

TaxTalk

YEAR END TAX PLANNING – 2002

As the end of 2002 approaches, personal tax planning should be reviewed. Personal tax planning is important to the management of one's financial affairs and should be considered on an ongoing basis throughout the year. This TaxTalk will be of assistance to those individuals resident in Ontario who desire to take advantage of opportunities that exist for minimizing income taxes for 2002 and subsequent years.

This TaxTalk is based on existing legislation and the current interpretation of the Income Tax Act (the Act) by Canada Customs and Revenue Agency (CCRA) and the courts as provided by relevant jurisprudence. In addition, recent proposals to amend the Act have been considered (and are referred to below as proposed amendments). 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 CCRA.

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IMPORTANT DATES AND DEADLINES

The Registered Retirement Savings Plans (RRSPs) of an individual who attains the age of 69 in 2002 will mature by December 31, 2002, at the latest.

If you turn 69 in 2002, the RRSP contribution for 2002 must be made by December 31, 2002, not March 1, 2003.

Many deductions and credits are available only if payments are made by December 31, 2002 or early in 2003. These dates are summarized below.

Amounts to be paid by December 16, 2002

- final personal income tax instalment for 2002

Amounts to be paid by December 31, 2002

- 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 maintenance payments
- certain legal, tax, and accounting fees
- political contributions
- tuition fees
- tax shelter investments
- Ontario Home Ownership Savings Plan contributions
- employment expenses (office in home, travel expenses, etc.)
- for capital losses and capital gains on most publicly traded securities, the last day for taking a tax loss is December 24, 2002, which will have a settlement date of December 31, 2002
- contributions to Registered Education Savings Plans to qualify for 2002 Canada Education Savings Grant

Information returns to be filed by January 15, 2003

- employee must advise employer of intent to elect to defer benefits from stock options exercised in 2002

Amounts to be paid by January 30, 2003

- any interest owing for 2002 on loans to family members (including loans to family trusts) must be paid by January 30, 2003 so that the income attribution rules will not apply for 2002 and subsequent years
- any interest owing by an employee to his or her employer must be paid by January 30, 2003 to reduce the interest benefit on a low-interest or interest-free loan for 2002

Amounts to be paid by February 14, 2003

- if an employee is provided with an automobile for work and uses it for personal use, it may be appropriate for the employee to repay the 2002 personal operating costs paid by his or her employer by February 14, 2003. This repayment will reduce or eliminate the taxable benefit for the personal operating costs paid for by the employer. This benefit must be included in income at the rate of 16 cents (13 cents for an automobile salesperson) per kilometer of personal use. For more information in this regard please refer to TaxTalk 2002 Issue 1, "Automobile Benefits and Deductions"

Information returns to be filed by February 28, 2003

- T4s and T4 Summaries and T5s and T5 Summaries for 2002

Amounts to be paid by March 1, 2003

- deductible contributions to an individual's RRSP or a spousal RRSP (for 2002)
- repayments of RRSP Home Buyers Plan (for 2002)

Amounts to be paid by March 17, 2003

- first personal income tax instalment for 2003
- Employer Health Tax allocation agreement to be filed by associated companies

Amount to be paid by April 30, 2003

- balance outstanding on 2002 personal taxes payable

Other amounts to be paid

- childcare expenses paid with respect to services rendered in the year

HIGHLIGHTS OF PERSONAL TAX CHANGES IN 2002

The December 2001 federal and the June 2002 Ontario budgets, announced various changes, some of which are highlighted below.

Federal Tax Rate Changes

Personal tax bracket income thresholds have been increased for 2002¹ as follows:

- the lowest federal tax bracket (at 16%) increases from \$30,754 to \$31,677
- the middle income bracket levels for 2002 (tax at 22%) will be \$31,678 to \$63,354 and (at 26%) \$63,355 to \$103,000
- the top tax bracket for 2002 for income in excess of \$103,000 will continue to be taxed at a rate of 29%

Other Federal Changes

- employee Canada Pension Plan² contributions have increased from 4.3% to 4.7% of pensionable earnings, resulting in an increase in the maximum employee contribution from \$1,496.40 in 2001 to \$1,673.20 in 2002
- employee Employment Insurance³ contributions have decreased from 2.25% to 2.20% of insurable earnings, resulting in a decrease in the maximum employee contribution from \$877.50 in 2001 to \$858.00 in 2002

Federal Tax Credits and Deductions

Other amendments affecting 2002 include the following increases to federal personal credits:

- basic personal from \$7,412 to \$7,634
- married/equivalent to spouse from \$6,294 to \$6,482
- disability from \$6,000 to \$6,180
- caregiver from \$3,500 to \$3,605
- claim for infirm dependents from \$3,500 to \$3,605

¹ Ontario tax rates are in addition to these federal rates.

² The maximum pensionable earnings for 2002 are \$39,100 (2001 - \$38,300); the first \$3,500 remains exempt.

³ The maximum insurable earnings remains at \$39,000.

Ontario Changes

In 2000, the Ontario tax system changed from a tax-on-tax to a tax-on-income system. The Ontario tax brackets and tax credits are fully indexed for inflation. The 2002 Ontario tax rates⁴ are as follows:

- the Ontario tax rate for the lowest tax bracket (up to \$31,893 – federal \$31,677) has been reduced to 6.05% (2001 – 6.16%).
- the tax rate for the middle income bracket level of \$31,894 to \$63,786 (federal – \$31,678 to \$63,654) has been reduced to 9.15% (2001 – 9.22%)
- the tax rate for income in excess of \$63,786 (federal brackets \$63,355 to \$103,000 and income in excess of \$103,000) will remain at 11.16%

As a result of the rate and bracket changes, the **top combined marginal rate in Ontario in 2002⁵ is 46.41%**, with this tax rate starting at \$103,000 of taxable income.

Ontario levies a surtax in addition to its normal tax. For 2002, the first-tier surtax is 20% of Ontario tax in excess of \$3,685 (generally when taxable income exceeds \$56,000). The second-tier surtax is 36% of Ontario tax over \$4,648 (generally when taxable income exceeds \$66,000). Although the first-tier of surtax was to be eliminated effective January 1, 2003, Ontario has deferred the elimination to January 1, 2004.

The 2001 Ontario budget introduced a refundable tax credit to partially offset the cost of tuition fees paid to qualifying private schools.⁶ The credit rate is to be phased in, starting in 2002 and 2003⁷ at 10% of the first \$7,000 of tuition fees to a maximum of \$700 per child (\$350 for child of kindergarten age). The credit is to rise in annual increments of 10% thereafter to ultimately be 50% of fees paid in 2007.

⁴ Federal tax rates are in addition to these Ontario rates.

⁵ The top combined marginal tax rate for 2003 is expected to remain at 46.41%.

⁶ Private schools include kindergarten, elementary and secondary schools. Ontario issued a comprehensive list of eligible schools for purposes of the tax credit in July 2002.

⁷ The credit rate was to be phased in over a five-year period starting in 2002 and was to increase to 20% in 2003. The 2002 Ontario budget deferred the increase in the credit by one year. The credit will remain at 10% for 2003 and increase to 20% in 2004.

TAX DEFERRAL PLANS

Registered Retirement Savings Plans

Contribution Limits

For 2002, an individual's RRSP contribution limit equals the **lesser of**:

- 18% of an individual's **earned income** (see below) for 2001 (i.e. the previous year); and
- \$13,500

less:

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

plus:

- any "pension adjustment reversal" for 2002 to restore lost RRSP contribution room on termination of employment, and
- unused RRSP contribution room carried forward since 1991

CCRA provides the 2002 RRSP deduction limit statement as part of your 2001 Notice of Assessment. This statement indicates your 2002 deduction limit and also any unused RRSP contributions from prior years that could be deducted in 2002. You should verify the amounts when determining available RRSP contribution room for 2002.

Earned income includes employment income, business income, rental income, disability pension income received under the Canada Pension Plan, and alimony and taxable maintenance amounts received. Earned income does **not** include business and rental income earned as a limited partner, investment income, pension benefits, retiring allowances, death benefits and other amounts received from an RRSP or Deferred Profit Savings Plan (DPSP).

Earned income is **reduced** by alimony and deductible maintenance payments, employment expenses, business losses and rental losses. Business and rental losses incurred as a limited partner do **not** reduce earned income.

Unused RRSP contribution room can be carried forward indefinitely. The carry forward allows individuals to utilize their unused RRSP contribution room in years when they are able to save funds to make RRSP contributions. They may deduct current contributions in a future year when their tax rate may be higher. For

instance, it may be prudent to forego the RRSP deduction in a year where income is relatively low, and instead save the deduction to claim against higher rate income in a later year. However, the contributions made cannot exceed the cumulative contribution limit in any year.

The RRSP limits for 2002 and subsequent years, before any pension adjustments, are as follows:

YEAR	LIMIT
2002-2003	13,500
2004	14,500
2005	15,500
2006	Indexed for inflation

Spousal RRSP

An individual may contribute all or part of his or her allowed RRSP contribution limit to an RRSP of which his or her spouse⁸ is the annuitant ("spousal RRSP"). The advantages of a spousal RRSP include splitting income during retirement and, where the spouse is younger, there is a longer tax-deferred accumulation period available.

However, care should be taken if amounts are withdrawn from a spousal RRSP before maturity. Withdrawals are taxed in the hands of the contributing individual to the extent of his or her contributions to any spousal RRSP in the year of withdrawal or the preceding two calendar years. As such, contributions made in December 2002 can be withdrawn without attribution starting in January 2005, while contributions made in January 2003 would have to stay in the spousal RRSP until 2006 to avoid attribution.

It should be noted that an individual's ability to contribute to a spousal RRSP is not affected by whether his or her spouse has their own RRSP contribution limit or has made an RRSP contribution. In addition, although an individual who attained age 69 prior to 2002 cannot contribute to their own RRSP for 2002, they can, contribute to a spousal RRSP for 2002 as long as the spouse is not over age 69 in 2002.

Retiring Allowances and Severance Payments

In addition to the normal RRSP contributions, a lump-sum retiring allowance (including severance) received by an individual may be transferred to his or her RRSP within

⁸ "Spouse" includes a common-law spouse and, after January 1, 2001, includes a partner of the same sex.

60 days following the year of receipt, subject to certain limitations. The maximum “eligible” amount that can be transferred to an RRSP is limited to \$2,000 times the number of full or partial years during which the employee was employed by the employer **before 1996**, plus \$1,500 times the number of full or partial years of service **prior to 1989** for which the employer did not make vested contributions to an RPP or DPSP on behalf of the employee.

When an individual receives a large retiring allowance and does not require the funds currently, he or she should defer the tax on the allowance by transferring the maximum eligible amount (preferably directly by the employer to avoid withholding tax) to an RRSP. The transfers cannot be made to a spousal RRSP.

Timing of Contributions

Consideration should be given to making the year 2003 RRSP contributions early in 2003, in order to maximize the tax sheltering of RRSP investment income. A maximum contribution of \$13,500 for 2003 will require earned income of \$75,000 in 2002 (assuming that there is no RRSP carry forward or reduction for a pension adjustment).

Non-Cash Contributions

It is possible to make a contribution other than in cash to an RRSP. A non-cash contribution may, however, result in a capital gain being recognized for tax purposes. The capital gains inclusion rate (50%) may make such a transfer more attractive. However, if property that has an unrealized capital loss is contributed to an RRSP, **the loss is denied**. To utilize the loss, the property should be sold or switched to another investment and the cash proceeds/new investment could be contributed to the RRSP.

Equity Investments in RRSPs

Although income earned within an RRSP accrues tax-free, the income will be taxed at the full marginal rates of the taxpayer at the time funds are withdrawn from the RRSP.

The capital gains inclusion rate for net capital gains earned outside an RRSP is 50%, however capital gains earned within the RRSP will be taxed at 100% when the funds are eventually withdrawn from the RRSP. It may be better from a tax standpoint to hold growth equity shares outside of one's RRSP.

RRSP Investments in Small Businesses

For RRSP investments in **shares of private companies**⁹, there are specific rules and restrictions that apply, and are summarized below.

- A shareholder that controls a company **may not** own any shares of the company¹⁰ in their RRSP. In addition, anybody who is related to the controlling shareholder, i.e. spouse, children, siblings, parents are also precluded from owning shares of the company in their RRSP.
- A shareholder, who after taking into account the RRSP investment, together with a related group, owns 10% or more of the shares of any class of a private company¹⁰, may invest RRSP funds, provided that the total cost of their combined holdings after the RRSP investment is less than \$25,000.
- A shareholder, who together with a related group, owns less than 10% of the shares of any class of a private company¹⁰ may invest RRSP funds **without limit** provided that the shares held inside or outside of the RRSP after the investment do not cause the person and any related group to together own 10% or more of the issued shares of any class.

Over-Contribute Before Maturity

Individuals who have earned income in the current year but are required to collapse their RRSPs by the end of the year (i.e. those who turn 69 in 2002) should consider “prepaying” their “next year” RRSP contribution before the end of the current year (2002). The contribution made will become deductible in 2003, when the new contribution room (based on 2002 earned income) becomes available. This planning will allow the higher amount to be transferred into a Registered Retirement Income Fund (RRIF) prior to December 31, 2002. Although this “premature” contribution will be an over-contribution subject to a 1% penalty for each month that it is in the RRSP in 2002 (subject to the \$2,000 over-contribution that is allowable), the ultimate tax savings which will be realized on income earned on this over-contribution in the future may outweigh the penalty cost.

⁹ The company must either be an “eligible corporation” or a “small business corporation”. The definitions are not exactly the same, but generally the company must be a Canadian controlled private corporation that carries on an active business in Canada.

¹⁰ Including shares of related companies.

This planning is more beneficial where your marginal tax rate in 2003 is expected to exceed your marginal tax rate(s) in the year(s) that the contribution is to be ultimately withdrawn.

\$2,000 Over-Contribution¹¹

Consideration should be given to making a one-time (life time, not annual) non-deductible over-contribution of \$2,000 to an RRSP. This is beneficial where the funds will be left in the RRSP for many years and the tax benefits of sheltering the investment income exceed the tax cost of the future withdrawals. Consideration should also be given to making an over-contribution for a child over age 18. The over-contribution would be deductible by the child in future years as the child earns income which will create new RRSP contribution room.

Borrowing to Contribute

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

Lump Sum Payments

Lump sum payments from an RPP or a DPSP may be transferred tax-free to an RRSP provided the transfer is made directly to the RRSP (i.e. the individual cannot first receive the funds and then later contribute them to an 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.

¹¹ Prior to February 28, 1995, an individual could over-contribute up to \$8,000 to an RRSP without attracting a penalty. This limit was reduced to \$2,000 effective for RRSP contributions made after February 27, 1995. If the over-contribution amount has not yet been reduced to \$2,000, any RRSP deduction claimed in 2002 must first be applied to reduce any over-contribution in excess of \$2,000 that existed at February 27, 1995.

Withdrawals

An individual, who has an unusually low amount of income in 2002, should consider making a withdrawal from his or her RRSP in 2002 in order to raise taxable income to \$31,677 (being the top of the lowest federal tax bracket). Keep in mind, however, that RRSP withdrawals do not re-generate contribution room. An amount can only be "re-contributed" to an RRSP to the extent that the individual has "earned" additional RRSP contribution room.

Utilizing the Pension Income Credit

An individual who is at least age 65 is entitled to claim a non-refundable tax credit on the first \$1,000 of pension income. An individual who is under the age of 65 is entitled to the credit if they received qualifying pension income¹². For an individual taxed at a rate higher than the lowest tax bracket, there will be some net tax payable on the first \$1,000 of annuity income since the \$1,000 non-refundable tax credit is computed at the lowest tax rate.

RRSP Home Buyers' Plan

A "first-time" home buyer¹³ should consider utilizing the RRSP Home Buyers' Plan (HBP). The HBP allows an individual and, if applicable, his or her spouse, both of whom are first-time home buyers, to withdraw \$20,000 each from their existing RRSPs to purchase a home. Before making a HBP withdrawal, the funds must have been in the RRSP for at least 90 days before the withdrawal. The home must be purchased by October 1 of the year following the year of the RRSP withdrawal.

The amount withdrawn is treated like an interest-free loan from the RRSP and must be repaid annually over a

¹² Qualifying pension income would include most types of retirement income received on a periodic basis, such as life annuity payments out of a superannuation or pension plan or payments received by virtue of the death of a spouse as annuity payments from an RRSP or DPSP or income from a RRIF.

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

maximum period of 15 years, beginning the second year after any withdrawals are made.

If an HBP is being considered near the end of 2002, consideration should be given to delaying the withdrawal until early in 2003. This delay will extend (1) the deadline for purchasing a house using the HBP withdrawals from October 1, 2003 to October 1, 2004, and (2) the commencement of the required repayments by one year from 2004 to 2005.

The use of an HBP involves withdrawing capital from an RRSP. As such, HBP individuals will forego the tax-deferred growth of the income on the HBP funds. Whether an HBP makes sense depends in part on what the individual intends to do with the savings that result from having a higher down payment and a lower mortgage. If the savings are re-invested by either paying down the mortgage faster or by increasing RRSP contributions, then the HBP can be an effective plan.

A HBP repayment is made by making a regular RRSP contribution. When the individual files his or her income tax return, he or she must designate that the RRSP contribution is a HBP repayment, and not a regular RRSP contribution. If this designation is not made, then no repayment would be recognized and the required repayment amount would be included in income. CCRA will advise the individual of the amount to be repaid.

If the individual ceases to be a resident of Canada, any outstanding balance on the HBP must be repaid within 60 days from that date or the outstanding balance must be included in his or her final tax return for the year in which he or she ceased to be a resident of Canada.

Lifelong Learning Plan (LLP)

Under the LLP, RRSP funds may be withdrawn tax free to finance full-time (or part-time if the student has a mental or physical impairment) post-secondary education of the individual or his or her spouse. Annual withdrawals are limited to \$10,000, with a four-year maximum limit of \$20,000. The funds must have been in the RRSP for at least 90 days before the withdrawal.

Withdrawals under the LLP are treated as interest-free loans and must be repaid in equal instalments over 10 years, with the first repayment due no later than 60 days following the fifth year after the first withdrawal. 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 for education, providing all previous withdrawals have been fully repaid.

If the individual ceases to be a resident of Canada, any outstanding balance on the LLP must be repaid within 60 days from that date or the outstanding balance must be included in his or her final tax return for the year in which he or she ceased to be a resident of Canada.

Transferring Out of an RRSP By Age 69

The maximum age limit for maturing RRSPs is age 69. **All individuals who attain the age of 69 in 2002 must mature their RRSPs by December 31, 2002¹⁴.**

An individual who collapses their RRSP can choose to:

- (1) pay tax currently on the full value of the RRSP;
- (2) convert the RRSP into a fixed term or a life annuity; and/or
- (3) convert the RRSP to a RRIF.

A RRIF allows an individual to manage his or her investments in much the same manner as with a self-directed RRSP. As well, withdrawals from a RRIF can be varied to correspond with cash requirements, subject to a minimum annual withdrawal.

If you turn age 69 in 2002, your RRSP contribution for 2002 must be made by December 31, 2002 and not March 1, 2003. Also, your RRSPs must be matured by December 31, 2002. For further planning, please refer to the discussions on "Spousal RRSP" and "Over-Contribute Before Maturity" above.

RRSP Contributions and Source Deductions on RRSP Contributions

Employees and owner-managers, who receive a salary/annual bonus,¹⁵ may contribute all or a portion of this remuneration (subject to their RRSP contribution room) directly to an RRSP with the agreement of their employer. No income tax is required to be withheld provided the employer makes the contribution directly to the RRSP **and** the amount contributed does not exceed the individual's RRSP contribution limit.¹⁶

¹⁴ However, an individual may collapse the plan in an earlier year if he or she desires.

¹⁵ 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 on small business.

¹⁶ Any lump sum payment transferred by the employer to an RRSP prior to January 1, 2001, was exempt from the withholding tax only if the payment did not exceed \$10,000.

No letter of authority from CCRA is required to reduce the tax withheld on direct transfers of remuneration to an RRSP. With a direct transfer, the individual will receive an immediate tax benefit as a result of making the RRSP contribution, rather than having to wait until their tax return is filed.

This rule may enable the employee to contribute 100% of the eligible salary/bonus into an RRSP since no tax would be withheld. However, the amount contributed to the RRSP will only reduce the amount of salary that is subject to income tax withholdings. The full amount of the salary (before the RRSP contribution) will still be subject to Canada Pension Plan and Employment Insurance premiums, if the maximum premiums for the year have not already been made.

Retiring Allowances

Along with the special rollover available for “eligible” retiring allowances (discussed above), additional amounts of a retiring allowance may be contributed to an RRSP without the employer withholding tax, but only if the “retiree” has unused RRSP contribution room.

Other RRSP Contributions

An individual may apply to CCRA for authorization to have their withholding tax reduced based on an RRSP contribution made directly by the individual. Once his or her employer receives the authorization, the amount of income tax deducted from his or her pay cheque may be reduced. Evidence of the RRSP contribution must be provided to CCRA (i.e., the RRSP contribution receipts) before CCRA will authorize the employer to reduce his or her tax withholdings.

It appears, however, that advance authorizations for reduced withholdings may be provided to individuals who will be making monthly pre-authorized RRSP contributions if suitable documentation is provided to CCRA (e.g., a copy of the pre-authorized RRSP contribution contract).

Rollover of RRSP and RRIF Upon Death

Generally, all of the fair market value of an RRSP or a RRIF is taxed as income in the terminal return of a deceased taxpayer. Certain exceptions are available where tax deferred transfers can be made to certain designated persons or beneficiaries.

For instance, a tax deferred “rollover” of an RRSP or a RRIF is available where the RRSP/RRIF amount is transferred to the RRSP/RRIF of a spouse. The

mechanics to obtain a rollover can be complex and will differ depending on whether the spouse is a beneficiary under the will or directly under the RRSP/RRIF, and whether the RRSP has matured or not at the time of death. In some cases, elections need to be filed with CCRA in order for the transfer to be tax deferred.

RRSP and RRIF funds can also be rolled tax-free on death to the RRSPs of beneficiaries other than a spouse, i.e. financially dependant children or grandchildren, even if there is a surviving spouse.

Individual Pension Plans

A high-income individual may be able to have his or her employer make contributions to a special registered pension plan called an Individual Pension Plan (IPP). Contributions to an IPP can significantly exceed the normal RRSP contribution limits. The amount of the IPP contributions depends, in part, on the age of the individual - the higher the age, the higher the contributions allowed¹⁷. The rules regarding IPPs are complex. As well, there are set-up and administrative costs, and costs to comply with reporting requirements¹⁸.

Registered Education Savings Plans

A Registered Education Savings Plan (RESP) is a contract between an individual and an issuer under which the individual makes current payments toward the future post-secondary education of a designated beneficiary (such as the individual's child). The contributions are **not tax deductible**. However, income earned in the plan is not taxable until it is distributed. Upon distribution, the income element is taxed in the hands of the beneficiary (child), and may therefore attract minimal tax to the extent that he or she is a student who has a credit for tuition fees paid and is subject to low marginal tax rates.

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

The Federal government provides a Canada Education Savings Grant (CESG) equal to 20% of the first \$2,000 of the annual RESP contribution, to a maximum grant of \$400 per year for each beneficiary under age 18. Grant contribution room accumulates at \$2,000 per year for each

¹⁷ Generally, an IPP may be suitable for a key executive and/or an owner/manager who is over 55 years old and who is earning a base salary of more than \$100,000.

¹⁸ The costs to setup an IPP may range from \$3,000 to \$5,000, and annual administrative costs may range from \$1,500 to \$3,000.

beneficiary. If a \$2,000 contribution is not made in a year, the grant entitlement will carry forward to a subsequent year (keeping in mind that the annual RESP contribution limit is \$4,000 per child, and thus the annual grant cannot exceed \$800). The maximum grant of \$7,200 per child can be obtained by contributing a total of \$36,000 to the RESP over an 18-year period. The grant is paid directly into the RESP and must be repaid to the government if the beneficiary does not pursue higher education.

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

If a beneficiary does not pursue a post-secondary education, an RESP subscriber may be eligible to receive the income element of the RESP under certain circumstances. To receive the income element that would otherwise be forfeited, all the intended beneficiaries must be at least 21 and not be pursuing a qualified educational program, and the plan must have been running for 10 years. The subscriber may cause the income element to be transferred to an RRSP (to a maximum of \$50,000) to the extent of any available RRSP contribution room. Any income not transferred to an RRSP will be subject to a special 20% tax, which would be in addition to the regular income tax that will apply to the investment income.¹⁹

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 insurable individuals to pay insurance premiums and, at the same time, make deposits to a tax sheltered investment account. The insurance premiums are not tax deductible when made, but the ultimate insurance receipt is tax-free.

This type of tax-sheltered investment is generally appropriate for taxpayers who have maximized their RRSP contributions.

¹⁹ The additional 20% tax is to ensure that the RESP is not used to unduly defer tax.

INVESTMENT STRATEGY

Investment Returns

As part of year-end tax planning, an individual should review the mix of investments in his or her investment portfolio to ensure that he or she is getting the best possible **after-tax** return.

Each type of investment income is taxed differently. Interest income is accrued annually and fully taxed. Dividends from taxable Canadian corporations receive preferential tax treatment – they are only taxed as received and are eligible for a dividend tax credit. Capital gains are not fully taxed, and some capital gains can be exempt from tax entirely.

The table below shows the after-tax retention on \$100 of investment income earned by an individual who is in the top tax bracket in Ontario (the 2003 rates may be changed by future Federal and Ontario budgets).

After-tax Retention of \$100 of Investment Income	2002 and 2003
Interest	\$53.59
Dividends	\$68.67
Capital Gains – Non-exempt	\$76.79
Capital Gains – Exempt	\$100.00

Given the differing tax treatment on the various types of investment returns, 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.

Accrual of Interest Income

Interest income must generally be included in income annually (on the anniversary date of the investment), whether the income is actually received or is accrued (as with a compound interest GIC).²⁰

²⁰ A three-year accrual rule continues to apply to investment contracts acquired before January 1, 1990.

An individual considering the purchase of an interest bearing investment near the end of 2002 may want to consider delaying the purchase until 2003 to defer the forced recognition of interest income until 2004.

Interest Expense

An individual who has fully paid investment assets and is paying non-deductible interest should seek professional advice to determine whether his or her situation can be structured to make the interest payments tax-deductible. When paying down debt, it is prudent to reduce debts on which interest is not deductible, such as personal mortgages and credit card balances.

Leveraged investors can continue to deduct loan interest after selling investments at a loss and reducing their related debt; however, this relief is not available for interest on debts related to real estate or other depreciable property that has been sold.

Capital Gains and Losses

The capital gain inclusion rate is one-half of the capital gains (net of capital losses) realized in 2001 and subsequent years. The inclusion rate for capital losses is the same as for capital gains. When deciding which investment assets to sell, consideration should be given to the following planning points.

Investments With Accrued Losses

An individual who has realized capital gains in 2002 should consider selling investments with accrued losses before the end of 2002²¹ to offset the taxable gains. This is one of the most popular year-end tax planning techniques.

Consideration should also be given to realizing accrued losses if the individual realized capital gains in any of the **preceding three years**, which were not sheltered by the capital gains exemption. These capital gains may have been taxed at the higher 3/4 and 2/3 capital gains inclusion rates²², and a loss carryback to these years could

recoup income tax paid on these gains. Capital losses can be carried back three years and forward indefinitely, but can only be deducted against capital gains in those carryover years.

If an investment is sold to realize an accrued loss, there is an anti-avoidance rule (“superficial loss”) that denies the loss if either the individual or his or her spouse repurchases²³ the investment within (i.e. before or after) 30 days of the sale. If investments with accrued losses are transferred to an RRSP, either as a contribution or by way of a sale from the annuitant, the loss is deemed to be nil and no tax will be saved in respect of the accrued loss.²⁴

Foreign Spin-Offs

A holder of foreign shares may receive a distribution from the foreign corporation in the form of shares of another corporation. Such a distribution is generally considered a dividend in Canada and is taxable as foreign source income (subject to the top marginal rate). If the share distribution meets certain criteria, the holder of the foreign shares may **elect** to exclude the dividend from income. The tax will be deferred until the shares are disposed of and could be reduced if the deferral election converts the dividend to a capital gain subject to lower tax rates.

Utilize the \$500,000 Small Business Exemption

There is a lifetime \$500,000 capital gains exemption for capital gains realized by an **individual** on dispositions of qualifying shares of small business corporations and qualified farm property. The \$500,000 limit is reduced to the extent that the general \$100,000 exemption²⁵ was previously used.

The potential tax savings available by claiming the \$500,000 exemption are significant. By utilizing the full exemption, an individual at the top tax rate in Ontario can potentially realize tax savings of approximately \$116,000 for qualifying dispositions.

²¹ To realize a capital loss in 2002, the last day on which a publicly traded transaction should occur is **December 24, 2002**. (Final trade date is December 26, 2002 for shares on a US stock exchange). For option transactions, the last date to trade for 2002 is December 30, 2002 for both Canadian and US exchanges.

²² The capital gains inclusion rates were three-quarters of net capital gains realized prior to February 28, 2000; and two-thirds of net capital gains realized after February 27, 2000 and before October 18, 2000. The timing of creating capital

losses should take into consideration net capital gains earned in prior years.

²³ This restricted loss rule does not apply to sales made to, or repurchases by parents, children, nieces or nephews.

²⁴ An alternative is to sell the publicly traded investment on the open market for a loss and then re-purchase the investment in your RRSP. As an individual is not affiliated to the RRSP trust, the loss realized by the individual would not be denied.

²⁵ The general \$100,000 capital gains exemption was eliminated for gains realized after February 22, 1994.

There are ways to effectively utilize the \$500,000 exemption without selling the qualifying assets to a third party. This planning should be considered now to avoid losing the ability to use the exemption if it should be eliminated.

An individual claiming the exemption should be aware of the following:

- the exemption can only be claimed in respect of shares of Canadian private companies or farm properties that meet certain stringent criteria, i.e. not all shares or farm property will qualify for the capital gains exemption;
- the exemption can only be claimed to the extent that taxable capital gains in the year (net of allowable capital losses) exceed the Cumulative Net Investment Loss amount (see the discussion below);
- significant capital gains in any one year can create Alternative Minimum Tax (see the discussion below); and
- the exemption is generally reduced to the extent of capital gains exemptions claimed in previous years, and allowable business investment losses (ABILs) claimed after 1984.

Cumulative Net Investment Loss (CNIL)

The use of the capital gains exemption is reduced to the extent of any CNIL amount. While the reduction is not permanent, it has the effect of delaying the ability to use the exemption until such time as the individual's taxable capital gains in a particular year exceed the CNIL amount. The CNIL amount is the cumulative excess of investment expenses over investment income after 1987.

Planning considerations to minimize the effect of the CNIL amount include the following:

- consider realizing capital gains early if the accumulation of CNIL in a subsequent year will erode the capital gains exemption
- consider deferring the payment of investment expenses to a subsequent year or accelerating the receipt of investment income to offset the CNIL
- an owner/manager of a private company should consider receiving dividends rather than salary, or charging the company interest on amounts owed to him or her by the company
- maximize borrowing for business purposes and use savings for investment purposes

Alternative Minimum Tax (AMT)

The AMT operates in a limited range of circumstances to reduce or eliminate the current income tax savings otherwise generated by "preference" items such as losses from limited partnerships and tax shelter investments, capital gains, and certain other allowable deductions²⁶, including carrying charges related to investments in limited partnerships, tax shelters and rental properties (to the extent of rental losses).

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. An individual with significant amounts of "preference" items should seek professional advice before making limited partnership and tax shelter investments, and/or realizing capital gains.

Any AMT paid in one year is potentially recoverable in the next seven years to the extent that regular tax exceeds AMT in any of the carry over years. If an individual has paid AMT in a previous year, consideration should be given to obtaining a refund of the AMT through proper structuring of income in 2002 and/or income in future years.

Small Business Capital Gains Deferral

In addition to the small business capital gains exemption discussed above, a tax-free rollover or deferral of capital gains realized by individuals is available on capital gains realized on the sale of qualifying small business shares **if** the proceeds of disposition are reinvested in shares of another qualifying small business. The deferral is not available to trusts and is limited to \$2 million of capital gains.

Tax Shelters

Tax shelters are effectively tax-assisted investments in real estate, oil & gas, and other operating businesses. Although tax shelters can reduce and defer tax, they should be examined first and foremost for their investment potential. It is imprudent to invest in a shelter if there is little chance of earning a return or recovering the after-tax cost of your investment. Tax benefits should be a secondary consideration, and care should be taken to ensure that the tax shelter has a reasonable expectation of profit.

²⁶ RRSP deductions are no longer required to be added back to compute taxable income for AMT purposes.

Tax considerations when evaluating tax shelters include:

- significant tax shelter deductions can create AMT
- most tax shelter deductions will be added to the CNIL amount
- the at-risk rules, which limit the available write off (i.e. deductions) to the amounts invested or earned
- recognition of a capital gain on any negative adjusted cost base in a limited partnership
- where amounts invested are not at risk and limited recourse debt is used to finance the tax shelter purchase, the deductions available will be restricted

An individual with significant tax shelter deductions for 2003 should consider filing a request for a reduction of income tax withholdings from employment income in 2003, rather than waiting until filing his or her 2003 personal tax return in 2004 to claim the related tax savings.

Generally, an individual should be in the highest tax bracket after contributing the maximum to an RRSP or RPP before considering an investment in a tax shelter. An investment in a tax shelter must be made by December 31, 2002 to obtain a tax deduction for 2002.

Also, for investments other than flow-through shares, an investor should ensure that the shelter has a Tax Shelter Identification Number assigned to it by CCRA. Tax deductions will be denied by CCRA if a tax shelter does not have an identification number.

The tax rules for tax shelter investments have become more complex in recent years. Rules have been introduced to significantly curtail certain types of shelters - for instance, computer software and film tax shelters. In addition, CCRA has been aggressively auditing existing computer software and art shelters, and has published a press release to "warn investors about the potential risks and problems associated with tax shelters from a taxation perspective".

The income tax implications of tax shelters can be complex, and therefore professional advice should be obtained prior to purchasing a tax shelter.

Investment Holding Companies

In general, there is no longer a tax deferral benefit to owning investments (public stocks, bonds, etc.) in an investment holding company. Nonetheless, depending on individual circumstances, there could be other benefits to an investment holding company, such as:

- personal income may be reduced, leading to higher personal tax credits and no OAS clawback
- it may be possible to use the company to convert non-deductible interest to deductible interest
- ownership of assets in a company, instead of personally, could reduce probate fees and U.S. estate tax, as applicable

Taxpayers who have an investment holding company, but are not reaping any of the benefits, could consider winding up the company; however, consideration must be given to potential tax costs associated with the wind-up.

Foreign Investment Entities

New tax rules will allow CCRA to "attack" offshore investment plans. Effective January 1, 2003, to the extent you hold an investment which meets the definition of "foreign investment entity" you may have to recognize certain amounts into 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 may wish to seek professional advice to determine the nature of the investment and taxation thereof with respect to 2003 and subsequent years.

FAMILY TAX PLANNING

Charitable Donations

The first \$200 of donations earn a combined federal and Ontario credit at 22.16% of the donation while donations above this threshold earn a combined federal and Ontario credit (taking into account Ontario surtax) at 46.41% of the donation. Donations must be made by December 31, 2002 to obtain a credit in 2002. In order to obtain a higher overall tax credit, donations made by both spouses should be claimed by only one spouse. The maximum annual claim for donations is 75% of your net income for the year. This maximum is further increased to 100% in the year of death and the year before death. Excess donations can be carried forward for 5 years.²⁷

The net income threshold limit to claim the donation tax credit is 100% for: donations of capital property resulting in capital gains; depreciable property that triggers recapture of capital cost allowances; gifts of certified

²⁷To the extent donations cannot be utilized in the year of death, they can be claimed in the preceding year.

cultural property; and of ecologically sensitive lands to Canada, a province or municipality in Canada, and certain charities.

It is more beneficial to donate publicly traded securities with accrued gains directly to a charity, rather than selling the securities and donating the resulting cash. For donations of publicly traded securities, the income inclusion is one-half of the regular capital gains inclusion rate of 50 percent.²⁸

Donations from RRSPs, RRIFs or life insurance may be treated as a donation in the year of death, subject to the income thresholds.

Alimony and Child Support

Child support (not alimony) payments made pursuant to an agreement or court order entered into or altered after April 30, 1997 are **not** deductible by the payor, and therefore are not required to be included in income of the recipient. The amount payable for child support under the **new rules** is determined using prescribed rates depending on the level of income earned by the payor. In certain instances, it may be beneficial to change a pre-May 1997 agreement to the new rules. This can be done where both parties make a request in writing to CCRA. 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 aim to preserve agreements entered into before May 1997.

Alimony payments are not affected by the new rules. However, under the new rules, if there are any payments in arrears where child support and alimony are both payable, it will be assumed that the payments are made firstly in respect of child support, with a possible loss in tax deduction to the payor, pursuant to the post-April 1997 new rules.

Legal fees paid to establish, enforce or increase spousal or child support are deductible for income tax purposes²⁹. Legal fees are deductible regardless of whether the support is taxable to the recipient.

²⁸ For gifts prior to October 18, 2000, the inclusion rates are as follows: three-quarters of net capital gains realized prior to February 28, 2000; two-thirds of net capital gains realized after February 27, 2000 and before October 18, 2000.

²⁹ CCRA changed its position on the deductibility of legal fees incurred with respect to spousal and child support payments effective October 10, 2002. Under CCRA's prior position, legal fees to establish or increase support payments were not deductible for tax purposes.

Qualifying Retroactive Lump-Sum Payments

If a lump-sum payment of over \$3,000 relating to prior years is received after 1994, this receipt can be included in income in prior year(s) instead of the year received. This measure is intended to relieve the higher tax liability that may result if the entire lump sum is taxed in the year of receipt, rather than year-by-year as the right to receive the payments arose.³⁰ 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, spousal or child support payments.

Income Splitting

Benefits

Income splitting involves having income that would normally be taxed in the hands of an individual in a higher tax bracket, be taxed in the hands of another person (spouse, children or parents) at a lower marginal tax rate.

The benefits of income splitting are generally as follows:

- income may be taxed at considerably lower marginal tax rates (or not taxed at all due to utilization of personal exemptions)
- the accessibility within an individual's family to multiple \$500,000 small business capital gains exemptions may be attained

Opportunities for Income Splitting

There are a number of attribution rules that "block" income splitting. These rules can apply to attribute investment income and capital gains back to the original transferor. Accordingly, opportunities for income splitting are limited and planning must be done carefully.

The following opportunities may be available for income splitting and/or family tax planning, subject to the income splitting tax (see discussion below):

³⁰ 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.

- children for investment purposes will not result in attribution of investment income to the lender if the interest rate charged (and paid by January 30 of the following year) on the loan is at least equal to the lesser of CCRA's prescribed rate at the time of the loan, and the interest rate that would have been charged to an arm's length party³¹
- the attribution rules, which attribute investment income to a parent on funds loaned or gifted to a related minor or a trust for a related minor, do not apply to capital gains³², business income, or income earned on the initial investment income
- there is no attribution on gifts to children 18 years of age or older³³. The funds can be used for any purpose including contributions to their RRSPs (subject to their contribution limits)
- there is no attribution of income on gifts or loans made by a non-resident of Canada to a Canadian resident
- an individual who has little or no other income in 2002 can receive approximately \$28,800 annually in dividends from Canadian corporations without attracting any tax liability³⁴
- a parent can make a low-interest or interest-free loan to an adult child to assist him or her in acquiring a principal residence
- child tax benefit cheques can be deposited into bank accounts for children in order for the income generated by investing these funds to be taxed in the hands of the children
- if both spouses are earning income but one spouse is taxed at a higher 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

³¹ With interest rates at their lowest levels in years, **it is an ideal time to consider an income-splitting arrangement using a loan.** For the strategy to work, the loan recipient must pay interest to the creditor at the prescribed interest rate in effect at the time the loan is made, i.e. 3% for loans that arise in 2002 after July 1, 2002. See *TaxTalk 2002 Issue*, "Tax Matters of Note" for a more detailed discussion.

³² Consider buying investments with high capital gains potential in the names of minor children. There is no attribution of capital gains on property loaned or transferred to minor children.

³³ Gifts of assets with accrued gains will give rise to a capital gain to the transferor. There is no "gift" tax in Canada.

³⁴ Provided the dividend is not subject to the "kiddie tax".

- income which would be taxed at their lower tax rate
- the higher income spouse can contribute to a spousal RRSP (as discussed above)
- an individual can make contributions to a registered education savings plan for a child (as discussed above)
- an individual can assign 50% of his or her Canada Pension Plan benefits to his or her spouse, if both are over 60 years of age
- a spouse and/or a child can participate in an incorporated business by owning shares that they purchased with their own funds (consider "Income Splitting Tax" as discussed below)
- an individual can create testamentary trusts in their will, to allow income to be taxed at a lower tax rate
- an unincorporated professional could consider setting up an entity to provide either management³⁵ or technical services to the practice (consider "Income Splitting Tax" as discussed below)
- generally, the charitable donation credit is maximized by having one spouse claim all donations
- generally, having the lower income spouse claim all medical expenses maximizes the medical expense credit

Income Splitting Tax

In 1999, the federal government introduced an income splitting tax known as the "kiddie-tax", which is intended to discourage high-income taxpayers from splitting certain types of income with **minor children**, who may have no or very little other income and would therefore be subject to no tax or tax at low marginal tax rates. This "kiddie-tax" applies to 2000 and subsequent years.

In general, the types of income that are subject to the "kiddie-tax" include:

- dividends flowing from private companies to minor children, either directly or through trusts (except capital dividends);
- the service partnership/trust arrangements wherein a service partnership is set-up to earn fees from a professional practice or a related company; and

³⁵ 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.

- income from a partnership or trust³⁶ 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

The “kiddie-tax” does **not** apply to various types of income such as:

- income from employment or personal services of a minor
- dividends³⁷ received on public stocks, including mutual fund corporations
- income from property acquired on the death of a parent

The effect of the income splitting tax will be to assess tax to the minor child recipient at the **highest income tax rate**³⁸ (excluding the Ontario surtax), thereby blocking most or all of the income splitting advantage otherwise available where this income is split with minor children. For more information on the “kiddie-tax”, please refer to our TaxTalk 1999 Issue 3, “New Income Splitting Tax”.

Salaries to Spouse and Children

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

- contributions to Canada Pension Plan (“CPP”) and RRSPs
- contributions to Employment Insurance (“EI”) in certain situations

The salary must be reasonable in relation to the services performed by the spouse or child in order to ensure that the amount is deductible to the business. Also, whenever salary is paid to a spouse or children, the appropriate withholdings and remittances for income tax, CPP, EI, and Ontario Employer Health Tax must be made. Liability for payments to the Workplace Safety and Insurance Board (WSIB) should also be considered.

³⁶ If structured properly, there are still advantages to income splitting using family trusts depending on an individual’s specific circumstances.

³⁷ Other attribution rules could apply to this income.

³⁸ In Ontario, the highest rate is 40.2% before application of Ontario surtax; which starts to apply when Ontario tax payable exceeds \$3,685.

PLANNING FOR PROFESSIONALS AND OWNER/MANAGERS

Incorporated Business Owners

Remuneration

There are several factors that an owner/manager should consider when determining how best to carry on business in a corporation and how to receive profits from it.

A Canadian-controlled private corporation (CCPC) is taxed in **2002** on active business income (ABI) at the following rates (*assuming a December 31 fiscal year end*):

Income	Federal Rate % *	Ontario Rate %	Total %
ABI up to \$200,000	13.12	6.00	19.12
ABI from \$200,001 to \$280,000	22.12	6.00	28.12
ABI from \$280,001 to \$300,000**	22.12	16.83	38.95
ABI from \$300,001 to \$700,000**	26.12	16.83	42.95
ABI > \$700,000	26.12	12.50	38.62
ABI > \$700,000 with M & P ***	22.12	11.00	33.12

* includes surtax of 1.12%

** includes clawback of Ontario small business deduction

*** M & P – manufacturing and processing

The low rate of tax in 2002 (i.e. 19.12%) applies to active business income of \$200,000 per associated group. There are federal and Ontario rules that “clawback” the low rates of tax in certain cases (see discussion below for clawback rules).

A CCPC with ABI in excess of \$280,000³⁹ should generally reduce its income to \$280,000 through the use of year-end bonus accruals.⁴⁰ If income is not bonused down to \$280,000, an overall tax burden (combined corporate and individual) of approximately 58% (instead of a top rate of 46% by the individual) could be incurred

³⁹ \$280,000 is the limit for corporations with a December 31, 2002 year end. The amount will differ for corporations with year ends other than December 31, 2002.

⁴⁰ If the shareholder is likely to withdraw corporate earnings in the near future, additional consideration should be given to reducing taxable income to \$200,000. If the income in excess of \$280,000 is eligible for the manufacturing and processing tax credit, the decision to bonus income down to \$280,000 depends on how long the funds (after corporate tax) would otherwise remain in the company.

by the time dividends are ultimately distributed to the shareholder.

The federal and Ontario corporate tax rates are scheduled to decrease over the next four years. The active business income thresholds are also scheduled to be increased for federal and Ontario corporate income tax.

The following table compares the combined federal and Ontario corporate tax rates, for a company with a December 31 year-end, giving effect to the scheduled Ontario tax rate reductions and proposed federal tax rate reductions. As indicated, the high tax rate is scheduled to decrease substantially from 38.62% in 2002 to 30.12% in 2006.

Combined Federal and Ontario Corporate Income Tax Rates for Active Business Income			
Year	M & P (%)	Other Business Income	
		High Rate	Low rate ⁴¹
2002	33.12	38.62	19.12
Proposed tax rates:			
2003	33.12	36.62	18.62
2004	32.12	33.12	18.12
2005	31.12	31.62	17.12
2006	30.12	30.12	17.12

The proposed **2003** combined federal and Ontario tax rates (assuming a December 31 fiscal year end) will be as follows:

Income	No M&P %	With M&P %
ABI up to \$200,000	18.62	18.62
ABI from \$200,001 to \$300,000	27.62	27.62
ABI from \$300,001 to \$320,000	29.62	27.62
ABI from \$320,001 to \$800,000	41.29	36.79
ABI over \$800,000	36.62	33.12

Corporations with income, which fluctuates from year to year, could consider paying tax at the high rate in one year if the high rate tax can be recovered by future loss carrybacks.

⁴¹ The low rate applies to the first \$200,000 of taxable income. When fully phased-in in 2005, a preferential rate will also apply to Canadian-controlled private corporation (CCPC) income between \$200,000 and \$400,000.

A bonus accrual can also result in a tax deferral since payment of the bonus (and any related taxes) can be delayed for up to 179 days from the end of the company's taxation year. For example, July 31, 2002, fiscal year bonus accruals can be paid as late as January 26, 2003. In this case, the corporate deduction would be in the 2002 fiscal year, and the related income would not be taxed to the shareholder until the year 2003⁴².

Where the active business income in a corporation that is eligible for the low rate of tax is below \$200,000, the combination of salary and/or dividends to the owner/manager is dependent on a number of other factors.

Advantages of Paying a Salary

- provides a source of earned income to maximize CPP, RRSP and RPP contributions
- salary is not subject to AMT
- does not create a personal instalment base due to withholding at source

Advantages of Paying a Dividend

- an overall tax savings to a top rate taxpayer of about 3.0% of the pre-tax corporate income
- provides investment income to reduce the CNIL account
- dividend payments are not subject to the Ontario Employer Health Tax
- dividend payments may trigger a refund of refundable dividend tax on hand in the company

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

Interest in Lieu of Salary

Where a shareholder has loaned money to his or her company, he or she could consider receiving interest on the loan instead of salary. Any interest charged on shareholder advances should be deductible to the company, would not be subject to the Ontario Employer Health Tax, and would reduce the shareholder's CNIL account balance, if any.

Federal Clawback of the Low Corporate Rate

The lower federal tax rates of 13.12% on the first \$200,000 of active business income and 22.12% on the

⁴² Source deductions, including income tax, would need to be remitted in February 2003 in this example.

next \$100,000 of active business income are eroded when the prior year's taxable capital⁴³ (including the taxable capital of associated corporations) exceeds \$10 million. The amount of income eligible for the low rate of tax is reduced when taxable capital exceeds \$10 million, and reaches zero when the taxable capital of the company and the associated group equals or exceeds \$15 million.

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

Ontario Clawback of the Low Corporate Rate

A surtax is imposed in Ontario on corporate taxable income between \$280,000 and \$700,000⁴⁴. This "clawback" gradually eliminates the Ontario tax rate benefit of the portion of the lower tax rates on the first \$280,000 of active business income for Ontario.

A company having taxable income over \$280,000 (in 2002) and earning both active and investment income should consider transferring the investment income earning assets outside the company to avoid the Ontario clawback. However, there may be tax implications associated with the transfer to be considered.

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. Recent measures were introduced to simplify and streamline SR&ED claims. Please refer to TaxTalk 1999 Issue 4, "Research and Development" for more information with respect to SR&ED.

The Ontario government has suspended the R&D Super Allowance indefinitely. In lieu of such measures, Ontario does not tax the federal SR&ED tax credits relating to Ontario research and development expenditures.

⁴³ The taxable capital includes debt and equity invested in a company, net of investments in other corporations by the company.

⁴⁴ The thresholds are based on a 2002 calendar fiscal year. For a 2003 calendar fiscal year the thresholds are \$320,000 and \$800,000.

Shareholder Loans

Loans by a company to its shareholders should be reviewed annually. The general rules with regard to these loans are as follows:

- loans, whether or not they bear interest, received from the company must generally be repaid before the end of the first taxation year of the company following the year in which the loan was made,⁴⁵ otherwise the amount of the unpaid loan is treated as income of the shareholder in the calendar year that it was received
- certain shareholder 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 the shareholder's income to the extent that the interest rate on the loan is less than the prescribed interest rate. However, the benefit is offset by a deduction of the same amount where the low-interest loan is used for income-producing purposes.

- if a loan is included in income, and is subsequently repaid, then the amount repaid may be a deduction to the shareholder in the year of repayment

A loan to a shareholder or an individual "connected" to a shareholder⁴⁶ made after April 26, 1995 that would have been exempt from income inclusion under the old rules (such as a qualifying housing loan) is exempt only if it is received by the shareholder in his or her capacity as an employee. 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.

Review Shareholder Agreements

Shareholder agreements should be reviewed. 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 or for 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 or buy back of the deceased shareholder's

⁴⁵ These payments cannot be a series of loans and repayments.

⁴⁶ 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.

shares. Recent tax amendments on this matter impose restrictions against tax planning opportunities. Therefore, professional advice should be obtained.

Employer Health Tax (EHT)

EHT is payable on remuneration paid to employees in Ontario⁴⁷. The first \$400,000 of the annual payroll is exempt from EHT.

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

EHT is calculated on all payroll amounts, including bonuses and lump sum payments made to former employees. Stock option benefits received by current and former employees are also included in the EHT base. However, EHT does not apply to employee stock option benefits arising from the exercise or disposition of stock options granted by eligible research and development intensive companies.

UNINCORPORATED PROFESSIONALS AND BUSINESS OWNERS

Unincorporated businesses, professionals and partnerships with individuals as members, can no longer defer income taxes by having a business year-end of other than December 31. A taxpayer affected by the rules is required to either adopt a December 31 business year-end or make certain calculations to include in income the amount of business income being deferred by the non-calendar year-end (i.e. by electing to use the "alternative method"). The rules are effective for all business year-ends commencing after December 31, 1994.

A business may switch from a non-calendar year-end to a December 31st year-end in any year. However, once the business has switched to the December 31st year-end, it cannot switch 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.

⁴⁷ *Self-employed individuals are not subject to EHT after 1998.*

Businesses in existence on December 31, 1994 are able to claim a reserve against the additional income otherwise reportable in 1995 so that the additional income is taxed over a 10 year period from 1995 to 2004. Generally, the additional income is to be reported as follows: 5% in 1995, 10% in each of the years from 1996-2003 and 15% in 2004. In a low-income year, consideration should be given to claiming less of the available reserve and thereby reporting additional deferred income to take advantage of lower tax rates.

If the individual ceases the business, the reserved income is generally taxable in the year following the business cessation. An individual planning to cease business operations in late 2002 may want to delay the cessation until early 2003. This will allow the reserve to be claimed for an extra year, thereby deferring the additional income until 2004.

The filing deadline for the income tax returns of a self-employed individual (and his or her spouse) is June 15th of the following year.⁴⁸ However, the balance of income tax is still due and payable on April 30th of the following year, and should be paid to avoid interest charges.

Incorporation of Professionals

Laws allowing professionals to incorporate came into effect as of November 1, 2001. The regulations or by-laws of the professional governing body must allow for incorporation of its members' practices. Professionals, who do not require all their profits for personal living, may wish to consider incorporating to take advantage (to the extent possible) of favourable corporate tax rates available to an active small business. On the downside, the professional will need to take any remainder of the 1995 business income reserve into personal income in the calendar year subsequent to incorporation. If interested, please contact us to obtain a copy of TaxTalk 2002 Special Issue 01, "Professional Corporations" for a detailed discussion of this topic.

It should be noted that the incorporation of a professional practice will not limit the liability of the professional, nor will it allow dividend splitting with other family members, as the professional must own the shares of the company.

⁴⁸ *GST returns are also due on June 15th of the following year; however, any GST balance payable is due on March 31st of the following year.*

Office in Home

A self-employed individual who uses an office in his or her home

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

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

Canada Pension Plan Premiums on Self-Employed Income

Self-employed individuals are allowed to deduct from income, one half of the Canada Pension Plan premiums paid on income from self-employment. The remaining half will continue to qualify for a non-refundable personal credit.

GST - Quick Method of Accounting

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

Under the Quick Method, GST is charged in the normal manner but is remitted based on a fixed percentage of revenues (including GST) that is lower than the 7% GST rate. The business cannot claim Input Tax Credits (ITCs) on its expenses; however, ITCs can still be claimed on capital expenditures.

The Quick Method can simplify reporting of GST, and can lead to lower GST remittances for businesses that have few expenses subject to GST.

EMPLOYEES

Employee Benefits

Non-taxable benefits

Certain types of employee benefits are not subject to tax. Examples of common non-taxable benefits are employer contributions to RPP, DPSP, group sickness or accident insurance plans, private health care premiums, subsidized

meals, social or athletic club memberships (when used primarily to promote the employer's business), certain training courses, relocation expenses and reimbursements of economic losses as a result of job transfers,⁴⁹ and reasonable allowances based on a per kilometre charge for the use of an employee's automobile for employment purposes.

An employer may provide an employee with **non-cash gifts** (no more than two in a 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 the employee and the employer is able to deduct the cost of the gifts. Should the cost of the gift(s) exceed \$500, the entire fair market value of the gift must be included in the employee's income. Employers may also give non-cash awards for achievement with the same \$500 limit and conditions applying. Where the gift or award offered is cash or near cash, the full amount of the gift must be included in the employee's income.

Taxable Benefits - Automobiles

Allowances received for employment-related use of an employee-owned or leased automobile which are **not** based on a per kilometre rate are **not** considered reasonable and must be included in the income of the employee. If an allowance is included in income, the portion of the automobile expenses that relates to employment use can be deducted by the employee to reduce or eliminate the impact of the income inclusion.

Where an individual is provided with an automobile by his or her employer, there are two components to the taxable benefit received by the employee.

- a "standby charge" benefit that is based on the fact that the employee has the employer's automobile available to him or her for personal use, and
- an "operating cost" benefit that is based on the portion of the operating costs paid by the employer that relate to the personal use of the automobile by the employee.

There is also a GST component to the taxable benefits. Where the employer provides a taxable benefit, the employer is required to self-assess and remit the GST component of this benefit.

⁴⁹ 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.

There may be a reduction in the standby charge benefit otherwise calculated if the annual **personal** use of the automobile is less than 12,000 kilometres **and** personal use is less than 10% of the total use.

Where the employee's 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 the employee to his or her employer. An employee must notify his or her employer in writing by December 31, 2002 if he or she wishes to have the operating cost benefit calculated as one-half of the stand-by charge.

Where the employee's employment-related use is 50% or less, or where the employee chooses not to have the operating cost benefit calculated as one-half of the standby charge, the operating cost benefit is calculated as 16 cents per kilometre of personal use (13 cents for automobile salespersons). To avoid the benefit being computed in this way, the employee may, by February 14, 2003, fully reimburse their employer the actual personal operating costs paid by their employer for the year 2002. This issue is discussed in more detail in TaxTalk 2002 Issue 1, "Automobile Benefits and Deductions".

An employee should review his or her personal use of the automobile before year-end to determine how close he or she is to the 90% and 50% employment use thresholds. It may be prudent to reduce personal use between now and the end of the year to reduce the stand-by charge and/or operating cost benefits.

The standby charge is based on the original cost of the vehicle to the employer, rather than its depreciated value. Where the fair market value of the used vehicle is substantially less than its original cost, it may be prudent for the employee to purchase an older vehicle from the employer⁵⁰ and then be reimbursed by their employer for the employment use of the vehicle, than be taxed on a significant standby charge.

Employee-owned Vehicles

If an employee uses his or her own automobile for employment and is considering purchasing a new vehicle, consideration should be given to purchasing the vehicle before the end of the year. This will accelerate tax depreciation claims by one year.

⁵⁰Alternatively, the standby charge would be reduced if the employer sells the car and then repurchases it or leases it back based on the reduced value.

Stock Option Benefits

When employees of a **public company** acquire shares under a stock option plan, the difference between the fair market value of the shares on the date the option is exercised and the amount paid for the shares is included in income in the year the shares were acquired. This income inclusion may, however, be deferred to the year in which either the shares are sold, the individual dies or becomes a non-resident. This deferral is subject to an annual ceiling of \$100,000.⁵¹ To obtain the deferral in respect of option benefits arising in 2002, the employer must be notified in writing by January 15, 2003.

If the shares of the public company are acquired at an option price that is at least equal to the value of the shares on the date that the option was granted, a deduction⁵² will be available.

When employees of a **CCPC** acquire shares under a stock option plan, the entire amount of income inclusion is not included in income until the date on which the shares are actually disposed of.

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 that may substantially reduce or eliminate their Ontario personal income tax. The Ontario Research Employee Stock Option (ORES) credit applies to stock options granted after December 21, 2000. The credit, claimed in the year that the stock option benefit is included in income, is based on the amount of stock option deduction available under the rules of the Income Tax Act.⁵³

Employee Loans

The taxable benefit that arises in 2002 from a low-interest loan by a company to an employee is reduced by interest paid by the employee to the company by January 30, 2003. An interest deduction can be claimed by the employee to offset the taxable benefit for the imputed

⁵¹The application of the \$100,000 annual limit to specific taxpayers can be complex. Professional advice should be sought before options are exercised.

⁵²The deduction is 50% of the benefit. This results in an income inclusion of 50%, which parallels the capital gains inclusion rate.

⁵³Taxable income for Ontario purposes may be reduced by the amount of taxable stock option benefits and taxable capital gains included in income in the year, subject to an annual limit of \$100,000.

interest benefit, to the extent that the borrowed funds were used to earn income from a business or property.

Employee Deductions

Employment Expenses

Certain expenses incurred to earn employment income are deductible against employment income earned. Commission employees may be entitled to deduct various expenses incurred to earn commission income, if certain conditions are met. For any year, the amount deductible is limited to the amount of commission income earned. Deductions for non-commission employees are restricted to employment related items, such as supplies and office rent, while promotional type expenditures are not allowed.

Office in Home

An employee who is required by his or her employer to maintain an office in their home may be able to deduct some home expenses related to the office space.⁵⁴ The types of expenses eligible for deduction differ depending on whether the employee earns commission income or not. For employees, cellular phones, computers and fax machines should be leased in order to obtain tax deductions as capital cost allowance is disallowed to an employee if these types of equipment are purchased.

In order to deduct office in home and other employment expenses from income, form T2200 - Declaration of Conditions of Employment - must be completed and signed by the employer, and retained by the employee with his or her records.

GST Rebate

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

To receive a rebate, a GST rebate application form (Form GST 370) should be completed and filed with the employee's or partner's personal income tax return.

⁵⁴ Home office expenses that are deductible include prorated rent, utilities, repairs, and cleaning materials. Capital cost allowance, insurance, property taxes and mortgage interest cannot be deducted. However, if an employee earns commission income, he or she may deduct a prorated amount of insurance and property taxes.

Alternatively, an individual has up to four years to claim the rebate. The rebate must be included in income in the year in which it is received. For rebates related to capital cost allowance claims, the rebate 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 1981 and 1982 may be subject to this 21 year rule in 2002 and 2003 respectively. There may be significant tax costs associated with the deemed disposition to the extent that the assets of the trust have appreciated in value.

Professional advice should be obtained for trusts, which will be affected by the deemed disposal rule.

In appropriate circumstances, trusts can be a valuable vehicle to meet estate, tax and probate planning objectives. Recent legislation has introduced alter ego and joint partner trusts, which present some new planning opportunities for individuals over 65.

Preferred Beneficiary Election

The preferred beneficiary election allows trust income to be retained by the trust but allocated to "preferred" beneficiaries and taxed in their hands, rather than in the trust. This election can only be made for a beneficiary of a trust who is mentally or physically impaired.

OTHER PLANNING POINTS

Personal Tax Instalments

Interest charges (compounded daily) and penalties can be avoided by paying the required personal income tax instalments, and any final balance of tax on time. Tax instalments in respect of a taxation year are due in quarterly payments and must be received by CCRA no later than March 15, June 15, September 15, and December 15⁵⁵. Instalments are required if the difference between combined federal and provincial income tax payable and the amount deducted or withheld at source is greater than \$2,000 in both the current year and either of the two preceding years.

⁵⁵ When the 15th of the month falls on a weekend or statutory holiday, the instalment is due the next business day.

Based on their records, CCRA will send notices to individuals indicating amounts of instalments required. As long as the individual pays the instalments required by CCRA, no interest or penalties will be charged. If instalments have been made late, future instalments can be made earlier than required to create an interest offset to reduce or eliminate interest and penalties.

CCRA currently charges interest at 4% above a "prescribed" interest rate (which is based on current treasury bill rates). The rate for the last quarter of 2002 is 7%. The interest is not deductible and compounds daily, and equates to a pre-tax rate for a taxpayer in the top tax bracket of approximately 13%, a rate much above current lending rates.

It should also be noted that a penalty for late or deficient instalments would be assessed equal to 50% of the interest payable where the instalment interest payable exceeds \$1,000 in any year. Consequently, where this additional penalty will apply, it is generally better to pay instalments before paying arrears from prior years.

Interest and penalties paid to CCRA, and on money borrowed to pay amounts owing to CCRA, are not deductible. An individual borrowing to pay taxes may be able to convert the non-deductible interest into deductible interest with proper tax planning.

SOCIAL ASSISTANCE AND FAMILY BENEFITS

An individual who has net income in 2002 of over \$56,968 is required to repay some or all of their Old Age Security (OAS) benefits. The clawback is the lesser of the OAS benefits and 15% of income in excess of the threshold amount. A 100% clawback of the benefit occurs when net income is \$92,435. Consideration should be given to sheltering or deferring 2002 income to ensure that net income does not exceed this threshold amount.

An individual who receives OAS benefits and has significant investment income that is not required to meet his or her on-going cash needs should consider holding his or her personal investments in a personal holding company. This would minimize personal net income for purposes of the OAS repayment threshold. Each spouse's income is considered separately when determining whether an individual's income exceeds the threshold amount and if OAS benefits will need to be repaid.

OAS benefits are subject to tax withholdings as they are paid. The amount withheld will be based on the prior year's income. Any excess or deficiency in the amounts withheld will be determined when the tax return for the year is filed.

A qualifying family may be eligible for the monthly non-taxable **child tax benefit** payment. The amount of the benefit is based on family income, number of children, and child care expense deductions. As of July 2002, the benefit is \$1,151 per child, with an extra \$80 for the third and subsequent child, and an extra \$228 for each child under seven if no childcare expenses are claimed. The benefit begins to be phased out where family income exceeds \$32,960, but is still potentially available even where family income is quite high. For instance, the benefit is generally eliminated for a two child family if family income exceeds approximately \$79,000.

There is also a National Child Benefit Supplement (NCBS) available for family income below \$22,397 that is fully phased out when the family income reaches \$32,000. The benefits available are \$1,293 for one-child families; \$2,380 for two-child families; and \$2,380 plus an additional \$1,009 per child for families with three or more children.

The annual maximum Ontario Child Care Supplement for each child under age 7 for single parent families is \$1,310. For two parent families the amount is \$1,100.

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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