.

The payments made by an employer to an EPSP are based on the employer's profits. The employer contributions to the plan are deductible. All employer contributions and any income earned in the EPSP must be allocated to the employee beneficiaries on an annual basis; that is, the employee participants in the plan pay tax each year on income allocated to them. The allocated amounts qualify as earned income for RRSP/IPP deduction limit, but are not subject to CPP and EI contributions by either the employer or the employee. Income tax withholdings are

not required when amounts are allocated to an employee from an EPSP.

EPSP's can be used to facilitate income splitting in companies where two or more members of a family unit are bona fide employees of the company.

An EPSP can allow a tax deferral of one year beyond that provided by bonus accruals. Contributions are deductible to an employer in a particular taxation year if made within 120 days after the particular year-end. The income inclusion to an employee is in the calendar year that the EPSP allocation is actually made.

As such, for an employer with a December 31 year-end which makes a contribution in the 120 day period following the year-end, the employee is allocated income in the same calendar year that the contribution is made. As there is no withholding tax on the payment from the EPSP, the payment of personal tax is deferred (i.e. employee pays the related tax liability by the end of April in the subsequent calendar year). However, if regular allocations are made on an annual basis, employees will have to start making quarterly instalments, effectively eliminating this deferral advantage.

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 11.00% available on the first \$500,000 of active business is limited if the prior year's taxable capital⁷¹ (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.

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 \$500,001 and \$1,500,000. This "clawback" gradually eliminates the Ontario tax rate benefit of the portion of the lower tax rates on the first

⁷¹ Taxable capital includes debt and equity invested in a company, net of investments in other corporations.

\$500,000 of active business income for Ontario⁷².

As a result of the federal and Ontario clawbacks, 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.

A company with taxable income (including the taxable income of the associated group) over \$500,000 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.

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 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 employer⁷³ 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.

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.

⁷² The effect of the Ontario clawback is to increase the corporate tax rate on non-M&P income to 37.25% within this income range.

⁷³ Contributions made by the employer are based on actuarial calculations and are deductible by the employer on a paid basis.

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 income tax rates. This may be of particular benefit after retirement if the key employee has few other sources of income, or plans 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 may 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 2009 (46.41%, rising to 47.44% when the Employer Health Tax is payable on the bonus).

CCPCs Corporate Tax Instalments

Both the federal and provincial tax threshold for making instalments is \$3,000. Certain small CCPCs⁷⁴ are eligible to make quarterly (rather than monthly) tax instalments.

Capital Tax

The Ontario capital tax exemption remains at \$15 million until July 1, 2010, when capital tax is eliminated for all corporations.

The capital tax rate remains at 0.225% for 2009 and will decrease to 0.150% for the period January 1, 2010 to June 30, 2010.

⁷⁴ To qualify for quarterly instalments, in either the preceding year or the current year, the CCPC's taxable income cannot be greater than \$500,000 (\$400,000 for 2008), taxable capital (including associated companies) cannot exceed \$10 million, **and** the small business deduction must have been claimed. The company must also be in compliance with its reporting and remittance requirements for the past 12 months.

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.

Buying and Selling assets

If you are planning to buy a depreciable asset, you should generally purchase it before fiscal year-end so as to be able to claim capital cost allowance (CCA) in the year of purchase.⁷⁵ For asset sales, if the asset has appreciated in value, there could be significant income tax (due to capital gains and/or recapture of previously claimed CCA), so it is generally recommended that the sale be deferred to the next fiscal period if possible.

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 (whether or not they bear interest) made to you as a shareholder, 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 you⁷⁶. 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.

⁷⁵ To claim CCA, the asset must be 'available for use.' Also, in the first year, CCA claims for many assets are restricted to one-half of the normal CCA claim.

⁷⁶ These payments cannot be a series of loans and repayments.

A loan to you or an individual “connected” to you⁷⁷ 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.

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 15th 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.

⁷⁷ 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.

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 base⁷⁸.

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 31st. A taxpayer commencing business operations is required to either adopt a December 31st 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.

You may switch your business from a non-calendar year-end to a December 31st year-end in any year. However, once you have switched the business to the December 31st 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 15th of the following year⁷⁹. However, the balance of income tax is still due and payable on April 30th 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. Incorporating a professional practice has its advantages, with the most compelling arising from the potential tax benefits: the deferral of income taxes, possible access to the capital gains exemption, and, more recently for physicians and dentists, the potential to income-split with certain family members.

⁷⁸ 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.

⁷⁹ When an individual files an annual GST return, then that GST return is also due on June 15th of the following year, however, any GST balance payable is due on April 30th of the following year.

However, to incorporate, the regulations or by-laws of the relevant professional governing body must allow the member to incorporate their practice. If you are a professional who does not require all the profits of your business for personal living, has significant business debt and/or wants 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.

It should be noted that the incorporation of a professional practice will not limit your professional liability.

For physicians and dentists, the benefits of incorporation were further enhanced with legislative changes introduced in 2006, which allow family members to hold non-voting shares of their professional corporation. The ability for the professional's family members to hold shares in the professional corporation provides for some income-splitting opportunities (via dividends), as well as multiplying access to the capital gains exemption.

Lawyers, accountants and other professionals cannot have other family members own shares in their professional corporations and thus are not able to income split with dividends.

Please refer to TaxTalk 2007 Special Issue 1, *Professional Corporations in Ontario* for a detailed discussion of incorporating a professional practice.

Home Office

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

- as your principal (i.e. more than 50%) 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 expenses⁸⁰ 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.

⁸⁰ 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.

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

As a self-employed individual, you will pay both the employer and employee portions of CPP. You are allowed to deduct from income, one-half of the CPP premiums paid on income from self-employment. The remaining half qualifies for a non-refundable personal credit.⁸¹

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 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.

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 transfers⁸², as well as reasonable allowances based on a per kilometre charge for the use of an employee's automobile for employment purposes.

⁸¹ For 2009, the maximum CPP contribution for self-employed persons is \$4,237.20.

⁸² 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.

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.⁸³ 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 month⁸⁴ (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.

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 employer⁸⁵. Subsequent to your purchase, your employer could reimburse you for the employment use of the vehicle as discussed below.

⁸³ Starting in 2010 only the portion in excess of \$500 will be taxable. Also, starting in 2010, a separate non-cash long service/anniversary award up to \$500 will also be non-taxable, any excess over \$500 will be taxable.

⁸⁴ If you are an employee of an automobile dealership, the 2% rate may be reduced to 1.5%.

⁸⁵ 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.

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, 2009 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 24 cents per kilometre of personal use (21 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, 2010. This topic is discussed in more detail in TaxTalk 2008 Issue 1, *Automobile Benefits and Deductions*.

You should review your personal use of your employer-provided automobile before December 31st 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 4/104 for 2009 of the standby charge and 3% for 2009 of the operating-cost benefit. Your employer is required to compute and self assess GST on the benefits.

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 use⁸⁶ 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 exercise the options to 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 \$100,000⁸⁷. You must notify your employer in writing by January 15, 2010 in order to obtain the deferral in respect of option benefits arising in 2009.

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,

you may deduct 50% of the stock option benefit in the year you must recognize the stock option benefit. The effect of this deduction is to cause only 50% of the benefit to be taxed, the same inclusion rate for capital gains (50% of gains are taxed).

⁸⁶ To deduct automobile expenses on your tax return, you must receive a duly-completed form T2200 - Declaration of Conditions of Employment - from your employer.

⁸⁷ The application of the \$100,000 annual limit to specific taxpayers can be complex. Professional advice should be sought before options are exercised.

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 2009 from a low-interest loan by your employer to you is reduced by interest paid by you to the company by January 30, 2010. 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. More types of expenses are eligible for deduction if you earn commission income from your employment.

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.⁸⁸ For home office expenses to be deductible, you must either:

- perform 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.

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.

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 1988 and 1989 may be subject to this 21 year deemed disposal rule in 2009 and 2010 respectively. There may be significant tax costs associated with the deemed disposition to the extent that

⁸⁸ 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.

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.

For more information with regards to Trusts please refer to TaxTalk 2008 Special Issue 1, *Family Trusts*.

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 15th, June 15th, September 15th, and December 15th. 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 \$3,000 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 2009 is 6% for the first quarter, and 5% for the last three quarters. The interest is not deductible, compounds daily, and equates to a pre-tax rate of approximately 11% 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.

Home Renovation Tax Credit (HRTC)

The HRTC is a temporary 15% non-refundable tax credit for eligible home renovation expenditures for work performed, or goods acquired, after January 27, 2009, and before February 1, 2010, pursuant to agreements entered into after January 27, 2009. The credit is available for the costs of renovations and alterations that are of a permanent, long-term nature and that are integral to an eligible dwelling or the land that forms part of the eligible dwelling.

An eligible dwelling can include your house or condo and your cottage. Eligible expenditures for the HRTC are not restricted to only one dwelling. You can claim the tax credit for eligible expenditures between \$1,000 and \$10,000 made to both your home and/or cottage (maximum credit is \$1,350).

Eligible expenditures⁸⁹ must be enduring in nature and can be as major as renovating your kitchen or bathroom, re-shingling the roof, adding a deck or swimming pool, installing a home security system, replacing carpet or installing or refinishing hardwood or laminate floors, installing a new furnace, resurfacing your driveway, or as minor as repainting your house (inside or outside), installing lights, fans or other fixtures, and even landscaping, such as new sod or planting perennial trees and flowers. Provided they are permanently installed in the home or cottage, expenditures for items such as air conditioners, heat pumps, window coverings and, even, solar panels or a hot tub, are eligible for the HRTC.

⁸⁹ Eligible expenditures include all costs associated with the renovation or alteration, including building permits, professional services, equipment rentals and other incidental expenses.

General and routine repairs and maintenance costs such as furnace or carpeting cleaning, lawn care, and snow removable *are not eligible* expenditures. Also, purchases of new furniture and appliances, tools and electronics *are not eligible* expenditures.

The credit claim may be either made by one family member or shared amongst members in their 2009 personal tax return, even if the qualifying expenditures are made in 2010 but before January 31, 2010. If you have eligible renovation expenditures that you claim under the Medical Expense Tax Credit, you may also claim these expenses under the HRTC.

Although you do not have to submit the receipts with your tax returns, you should ensure that you get written contracts and keep all your receipts with proof of payments, should CRA request copies.

SOCIAL ASSISTANCE AND FAMILY BENEFITS

Old Age Security Clawback

If your net income in 2009 is over \$66,335, 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 \$66,335. The OAS clawback is calculated solely on your net income and is not affected by your spouse's income.

If your net income is \$107,692 or greater in 2009, you are required to repay all of your OAS benefits; therefore, you should consider steps to reduce your 2009 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

There are several federal programs which provide tax benefits for those who have children. Some benefits are tax-free but others are taxable, generally in the hands of the lower income spouse or common-law partner.

A qualifying family may be eligible to receive the non-taxable Canada Child Tax Benefit (CCTB). The benefit is paid monthly and is based on:

- your family net income (i.e. you and your spouse) of the prior year (i.e. 2008),
- the number of minor children you have, and
- your child care expense deduction in the prior year.

The basic benefit is \$1,340 for each child under the age of 18 and there is a supplement of \$93 for the third and each additional child. The benefit is reduced if your family income is more than \$40,726.

You may also be eligible for the National Child Benefit Supplement (NCBS). The NCBS benefits are: \$2,076 for one-child families, \$3,913 for two-child families, and \$3,913 plus \$1,747 per child for the third and subsequent child. To receive the full benefit your family net income in 2008 must be below \$23,710. When your family net income is over this threshold, the benefit is reduced. The benefit is eliminated when the income of a family with one child reaches \$40,726.

In addition, families who care for a child under the age of 18 who is eligible for the disability credit may receive a tax-free Child Disability Benefit (CDB) of up to \$2,455 per qualified child. The full benefit is received when your family net income is less than \$40,726 and is reduced if your family net income exceeds this threshold. The benefit is fully eliminated for a family with one qualified child when the family income exceeds \$163,476.

The Universal Child Care Benefit (UCCB) provides families with \$100 per month taxable benefit for each child under the age of six. There are no income restrictions and the benefit is taxable in the hands of the lower income spouse or common-law partner. It is necessary to apply for this benefit.

A memorandum of this nature cannot be all encompassing and is not intended to replace professional advice. Its purpose is to highlight tax-planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

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