

TaxTalk

YEAR END TAX PLANNING - 2004

As the end of 2004 approaches, this TaxTalk is a reminder to everyone to review their personal tax situation. Personal tax planning is important to the management of your financial affairs and should be considered throughout the year and not just late in the year.

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

This TaxTalk will assist those individuals resident in Ontario who desire to take advantage of opportunities that exist for minimizing income taxes for 2004 and subsequent years.

This TaxTalk is based on existing legislation and the current interpretation of the Income Tax Act (the Act) by Canada Revenue Agency (CRA) and by the courts. In addition, recent proposals to amend the Act have been considered and are referred to below as proposed amendments. Other than these proposed amendments, this Tax Talk 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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IMPORTANT DATES AND DEADLINES

The Registered Retirement Savings Plans (RRSPs) of an individual who attains the age of 69 in 2004 will mature by December 31, 2004, at the latest.

If you turn 69 in 2004, the RRSP contribution for 2004 must be made by December 31, 2004, not March 1, 2005.

Many deductions and credits are available only if payments are made by December 31, 2004 or early in 2005. Important deadlines are summarized below.

Amounts to be paid by December 15, 2004

- final personal income tax instalment for 2004

Amounts to be paid by December 31, 2004

- 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
- 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 28, 2004 resulting in a settlement date of December 31, 2004
- contributions to Registered Education Savings Plans to qualify for 2004 Canada Education Savings Grant

Information returns to be filed by January 15, 2005

- an employee must advise their employer of their intent to elect to defer benefits from stock options exercised in 2004

Amounts to be paid by January 30, 2005

- any interest owing for 2004 on loans to family members (including loans to family trusts) must be paid by January 30, 2005 so that the income attribution rules will not apply for 2004 and subsequent years
- any interest owing by an employee to his or her employer must be paid by January 30, 2005 in order to reduce the interest benefit on a low-interest or interest-free loan for 2004

Amounts to be paid by February 14, 2005

- 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 2004 personal operating costs paid by his or her employer by February 14, 2005. 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 17 cents (14 cents for an automobile salesperson) per kilometre of personal use. For more information in this regard please refer to TaxTalk 2004 Issue 1, "Automobile Benefits and Deductions"

Information returns to be filed by February 28, 2005

- T4s and T4 Summaries and T5s and T5 Summaries for 2004

Amounts to be paid by March 1, 2005

- deductible contributions to an individual's RRSP or a spousal RRSP (for 2004)
- repayments of RRSP Home Buyers Plan (for 2004)

Amounts to be paid / information returns to be filed by March 15, 2005

- first personal income tax instalment for 2004
- Employer Health Tax allocation agreement to be filed by associated companies

Amount to be paid by May 2, 2005

- balance outstanding on 2004 personal taxes payable

Other amounts to be paid

- childcare expenses¹ paid with respect to services rendered in the year, even if paid after December 31, 2004

¹ The maximum childcare expenses for 2004 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 2004

In addition to annual adjustments to tax rates, thresholds and tax credits, the March 2004 federal and the May 2004 Ontario budgets announced various changes, some of which are highlighted below.

Federal Changes

In general, there are four different income brackets for federal tax rates. Personal tax bracket income thresholds have been increased for 2004 as follows:

- the lowest federal tax bracket (at 16%)² increases from \$32,183 to \$35,000,
- the middle income bracket levels (tax at 22%)² will be \$35,001 to \$70,000 and (at 26%)² \$70,001 to \$113,804,
- the top tax bracket for income over \$113,804 will continue to be taxed at a rate of 29%².

The employee Canada Pension Plan (CPP) contribution rate remained the same for 2004 at 4.95% of pensionable earnings. However, the maximum pensionable earnings in 2004 increased to \$40,500³ (from \$39,900 in 2003). This results in an increase in the maximum employee contribution from \$1,801.80 in 2003 to \$1,831.50 in 2004.

The employee Employment Insurance contribution rate decreased from 2.10% to 1.98% of insurable earnings⁴ for 2004, resulting in a decrease in the maximum employee contribution from \$819 in 2003 to \$772 in 2004.

Federal Tax Credits and Deductions

Other changes in 2004 include the following increases to federal personal credits:

- basic personal from \$7,756 to \$8,012
- married/equivalent to spouse from \$6,586 to \$6,803
- disability from \$6,279 to \$6,486
- caregiver from \$3,663 to \$3,784
- claim for infirm dependants from \$3,663 to \$3,784

² Ontario tax rates are in addition to the federal rates.

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

⁴ The maximum insurable earnings remains at \$39,000.

Ontario Changes

Whereas there are four federal tax brackets, Ontario has three income brackets for its personal tax rates.

The Ontario tax brackets and tax credits are fully indexed for inflation. The 2004 tax rates⁵ are as follows:

- the Ontario tax rate for the lowest tax bracket (up to \$33,375 – the federal bracket threshold is \$35,000) will remain at 6.05%,
- the tax rate for the middle tax bracket level of \$33,376 to \$66,752 (federal - \$35,001 to \$70,000) will remain at 9.15%,
- the tax rate for income over \$66,752 (federal brackets \$70,001 to \$113,804 and income over \$113,805) will remain at 11.16%.

Ontario levies a surtax in addition to its normal tax. For 2004, the first-tier surtax⁶ is 20% of Ontario tax over \$3,856 (generally when taxable income exceeds \$58,768). The second-tier surtax is 36% of Ontario tax over \$4,864 (generally when taxable income exceeds \$69,238).

For 2004, the top combined marginal tax rate for Ontario residents remains at 46.41%, and starts when taxable income exceeds \$113,805 (2003 - \$104,648).

To provide relief for seniors, the 2004 Ontario Budget proposed to enhance the property tax credit for 2004 and future years by increasing the basic credit to \$625 from \$500 and the maximum eligible credit to \$1,125 from \$1,000.

The 2004 Ontario budget introduced the **Ontario Health Premium**. The “premium” will start to apply on taxable income in excess of \$20,000. The maximum premium will apply when taxable income exceeds \$200,600, and will be \$450 for 2004 and \$900 for 2005. For more information please refer to TaxTalk 2004 Issue 3, “2004 Ontario Budget Highlights”.

⁵ Federal tax rates are in addition to the Ontario rates.

⁶ Although the first tier of surtax was scheduled to be eliminated effective January 1, 2004, this proposal was repealed in November 2003 by Ontario’s new government.

TAX DEFERRAL PLANS

Registered Retirement Savings Plans

Deduction Limits

For 2004, your RRSP deduction limit equals the **lesser of**:

- 18% of your 2003 **earned income** (see below) (i.e., the previous year); and
- \$15,500

less:

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

plus:

- any “pension adjustment reversal” for 2004 to restore lost RRSP deduction limit on termination of employment, and
- your unused RRSP deduction limit carried forward since 1991.

CRA provides the “2004 RRSP Deduction Limit Statement” for you as part of your 2003 Notice of Assessment. This Statement indicates your 2004 deduction limit which is the maximum you can deduct on your 2004 tax return. This Statement also indicates RRSP contributions from prior years that you have made but have not claimed a tax deduction for. You should verify the amounts when determining your available RRSP deduction limit for 2004.

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

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

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

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

The RRSP limits for 2004 and subsequent years, before any pension adjustments, are as follows:

YEAR	LIMIT
2004	\$ 15,500
2005	16,500
2006	18,000
2007	Indexed for wage growth.

Spousal RRSP

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

You will lose the benefits of a spousal RRSP if your spouse withdraws funds from the plan too soon. Normally, RRSP withdrawals are taxed in the hands of the recipient spouse; however, where 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.

⁷“Spouse” includes a common-law spouse and, after January 1, 2001, includes a partner of the same sex.

For example, for spousal RRSP contributions made in 2004, your spouse will be taxed on withdrawals made on or after January 1, 2007. On the other hand, you would include the withdrawal in your income if the withdrawal happened prior to January 1, 2007. This rule applies whether your spouse has one or many spousal RRSP accounts.

Finally, if you turned 69 prior to 2004, you can no longer contribute to your own RRSP; however, you can contribute to a spousal RRSP, for which you will receive a deduction, provided that your spouse is 69 or younger at the end of 2004.

Building Unused RRSP Deduction Room for Children

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

Retiring Allowances and Severance Payments

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

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 Deferred Profit Savings Plan (DPSP) on your behalf.

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

Where you began your employment after 1996 or you received a retiring allowance in excess of the eligible amount, these amounts will not be eligible for the RRSP

rollover. However, if you have unused RRSP deduction room, you may choose to transfer this ineligible (for rollover) retiring allowance to your RRSP and claim an RRSP deduction.⁸

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

Timing of Contributions

Subject to your 2004 RRSP deduction limit, RRSP contributions you make by March 1, 2005 will be deductible for 2004.

If you turn 69 in 2004, your RRSP contribution for 2004 must be made by December 31, 2004. For further planning, please refer to the discussions on "Spousal RRSP" and "Over-Contribute before Maturity".

You should consider making your 2005 RRSP contribution as early as possible in 2005. In doing this, you will benefit from a longer period during which your retirement fund can grow tax deferred.

If you wish to increase your deduction limit to the maximum of \$16,500 for 2005, you will need earned income of \$91,667 in 2004.

Non-Cash Contributions

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

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

The best approach to take, with property that would create a capital loss, is to sell the property in the open market (i.e., a third party), and then contribute the cash proceeds to your RRSP. In this way, the loss can be recognized.

⁸ If the transfer is made directly by your former employer to your RRSP, no tax would be withheld.

Equity Investments in RRSPs

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

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

RRSP Investments in Small Businesses

Your RRSP may, subject to certain restrictions, hold shares of **private companies**⁹. Some of the specific rules and restrictions that apply are summarized below:

- Your RRSP cannot own shares of any corporation¹⁰ that you control. In addition, anybody who is related to you (i.e., spouse, children, siblings or parents) is also precluded from owning shares in their RRSP of a company that you control.
- Where you own, together with a related group, 10% or more of the issued shares of a private company¹⁰, inside and outside RRSPs, and you deal at arm's length with the company, your (combined) cost of the investment in the company must be less than \$25,000.
- Where you, together with a related group, own less than 10% of the shares of any class of a private company¹⁰, 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, does not cause you, and the related group together, to own 10% or more of the issued shares of any class of the company.

⁹ 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.

¹⁰ Including shares of related companies.

\$2,000 Over-Contribution¹¹

You could consider making a one-time (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. When the funds are withdrawn from your plan, the funds will be taxed again; however, you can overcome this double taxation and realize a tax benefit if the funds are allowed to grow tax free in the plan for a considerable period of time.

You could also consider making an over-contribution for any of your children who are 18 or older. The over-contribution will be deductible by your child in future years as the child earns income, which will create new RRSP deduction 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 (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., 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.

Withdrawals

If your income for 2004 is unusually low, you should consider making a withdrawal from your RRSP in 2004 in order to raise your taxable income to \$35,000. This income amount is the maximum for the lowest federal tax bracket. Please keep in mind, however, that RRSP

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 2004 must first be applied to reduce any over-contribution in excess of \$2,000 that existed at February 27, 1995.

withdrawals do not re-generate deduction limit. An amount can only be “re-contributed” to an RRSP to the extent that you have “earned” additional RRSP deduction limit.

Using the Pension Income Credit

If you are 65 or older, you are entitled to claim a non-refundable tax credit on the first \$1,000 of pension income. However, if you are younger than 65, you are only entitled to the credit if you have received qualifying pension income¹².

If you are taxed at the higher brackets rather 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

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

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

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, income from a RRIF, or payments received by virtue of the death of a spouse as annuity payments from an RRSP or DPSP.*

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

The amount you withdraw under an HBP is treated like an interest-free loan from the RRSP and must be repaid annually over a maximum period of 15 years¹⁴, beginning in the second year after the withdrawal. An HBP repayment is made by making a regular RRSP contribution. When you file your income tax return, you must designate the required repayment amount of the RRSP contribution as an HBP repayment and not as a regular RRSP contribution. 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 amounts you must repay each year.

If you plan to withdraw funds as an HBP late in 2004, you should consider delaying the withdrawal until early in 2005. This strategy will: (i) extend the deadline for purchasing a house from October 1, 2005 to October 1, 2006, and (ii) delay the start of the required repayments by one year from 2006 to 2007.

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

Lifelong Learning Plan (LLP)

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

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

¹⁴ *If an individual ceases to be a resident of Canada, any outstanding balance on the HBP or Lifelong Learning Plan (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.*

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 withdrawal¹⁴. Any unpaid amounts will be included in income in the year that the repayment is missed (similar to the HBP). Future withdrawals can be made from your RRSP for education, provided all your previous withdrawals have been fully repaid.

Transferring Out of an RRSP by Age 69

If you were older than 69 at the start of 2004, you can no longer contribute to your RRSP. **If you turn 69 this year you must mature (i.e., collapse) your RRSP accounts by December 31, 2004.**¹⁵

In collapsing your RRSP, your choices are:

- (1) withdraw the funds from your RRSPs (a fully taxable transaction),
- (2) convert your RRSPs into a fixed term or a life annuity (a tax deferred transaction), and/or
- (3) convert your RRSPs to a Registered Retirement Income Fund (RRIF) (a tax deferred transaction).

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. You can vary the withdrawals from your RRIF to correspond with your cash requirements, subject to the minimum annual withdrawal.

Over-Contribute Before Maturity

If you have earned income in the current year and you are required to collapse your RRSPs by the end of the year (i.e., if you turn 69 in 2004), you should consider "prepaying" your "next year" RRSP contribution before the end of the current year. The contribution you make in late 2004 will be deductible in 2005 when the new deduction limit (based on your 2004 earned income) becomes available.

This strategy will allow you to transfer a higher amount to your RRIF. Although this "premature" contribution is an over-contribution subject to a 1% penalty for each month that it is in the RRSP in 2004 (subject to the \$2,000 over-contribution that is allowable), your ultimate future after-

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

You will benefit the most from this strategy where your marginal tax rate in 2005 is expected to exceed your marginal tax rate(s) in the year(s) that the RRSP contribution is to be ultimately withdrawn.

Source Deductions on RRSP Contributions

If you are an employee or owner-manager who receives a salary/annual bonus,¹⁶ you can choose to contribute all or a portion of your remuneration (subject to your RRSP 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. Further, you are not required to obtain a letter of authority from CRA to do this.

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

Other RRSP Contributions

You may ask CRA for authorization to have withholding tax on your salary reduced based on your direct RRSP contribution(s). Once your employer receives the authorization, the amount of income tax your employer will deduct from your pay cheque may 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.

It appears, however, that CRA will provide advance authorizations for 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).

¹⁵ However, an individual may collapse the plan in an earlier year if he or she desires.

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

Rollover of RRSP and RRIF Upon Death

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

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

The mechanics to obtain a rollover can be complex and will depend on the facts of the situation. For instance, the procedures differ depending on whether the spouse is a beneficiary under the will or directly under the RRSP/RRIF, and whether or not the RRSP has matured at the time of death. In some cases, elections need to be filed with CRA in order for the transfer to be tax deferred. You should discuss this matter with your professional advisor.

Individual Pension Plans

If you are a high-income individual, you may be able to have your employer make contributions to a special registered pension plan called an Individual Pension Plan (IPP). Contributions to an IPP can significantly exceed the normal RRSP deduction limits. The amount of the IPP contributions depends, in part, on your age - the higher your age, the higher the allowed contributions.¹⁷

The rules regarding IPPs are complex. As well, there are set-up, administrative and compliance costs.¹⁸ Compliance costs include costs to file returns etc., as applicable.

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 an 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

¹⁷ In general, an IPP may be suitable for a key executive and/or an owner/manager who is over 45 years old, is earning a base salary of more than \$100,000, and has worked for the company for several years (back to 1990).

¹⁸ The costs to setup an IPP may range from \$3,000 to \$5,000. Annual administrative costs may range from \$500 to \$600, with an additional triennial fee for an actuarial report of \$1,600 to \$2,000.

(child), and may, therefore, attract minimal tax to the extent that he or she is a student subject to low marginal tax rates with a tax credit for tuition fees.

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

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 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 (capital) are not deductible when made, they are not taxable when returned.

If a beneficiary does not pursue a post-secondary education¹⁹, 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 his or her RRSP deduction limit. 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.²⁰

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

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

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 generally not tax deductible when made, but the ultimate insurance receipt on death is tax free.

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

INVESTMENT STRATEGY

Return on Investments

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

Each type of investment income is taxed differently:

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

The table below shows the after-tax amount on \$100 of investment income earned by an individual who is in the top tax bracket in Ontario. The 2005 rates may change with future federal and Ontario budgets.

Type of Income	After-tax Amount of \$100 in 2004/2005
Interest ²¹	\$53.59
Dividends	\$68.66
Capital Gains–Non-exempt	\$76.79
Capital Gains–Exempt	\$100.00

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

- hold interest-yielding investments inside an RRSP (to defer tax on the higher-taxed interest), and

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

- hold equity investments, which yield dividends and capital gains, outside an RRSP.

If you hold units in an income trust, please be aware that the cash distribution you receive is a combination of income, subject to tax, and a return of capital which you receive tax free²². As result, when you calculate your return on investment or yield, you need to exclude the capital portion.

Accrual of Interest Income

In general, you must include interest income annually on your tax return, based on the anniversary date of the investment, whether you receive the interest in cash or the interest is accrued, as is the case with a compound interest investment.²³

If you plan on purchasing an interest-bearing investment near the end of 2004, you may want to delay your purchase until 2005 to defer the forced accrual/recognition of interest income until 2006.

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 your situation with your professional advisor to determine whether your investments 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.

Where you purchased an investment using debt and 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 property²⁴.

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

²³ A three-year accrual rule continues to apply to investment contracts acquired before January 1, 1990.

²⁴ The interest restriction applies where the real estate assets or other depreciable property is earning income from property. Interest will remain deductible after sale where the property is used to earn income from a business.

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 gain inclusion rate is 50%). Your selling costs reduce your capital gain or increase your capital loss.

To the extent you have realized capital losses in the year, these losses can reduce your taxable capital gains but cannot reduce any other type of income.²⁵ 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 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.

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

Investments With Accrued Losses

If you have realized capital gains in 2004, you should consider selling investments with accrued losses before the end of 2004²⁶ to offset your taxable gains.

Further, you should consider triggering a capital loss if you paid tax on capital gains in any of the **preceding three years**.

If you realized a capital loss in 2004, the "superficial loss" anti-avoidance rule will deny your loss if either you or your spouse (or an affiliated company) re-purchase²⁷ the same investment within (i.e., before or after) 30 days of the sale.

When you transfer property, other than cash, to your RRSP, you are deemed to have disposed of the property for proceeds equal to its fair market value. If this transfer generates a capital loss, the loss will be denied. To benefit from the loss, you should dispose of the property

²⁵ In the year a taxpayer dies, capital losses can reduce other income on the terminal return or the return for the immediately preceding taxation year, not just capital gains; however, to the extent the taxpayer has claimed the capital gains exemption, this amount will reduce the amount of capital losses deductible against non-capital gain income.

²⁶ To realize a capital loss in 2004, the last day on which a publicly traded transaction should occur is **December 28, 2004**. For options, the last trade date for 2004 is December 30, 2004. These dates apply to securities and options traded on the Canadian and US exchanges.

²⁷ This restricted loss rule does not apply to sales made to, or repurchases by parents, children, nieces or nephews.

to a third party and then contribute the cash proceeds to your RRSP,²⁸ as discussed above.

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). However, if the spin-off meets certain criteria, you may **elect**²⁹ 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 the shares at the time of the spin-off. As a result, Canadian income tax on the spin-off will be deferred until the shares are disposed of, and could be reduced if the deferral election converts what otherwise would have been a dividend to a capital gain subject to a lower tax rate.

\$500,000 Small Business Exemption

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

The exemption will provide you with significant tax savings. If you are at the top tax rate and you are able to shelter \$500,000 of capital gains, your potential tax savings would be approximately \$116,000 in 2004.

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

²⁸ If your RRSP were to acquire the same property within 30 days of the sale, your loss would not be denied, as you and your RRSP are not affiliated.

²⁹ The election should be filed with your tax return.

- 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, and
- to the extent that you have used some or all of your capital gains exemption (including your general \$100,000 exemption), your access to the \$500,000 exemptions is reduced.

Cumulative Net Investment Loss (CNIL)

Your use of the capital gains exemption is reduced to the extent of your CNIL amount 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 exemption³⁰ is reduced by the CNIL. Your capital gains exemption is not affected where your CNIL is negative (i.e., more investment income than investment expense).

While the CNIL impact is not 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 the company, thereby reducing your CNIL,
- maximize your borrowings for business purposes and use your savings for investment purposes.

³⁰ 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 \$250,000 (1/2 of a \$500,000 gross capital gain).

- 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, certain allowable deductions,³¹ including carrying charges related to investments in limited partnerships, tax shelters and rental properties (to the extent of rental losses).

The 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 2004, the reinvestment must occur prior to April 30, 2005.

³¹ RRSP deductions are no longer required to be added back to compute taxable income for AMT purposes.

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, **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.**

You should consider the following tax issues when evaluating tax shelters:

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

If you have significant tax shelter deductions for 2005, you should consider filing a request for a reduction of income tax withholdings from employment income in 2005 rather than waiting until 2006 to file your 2005 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, 2004 in order to obtain a tax deduction for 2004.

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

The tax rules for tax shelter investments have become more complex in recent years. Rules have been introduced to significantly curtail certain types of shelters³² (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, will effectively be eliminated under draft amendments released in December 2003.

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, in certain circumstances, you may benefit from using an investment holding corporation.

For example:

- the use of a holding corporation may lower your income which may create higher personal tax credits and eliminate the Old Age Security clawback,
- it may be possible to use a holding corporation to convert non-deductible interest to deductible interest,
- if you own certain property in a holding corporation, you may reduce or eliminate probate fees and/or U.S. estate tax.

If you own an investment holding corporation, but are not benefiting from it, you should consider winding up the company. In doing so, the benefits of winding up the corporation should be weighed against the potential costs, including any tax to be paid on the wind-up.

³² On October 31, 2003, the Department of Finance released draft legislation which, if implemented, will deny a taxpayer's loss for a tax year from a business or property source unless, in the year, it is reasonable to expect that the taxpayer will realize, on a cumulative basis, a profit (excluding a capital gain) from that business or property. The draft legislation is far reaching and is the legislative response to recent losses by CRA in the courts. Under the draft legislation losses from a business or property may only be allowed if there is a reasonable expectation of profit for the business or property on a cumulative basis. These proposed rules are to apply to taxation years beginning after 2004. The introduction of the legislation is an indication of government intent to continue to attack tax shelters and other investments that may generate losses. Please refer to TaxTalk 2004 Issue 4, “Cases of Interest” for a more detailed discussion of this draft legislation.

Foreign Investment Entities

Proposed tax rules³³ will allow CRA to “attack” offshore investment plans.

To the extent that you hold an investment which meets the definition of “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 proposals³³ expand the rules for determining when an offshore trust is **deemed to be a resident of Canada** for income tax purposes and, therefore, subject to tax in Canada. The new rules will deem more offshore trusts to be resident in Canada than was the case under previous legislation. If you are a trustee or beneficiary of an offshore trust, you may wish to seek professional advice to determine the implications of these new rules.

FAMILY TAX PLANNING

Charitable Donations

The first \$200 of your charitable donations in 2004 will reduce your taxes payable at a rate of 25.4%³⁴ of the donation amount. This is a combined federal and Ontario rate. Your donations in excess of \$200 will reduce your taxes payable by 46.41%³⁵ of the donation amount.

In order to claim a donation in 2004, your donations must be made by December 31, 2004. To obtain a higher overall tax credit, donations made by both spouses should be claimed by only one spouse.³⁶

³³ As drafted, the proposals are to be effective retroactively on January 1, 2003.

³⁴ For those taxpayers who are subject to the Ontario surtax. For those who are not subject to the surtax, the tax saving on the first \$200 of donations is 22.05%.

³⁵ For those taxpayers who are subject to the Ontario surtax. For those who are not subject to the surtax, the tax saving for donations exceeding \$200 is 40.2%.

³⁶ It is CRA's administrative policy to allow either spouse to claim donations made.

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: (i) capital property with an unrealized capital gain, (ii) depreciable property with potential recapture of capital cost allowance, (iii) certified cultural property, and (iv) ecologically sensitive land to Canada, a province or municipality in Canada, and certain charities.

If you choose not to use a donation to reduce your taxes in the current year, or the above restrictions limit your donations, your unused donations can be carried forward 5 years.³⁷

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 charity, your after-tax cost of the gift is lower if you donate the shares instead of donating cash. For such gifts, the capital gain inclusion rate is 25% instead of 50%.

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

Child Support and Alimony

You cannot deduct child support payments 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 under the **new rules** is determined using prescribed rates and depends on the level of the income of 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 CRA.

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

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

³⁷ To the extent donations cannot be utilized in the year of death, they can be claimed in the preceding year.

Legal fees paid to establish, enforce or increase spousal or child support are deductible for income tax purposes.³⁸ Legal fees are deductible regardless of whether the support is taxable to the recipient.

Qualifying Retroactive Lump Sum Payments

If a lump sum payment of over \$3,000 relating to prior years is received, this receipt can be included in income in the prior year(s) instead of in 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.³⁹ 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

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

The benefits of income splitting are:

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

Opportunities for Income Splitting

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

³⁸ CRA changed its position on the deductibility of legal fees incurred with respect to spousal and child support payments effective October 10, 2002. Under CRA’s prior position, legal fees to establish or increase support payments were not deductible for tax purposes.

³⁹ A notional income tax liability is calculated, as if such income had been included in each prior year to which it relates. A notional interest component, using prescribed interest rates, is also computed, and must also be considered to determine the better alternative with respect to income recognition.

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

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

- Where your minor child earns income from property (e.g., interest or dividend income) and the funds to earn this income came from you as the child’s parent by way of a gift or loan, the income will be taxed in your hands unless your child pays you interest on the capital amount.⁴⁰ 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 party.⁴¹
- The above attribution rule on income from property to minor children does not apply to: capital gains⁴², business income, or income earned on reinvested income (i.e., the compound income portion). That is, any capital gains earned by your child on money you gave him or her would be taxed in your child’s hands and not in yours.
- There is no attribution on gifts to children 18 years of age or older.⁴³ The funds can be used for any purpose including contributions to their RRSP.
- There is no attribution of income on gifts or loans made by a non-resident of Canada to a resident of Canada.
- In 2004, an individual who has little or no other income can receive approximately \$31,218 in dividends from Canadian corporations without paying income taxes.⁴⁴

⁴⁰ This attribution rule also applies to loans or gifts from grandparents.

⁴¹ Since interest rates are currently at low levels, **you should consider an income-splitting arrangement using a loan to your spouse or minor child.** The loan recipient must pay interest to you as creditor at the prescribed interest rate in effect at the time the loan is made. The rate is 3% for the period October 1 to December 31, 2004. See *TaxTalk 2002 Issue 3, “Tax Matters of Note”* for a more detailed discussion.

⁴² You should consider buying securities with high capital gains potential in the names of minor children.

⁴³ Gifts of assets with unrealized capital gains will give rise to a capital gain to the transferor. There is no “gift” tax in Canada.

⁴⁴ Assuming that the “kiddie tax” does not apply.

- You can make a low-interest or interest-free loan to your adult children to assist them to acquire a principal residence.
- You can deposit the child tax benefit cheques you receive into a bank account in your child's name. The income earned in the account will be taxed in your child's hands and not in yours.
- If you and your spouse both earn income, but one of you is taxed at a higher tax rate than the other, the higher income spouse should pay all or most of the "non-deductible" family expenses, including income taxes, while the lower income spouse should invest all or most of his or her earnings to generate investment income which would be taxed at the lower tax rate.
- The higher income spouse can contribute to a spousal RRSP (see Tax Deferral Plans above).
- You can contribute to a registered education savings plan for your child (see Tax Deferral Plans above).
- You can assign half of your Canada Pension Plan benefits to your spouse, provided that both of you are over 60 years of age.
- Subject to the "Income Splitting Tax" as discussed below, your spouse or your children can participate in your incorporated business through share ownership if they purchased the shares with their own funds.
- You can create multiple testamentary trusts in your will. Each trust would be taxed separately thereby allowing multiple lower-tax-rate brackets.
- Subject to the "Income Splitting Tax" as discussed below, if you are a professional carrying on your practice in your own name, you should consider setting up an entity to provide either management⁴⁵ or technical services to your practice.
- In general, the charitable donation credit is maximized by having one spouse claim all donations.
- In general, the lower income spouse should claim all medical expenses to maximize the medical expense credit.

Income Splitting Tax

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

⁴⁵ 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.

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
- income⁴⁶ from a partnership or trust⁴⁷ 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.

The "kiddie tax" does **not** apply to:

- income from employment or personal services of a minor,
- capital dividends,
- dividends⁴⁸ received on public stocks, including mutual fund corporations, or,
- income from property acquired on the death of a parent.

Under this provision, the minor child is subject to tax at the **highest income tax rate**⁴⁹ on the first dollar of subject income and every dollar thereafter (i.e., no graduated rates). As a result, the benefits from some income splitting techniques have been reduced significantly. For more information, please refer to our TaxTalk 1999 Issue 3, "New Income Splitting Tax".

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 contribute to Canada Pension Plan (CPP) and RRSP (subject to their RRSP limits), and
- to contribute to Employment Insurance (EI), in certain situations.

⁴⁶ Pursuant to proposed legislation, income from property [e.g., rent, interest] earned from a business carried on by a related individual would also be subject to the kiddie tax.

⁴⁷ If structured properly, there are still advantages to income splitting using family trusts depending on an individual's specific circumstances.

⁴⁸ Other attribution rules could apply to this income.

⁴⁹ In Ontario, the highest rate is 40.2% before application of Ontario surtax; which starts to apply when Ontario tax payable exceeds \$3,856. The surtax starts to apply when taxable income exceeds \$58,768 (for taxpayers who do not receive Canadian-source dividend income).

The salary must be reasonable in relation to the services performed. To the extent a portion of the salary is unreasonable, your business will be denied this deduction, yet, at the same time, your spouse or child will pay tax on this income. This creates 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 (WSIB) in respect of the "family" salaries.

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 2004 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 \$250,000	13.12	5.50	18.62
ABI from \$250,001 to \$400,000	22.12	5.50	27.62
ABI from \$400,001 to \$1,128,519 **	22.12	18.67	40.79
ABI > \$1,128,519	22.12	14.00	36.12
ABI > \$1,128,519 with M & P ***	22.12	12.00	34.12

* includes surtax of 1.12%

** includes clawback of Ontario small business deduction

*** M & P – manufacturing and processing

The low rate of tax in 2004 (i.e., 18.62%) applies to active business income of \$250,000⁵⁰ per associated group. There are federal and Ontario rules that "clawback" the low rates of tax in certain cases (see discussion below for clawback rules).

A CCPC with ABI over \$400,000⁵¹ should generally reduce its income to \$400,000 through the use of year-end

⁵⁰ The federal small business deduction threshold increases to \$300,000 in 2005.

⁵¹ \$400,000 is the Ontario low rate income level for corporations with a December 31, 2004 year end. The

bonus accruals.⁵² If income is not bonused down⁵³ to \$400,000, an overall tax burden (combined corporate and individual) of approximately 56.1% (instead of a top rate of 46.4% by the individual) could be incurred by the time dividends are ultimately distributed to the shareholder.

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.

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, 2004, fiscal year bonus accruals can be paid as late as January 26, 2005. In this case, the corporate deduction would be in the 2004 fiscal year, and the related income would not be taxed to the shareholder until the year 2005⁵⁴.

Where the ABI in a corporation that is eligible for the low rate of tax is below \$250,000, 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 tax withheld at source
- some or all of the salary may be eligible for the SR&ED credit

Advantages of Paying a Dividend

- an overall tax savings to a top rate taxpayer of about 3.3% of the pre-tax corporate income

income level will differ for corporations with year ends other than December 31, 2004.

⁵² If the shareholder is likely to withdraw corporate earnings in the near future, additional consideration should be given to reducing taxable income to the federal low rate income level of \$250,000. If the income in excess of \$400,000 is eligible for the manufacturing and processing tax credit, the decision to bonus income down to \$400,000 depends on how long the funds (after corporate tax) would otherwise remain in the company before being distributed to the shareholders as dividends.

⁵³ There are alternatives to a "bonus down" strategy, including the potential use of an employee profit sharing plan (EPSP) or retirement compensation arrangement (RCA). A detailed discussion of these plans is beyond the scope of this TaxTalk.

⁵⁴ Source deductions on the bonus, including income tax, would need to be remitted in February 2005 in this example.

- 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

If you are a shareholder and you 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 the Ontario Employer Health Tax, and would reduce your CNIL account balance, if any.

Federal Clawback of the Low Corporate Rate

The lower federal tax rate of 13.12% on the first \$250,000⁵⁵ of active business is eroded when the prior year's taxable capital⁵⁶ (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 \$400,000 and \$1,128,519⁵⁷. This "clawback" gradually eliminates the Ontario tax rate benefit of the portion of the lower tax rates on the first \$400,000 of active business income for Ontario.

A company having taxable income over \$400,000 (in 2004) 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

⁵⁵ The federal amount will increase to \$300,000 in 2005.

⁵⁶ The taxable capital includes debt and equity invested in a company, net of investments in other corporations by the company.

⁵⁷ The thresholds are based on a December 31, 2004 fiscal year.

associated with the transfer that will need 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 2003 Issue 5, "Research and Development" for more information with respect to SR&ED.

Shareholder Loans

If your corporation lends you money in your capacity as a shareholder ("shareholder loan"), 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, 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.⁵⁸ 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.

A loan to a shareholder or an individual "connected" to a shareholder⁵⁹ is exempt only if it is received by the shareholder in his or her capacity as an employee and is available to other similar employee(s). 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.

⁵⁸ These payments cannot be a series of loans and repayments.

⁵⁹ 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.

- 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.

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 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 must be filed with the EHT return, and is due by March 15 of the following calendar year. If the agreement is not filed, all employers in the associated group will be denied the exemption for the year.

EHT is calculated on all payroll amounts, including bonuses and lump sum payments made to former employees. Stock option benefits received by current and former employees are also included in the EHT base. The May 2004 Ontario Budget proposed to eliminate the EHT exemption on stock option benefits granted by research and development intensive companies. Transition rules have been announced.⁶⁰

⁶⁰ 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.

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 31 year-end in any year. However, once the business has switched to the December 31 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.

1995 Reserve

Prior to 1995, many individuals had a non-calendar taxation year-end for their business. When the tax laws changed, the income reported in 1995 from an unincorporated business with a non-calendar taxation year included all business income to December 31, 1995; however, a reserve ("the 1995 reserve") was available to reduce the amount of income that was subject to tax in 1995. In each subsequent year, a minimum portion of the 1995 reserve was includable in income. 2004 is the final year for this adjustment - any remaining reserve must be included in income in 2004.⁶¹

Extended Tax Return Filing Date

The filing deadline for the income tax returns of a self-employed individual (and his or her spouse) is June 15 of the following year.⁶² However, the balance of income tax is still due and payable on April 30 of the following year, and should be paid at this time to avoid interest charges.

⁶¹ As reserves are a discretionary deduction, taxpayers may have short-claimed their reserve. Depending on how much reserve has been short-claimed in previous years, the required income inclusion in 2004 may be less than 15%.

⁶² GST returns are also due on June 15 of the following year, however, any GST balance payable is due on March 31 of the following year.

Incorporation of Professionals

Laws allowing professionals to incorporate in Ontario came into effect as of November 1, 2001. The regulations or by-laws of the professional governing body must allow for incorporation of its members' practices. Professionals, who do not require all their profits for personal living, and/or who want to potentially access the small business capital gains exemption on the sale of their practice, may wish to consider incorporating to take advantage (to the extent possible) of favourable corporate tax rates available to an active small business. If interested, please contact us to obtain a copy of TaxTalk 2002 Special Issue 1, "Professional Corporations" for a detailed discussion of this topic.

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

Office in Home

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

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

you may deduct home expenses related to the office space. These expenses⁶³ include the business portion of rent, mortgage interest, property taxes, utilities, home insurance, repairs, cleaning materials, and telephone. However, no capital cost allowance on the home may be claimed.

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

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

GST - Quick Method of Accounting

Certain self-employed individuals and small businesses may elect to use the "Quick Method" to simplify their

⁶³ For expenses to be deducted, it is important to obtain receipts and document the expense in your records, noting date, purpose and GST paid.

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 to CRA 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 on-going 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 employee benefits are not subject to tax. The following are some of these non-taxable benefits: 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,⁶⁴ 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 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 the employee and the employer is able to deduct the cost of the gifts. Where the cost of the gift exceeds \$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 annual \$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.

⁶⁴ One-half of employer-paid amounts in respect of eligible housing losses in excess of \$15,000 are treated as an employment benefit received by the taxpayer.

Taxable Benefits for Employer-Provided Vehicles

Where an employer provides an automobile to an employee, for personal use or employment use, the employee 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 the employee.

The standby charge is 2% per month⁶⁵ (whole or partial month) of the original cost of the vehicle. Where an 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) the total personal use of the automobile, in a calendar year, is less than 20,004 kilometres, **and** (ii) the personal use is less than 50% of total use.⁶⁶

The fact an automobile depreciates in value does not reduce the standby charge. As a result, where the fair market value of a used vehicle is substantially less than its original cost, it may be prudent for an employee to purchase the vehicle from the employer.⁶⁷ Subsequent to this transaction, the employer could reimburse the employee for the employment use of the vehicle as discussed below.

2. “**Operating costs.**” The operating costs benefit relates to the employee’s personal use of the automobile.

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, 2004 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 less than 50%, 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 at 17 cents per kilometre of personal use (14 cents for automobile salespersons).

An employee can avoid an operating cost benefit, if the employee reimburses the employer for their personal-use operating costs. The reimbursement must be made by February 14, 2005. This topic is discussed in more detail in TaxTalk 2004 Issue 1, “Automobile Benefits and Deductions”.

An employee should review his or her personal use of the automobile before December 31 to determine how close he or she is 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 an employee, an employer-provided automobile creates a GST liability for the employer. The GST liability is 6/106 of the standby charge and 5% of the operating-cost benefit. The employer is required to complete and self assess the GST on the benefits.

Employee-Owned Vehicles

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

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 deducted⁶⁸ by the employee 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 the option is exercised and the amount you paid for the shares is included in income in the year the shares were acquired.

⁶⁵ For employees of automobile dealerships, the 2% rate may be reduced to 1.5%.

⁶⁶ The kilometre limit increased from 1,000 to 1,667 km per month and the personal-use limit increased from 10% to 50% for 2003 and subsequent taxation years.

⁶⁷ Alternatively, 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.

⁶⁸ To deduct automobile expenses on their tax return, the employee must receive a duly-completed form T2200 from their employer.

This income inclusion may, however, be deferred to the year in which either the shares are sold, or an individual dies or becomes a non-resident. This deferral is subject to an annual ceiling of \$100,000.⁶⁹ You must notify your employer in writing by January 15, 2005 in order to obtain the deferral in respect of option benefits arising in 2004.

When employees of a CCPC acquire shares of the CCPC under an ESOP, the stock option benefit is included in income in the year in which the **shares are sold**, and not when the option is exercised.

If you acquired shares under an ESOP and the exercise price is at least equal to the value of the shares on the date the option was granted, you can deduct 50% of the stock option benefit. This deduction effectively treats the increase between the exercise price and the fair market value of the shares on the date the option is exercised as if it were a capital gain (i.e., only 50% taxed).

Ontario Research Employee Stock Option Credit

Under current law, 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 (ORESOP) 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 Income Tax Act.⁷⁰

The 2004 Ontario budget proposes to eliminate the credit for options granted after May 17, 2004. The proposals contain grandfathering rules to allow the credit for options granted after December 21, 2000 and before May 18, 2004, provided the options are exercised and shares disposed of before December 31, 2009.

Employee Loans

The taxable benefit that arises in 2004 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, 2005. An interest deduction can be claimed by the employee to offset the taxable benefit for the imputed

⁶⁹ The application of the \$100,000 annual limit to specific taxpayers can be complex. Professional advice should be sought before options are exercised.

⁷⁰ Taxable 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.⁷¹ 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.⁷² The office must be a separate room to qualify. The types of expenses eligible for deduction differ depending on whether the employee earns commission income or not. For commissioned 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.

⁷¹ For expenses to be deducted, it is important to obtain receipts and document the expense in your records, noting date, purpose and GST paid.

⁷² 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.

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. 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 1983 and 1984 may be subject to this 21 year deemed disposal rule in 2004 and 2005 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.

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 can present some planning opportunities for individuals over 65.

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

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

Preferred Beneficiary Election

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

OTHER PLANNING POINTS

Personal Tax Instalments

You can avoid interest charges (compounded daily) and penalties if you pay the minimum required personal income tax instalments, and any final balance of tax, by their due dates. Tax instalments in respect of a taxation

year are due in quarterly payments and must be received by CRA no later than March 15, June 15, September 15, and December 15.⁷³ You are required to pay instalments if the difference between your combined federal and provincial income tax payable and the amount deducted or withheld at source is greater than \$2,000 in both the current year and either of the two preceding years.

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

CRA charges interest on overdue taxes at "prescribed" interest rates which are based on current treasury bill rates and are adjusted quarterly. The rate for the last quarter of 2004 is 7%. The interest is not deductible, compounds daily, and equates to a pre-tax rate of approximately 13% for a taxpayer in the top tax bracket. Since, in most instances, commercial interest rates are lower, you will be better off borrowing from your financial institution to pay off any CRA debt.

In addition to interest on late payments, CRA assesses a penalty for late or deficient instalments equal to 50% of the interest payable where the instalment interest payable exceeds \$1,000 in any year. As a result, where this additional penalty would apply, you will be further ahead if your payments are applied to your instalment account instead of applying it 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 be able to re-arrange your debt to convert non-deductible interest into deductible interest. Professional advice should be sought in this regard.

SOCIAL ASSISTANCE AND FAMILY BENEFITS

Old Age Security Clawback

If your net income in 2004 is over \$59,790, 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 \$59,790. The OAS clawback is calculated solely on your net income and is not affected by your spouse's income.

⁷³ When the 15th of the month falls on a weekend or statutory holiday, the instalment is due the next business day.

If your net income is \$97,075 or greater in 2004, you are required to repay all of your OAS benefits; therefore, you should consider steps to reduce your 2004 income to below this threshold.

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

OAS benefits are subject to withholding tax. The amount the government withholds is based on your prior year's income.

Any excess or deficiency in current year withholdings will be determined and adjusted when your tax return for the current year is filed.

Federal Child Tax Benefits

A qualifying family may be eligible to receive a non-taxable **child tax benefit**. The benefit is paid monthly and is based on: (i) your family income (i.e., you and your spouse) of the prior year, (ii) the number of minor children you have, and (iii) your child care expense deduction in the prior year.

As of July 2004, the annual benefit is \$1,208 per child. The benefit increases by \$84 for the third and subsequent child and by \$239 for each child under seven if you do not claim any childcare expenses.

For 2004, the benefits begin to be phased out when your family income for 2003 exceeded \$35,000. In general, the benefit is eliminated when a family, with two children under the age of seven, has family income over approximately \$107,300.

You may also be eligible for the National Child Benefit Supplement (NCBS). You are eligible for the full benefit if your family income (i.e., you and your spouse) in 2003 was below \$22,615. When your family income was above this threshold, the payment is reduced. At a family income of \$35,000, the payment is eliminated. The NCBS benefits are: \$1,511 for one-child families, \$2,806 for two-child families, and \$2,806 plus an additional \$1,215 per child for the third and subsequent child.

In addition, there is a Child Disability Benefit which is \$1,653 per child, as of July 2004.

Ontario Child Tax Supplement

The annual maximum Ontario Child Care Supplement for each child under age 7 for single parent families is \$1,310. For two parent families the amount is \$1,100. For 2004, the benefits begin to be phased out when the family net income for 2003 exceeded \$20,750.

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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