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CAPITAL GAINS EXEMPTION

Every Canadian resident individual is eligible for the capital gains exemption under the Income Tax Act. The exemption allows you to realize up to \$750,000 of capital gains during your lifetime, tax-free, from dispositions of certain types of property. Since one-half of capital gains are taxable capital gains, the exemption covers up to \$375,000 of taxable capital gains. The properties that qualify for the exemption are qualified small business corporation shares (QSBC shares), and qualified farm and fishing property.

The exemption is most commonly claimed in respect of QSBC shares. A capital gain from the disposition of a QSBC share will qualify if you held the share for at least two years prior to the disposition, and the share met the following conditions:

First, the share must be a share of a “small business corporation” at the time of the disposition, which is a Canadian-controlled private corporation (CCPC) all or substantially all of the fair market value of the assets of which is attributable to assets that are

- used principally in an active business carried on primarily in Canada by the corporation or by a corporation related to it,
- shares or indebtedness of another small business corporation that is connected with the CCPC (generally meaning that the CCPC controls the corporation or owns more than 10% of the shares of the corporation representing the votes and value of the corporation), or
- a combination of the above.

The Canada Revenue Agency (CRA) generally takes the view that “all or substantially all” means 90% or more. A CCPC is basically a Canadian resident private corporation that is not controlled by non-residents or public corporations.

Additionally, in order to qualify as a QSBC share, the CCPC must have been a CCPC for at least 24 months prior to the disposition, and throughout that time more than 50% of the fair market value of its assets must have been attributable to the assets described above. If the assets included shares or debt in another CCPC, that other CCPC must meet similar asset tests during the 24-month period.



The amount of taxable capital gains that can be sheltered by the exemption is reduced to the extent of your cumulative net investment loss (CNIL) account and your allowable business investment losses (ABILs) for the year or previous years, if any. Your CNIL account generally means your net investment losses (investment expenses in excess of investment income) from 1988 to the end of the year in which you claim the exemption. Your ABILs generally are one-half of your capital losses from dispositions (after 1984) of certain shares or debt of small business corporations.

EXAMPLE

Before 2008, you had not used any of your capital gains exemption. In 2007, you sold shares in a small business corporation and realized a capital loss of \$100,000, which resulted in an ABIL of \$50,000. In 2008, you sold some QSBC shares and realized a \$75,000 taxable capital gain.

Only \$25,000 of the taxable capital gain can be sheltered by the capital gains exemption in 2008. Note, however, that the \$50,000 ABIL can be used to offset income, including taxable capital gains, in 2008 or future taxation years.

As noted, the capital gains exemption also applies to capital gains from dispositions of qualified farm and fishing property. In general terms, qualified farm property includes land used principally in the business of farming in Canada, a share of a family farm corporation, and an interest in a family farm partnership. Qualified fishing property includes land or a fishing vessel used principally in the business of fishing in Canada, a share of a family fishing corporation, and an interest in a family fishing partnership. Similar to the QSBC requirements, the qualified farm and fishing properties have certain ownership period and asset threshold tests that must be met.

INCOME SPLITTING

The obvious benefit of income splitting is the shifting of income to lower-tax bracket individuals such as your minor children with little or no income, or similarly your spouse if he or she has little income. For example, if your minor children have no other income, they can earn approximately \$10,000 of investment income tax-free due to the basic personal credit, and would be taxed at the lowest federal rate of 15% on any further income up to \$40,726 (2009 amounts).





Income splitting is not always possible because of the income attribution rules. Generally, if you lend or transfer property to your spouse or common-law partner, income or taxable capital gains subsequently realized from the property may be attributed back to you and included in your income. Similarly, income from property transferred or lent to your minor children may be attributed to you.

As noted in last month's Tax Letter, you can avoid the application of the attribution rules if you lend money to your spouse or minor child and charge the prescribed rate of interest in effect at the time of the loan. As discussed, the current prescribed rate to the end of June is only 1%, so that this option is currently very attractive. The interest must be paid to you for each year of the loan or within 30 days after the year.

There are, however, other exceptions to the income attribution rules and other scenarios in which they do not apply. Some of these are noted below.

The attribution rules do not apply to capital gains realized by your minor children. Therefore, you can legitimately "capital gains split" with your children, say, by purchasing stocks or equity mutual funds for them for the purpose of realizing future capital gains. Furthermore, the "kiddie tax", noted below, does not apply to capital gains.

The attribution rules do not normally apply to adult children. Therefore, you can give money to your adult children (18 years of age or over) to invest and the resulting income will not be subject to attribution. In this regard, the attribution rules for minors do not apply throughout the year in which the child turns 18 – thus, if your child turns 18 in December 2009, the rules do not apply throughout 2009.

There is no attribution of business income. Therefore, for example, if you give or lend money to your spouse that he or she uses in a business, the resulting income will not be subject to attribution.

The attribution rules do not apply if you transfer property to your spouse or minor child and receive back fair market value consideration. If the consideration is debt (i.e. they owe you the amount of the purchase price), the debt must bear interest at the prescribed rate of interest (as noted, currently 1%), and the interest must be actually paid each year while the debt remains outstanding or within 30 days after the year. Furthermore, in the case of a transfer to your spouse, you must elect out of the "rollover" that normally applies to inter-spousal transfers, meaning that the transfer of the property will take place at its fair market value. This may result in a capital





gain on the transfer. A capital loss will be denied due to the superficial loss rules in the Income Tax Act.

There is no attribution for income earned on attributed income. Therefore, for example, if you transferred a bond to your spouse that earned interest, any further interest earned on the re-invested interest would not be subject to attribution.

The attribution rules do not apply to income that is earned by investing the child tax benefit (which is available to low-income families) or the \$100 per month Universal Child Care Benefit (which is available for all families with children under the age of 6).

There is no attribution in respect of amounts paid by you that are deductible in computing your income and included in your spouse's or child's income. For example, if you run a business and employ your spouse in the business, the investment income he or she earns by investing the salary is not subject to attribution.

The attribution rules stop applying to you (the transferor or lender) if you cease to be resident in Canada. They do not stop if only your spouse or minor child (the transferee or borrower) ceases to be resident but you remain resident. Attribution stops upon your death (little solace).

There is obviously no attribution if the transferred property generates no income. Therefore, if you give money to your spouse or minor child that is used for personal purposes, there will be no attribution. Furthermore, your payment of their personal expenses or their income taxes may free up their own cash resources, which can be invested without attribution.

On a final note, the so-called kiddie tax can apply to certain income earned by children under 18. The kiddie tax is not an attribution rule, but it negates any benefit of income splitting because the child is subject to the highest marginal rate of tax on the income. The income that is subject to the kiddie tax includes dividends and shareholder benefits from private corporations (but not dividends from publicly-listed corporations or mutual funds).

MATURED RRSPS

A registered retirement savings plan (RRSP) allows you to earn tax-free investment income while the income remains in the plan. Although you can withdraw money from the RRSP at any time, and pay the resulting tax, most people wait until the RRSP matures to start their withdrawals.





In this regard, you must terminate your RRSP by the end of the year in which you turn 71. At that point you have three options.

First, you can simply withdraw the entire amount in a lump sum. If the amount is large, this option is not normally desirable because you will be subject to tax at a high marginal rate. In other words, you would normally prefer to spread out the income inclusions over time. The two other options noted below effectively allow you to do this.

The second option is to purchase an annuity. The annuity can be for life or jointly for your life and your spouse's life, or for a term to your or your spouse's age of 90. Annuity payments are taxed in the year in which they are received.

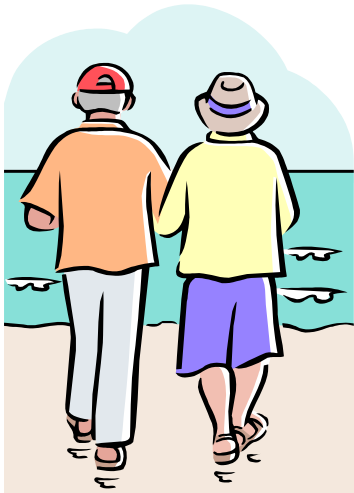
The third option is to convert or transfer the RRSP into a registered retirement income fund (RRIF). A RRIF is somewhat similar to an RRSP in that you can continue to buy and sell investments in the RRIF such as GICs, stocks, bonds, and mutual funds. However, you cannot make further contributions to the RRIF. As well, you must withdraw a minimum amount from the RRIF each year, beginning with the year after you enter into the RRIF, and the minimum amount increases each year over time.

The main differences between an annuity and a RRIF are therefore as follows. The annuity is generally less risky because the payments are fixed and guaranteed for a set period of time (i.e. the term of the annuity). The value of the RRIF can fluctuate if you hold risky investments such as stocks and mutual funds. However, the RRIF is more flexible because of the continued investment options, and also because you can withdraw any amounts at any time.

WRITING OFF BAD DEBTS

If you lend money to someone and the debt becomes uncollectible, you are not entirely out of luck, at least from an income tax perspective. Normally, the amount of the bad debt will be considered a capital loss, one-half of which is an allowable capital loss that can be deducted from taxable capital gains. Technically, there is a deemed disposition for nil proceeds at the end of the year in which the debt becomes bad, although you must elect for the deemed disposition to apply in your tax return for the year.

Any unused allowable capital loss in the year becomes a net capital loss, which can be carried back three years or forward indefinitely to future years to offset taxable capital gains in those years.





In order to claim the capital loss, the debt must either have been for the purpose of earning income from a business or property – this requirement will normally be met if you charged interest on the debt – or if it was a debt acquired as consideration for the disposition of capital property to an arm’s length person (e.g., a vendor take-back mortgage).

If you subsequently collect all or a portion of the debt, you will realize a capital gain equal to the amount so collected.

If you run a business, any bad debt owing to you, the amount of which was included in your income – such as an account receivable for services rendered – can be deducted from your business income in the year in which it becomes bad or uncollectible. The bad debt deduction in such case is a full “ordinary” deduction, that is, it is not a capital loss. If you subsequently collect any or all of the debt, the amount so collected will be included in your income in the year of receipt.

NO – OR LOW – INTEREST EMPLOYEE LOANS

General rule

If you receive a no – or low – interest loan from your employer, you will normally be subject to the deemed interest benefit provisions of the Income Tax Act.

Generally, you will include in your income, in each year in which the loan is outstanding, the prescribed rate of interest during the year applied to the amount of the loan. For these purposes, the prescribed rate is set quarterly, and, as noted earlier in the letter, is 1% in the current quarter ending on June 30. Subtracted from the benefit is any interest you pay in the year or within 30 days after the year. Therefore, if you pay the prescribed rate(s) of interest that applied throughout the year, you will have no net benefit for the year.

If you use the loan for the purpose of earning income from a business or property, you will get an offsetting deduction equal to the amount of the deemed benefit. For example, if you used the loan to purchase shares or mutual funds, the deemed interest benefit will be included in your income but you will get an offsetting deduction, resulting in a wash.

Of course, to the extent that you use the loan for non-income purposes, there will be no offsetting deduction. For example, if half of the loan was

used to buy mutual funds and the other half was used for personal purposes, the deemed interest benefit would be included in your income, while only half of the deemed interest paid would be deductible.

Home purchase loans

The above rules can apply to any employee loan. However, in the case of a home purchase loan, the rules are somewhat more favourable. In particular, for the first five years of the loan, the maximum interest rate that will apply is the prescribed rate that was in effect at the time of the loan, even if the prescribed rate otherwise increases during that time. However, if the prescribed rate decreases below the rate that was in effect at the time of the loan, the lower rate will apply. Effectively, the rate at the time of the loan is a “cap” on the amount of the interest benefit for up to five years.

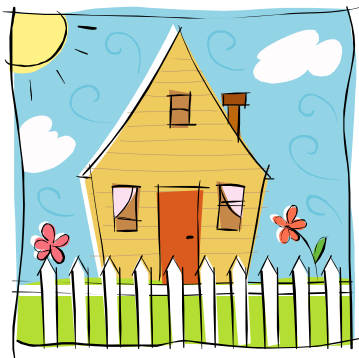
Therefore, for example, if your employer provides you with an interest-free home purchase loan during the current quarter (April-June 2009), the deemed interest benefit will not exceed 1% per year (the current rate) for the first five years of the loan. If the loan remains outstanding five years after the time the loan was made, the rule then applies to the prescribed rate of interest in effect at that later time. In other words, the maximum rate or “cap” is re-set every five years of the loan.

A home purchase loan is generally a loan used to acquire a home that will be inhabited by you or by a related person, or that is used to repay another home purchase loan.

Home relocation loans

A home relocation loan is subject to the favourable treatment accorded to home purchase loans described above. Additionally, you are generally allowed to deduct, in computing your taxable income, the deemed interest benefit in respect of \$25,000 of the loan for up to five years. In other words, you will have no net benefit in respect of the deemed interest on the first \$25,000 of your home relocation loan.

A home relocation loan is generally one that is used to acquire a home that is at least 40 kilometres closer to your employer’s place of business than your former residence.





AROUND THE COURTS

Spousal support paid in instalments not deductible

Spousal support payments are deductible to the payer of the amounts, subject to certain requirements under the Income Tax Act. For example, in order to be deductible, the payments must normally be “payable or receivable as an allowance on a periodic basis” for the maintenance of the recipient spouse or ex-spouse.

In the recent *Patenaude* case, the taxpayer was divorced and was ordered to pay \$26,500 of support to his former wife by a set date provided in the court order. However, the taxpayer encountered financial difficulties and could not pay the entire amount by the set date. As such, his former wife agreed in writing that the payment could be paid in four installments over four years. The taxpayer deducted the payments, on the grounds that they were for the maintenance of his former wife and were payable periodically because they were paid in four annual instalments.

The CRA disallowed the deductions on the grounds that the \$26,500 amount was not payable on a periodic basis. Upon the taxpayer’s appeal to the Tax Court of Canada, the court sided with the CRA. The court made a distinction between “paid” on a periodic basis and “payable” on a periodic basis. The court held that the amount was not payable on a periodic basis because the court order did not require the taxpayer to pay the amounts periodically. Furthermore, his former wife’s agreement to allow the instalments did not amend the substance of the court order. Thus, even though the taxpayer ended up actually paying the amounts periodically (i.e. annually over four years), they were not “payable” on a periodic basis and therefore not deductible.

Disability tax credit transferred to formerly-separated spouse

Under the Income Tax Act, if you are eligible for certain tax credits but unable to use them in a year (i.e. you have insufficient tax payable), you can transfer the credits to your spouse or common-law partner. The credits that qualify for the transfer include the educational, age, pension, and disability tax credits. However, the transfer of the credit is not allowed for a year if, by reason of a breakdown of your relationship, you are living separate and





apart at the end of the year and for a period of at least 90 days beginning in the year.

In the recent *Kara* case, the taxpayer and his spouse were legally married, but had been separated and living apart pursuant to a separation agreement since 1991. However, over time, they were on better terms and began spending more time together.

By 2006, when his spouse was disabled, the taxpayer was spending about five days a week at his spouse's home, even though he maintained a separate residence. The taxpayer attempted to claim his spouse's disability credit, but the CRA disallowed the claim on the grounds that the couple was still living separate and apart. The CRA seemed to take the view that the taxpayer was attending at his spouse's home simply as a courtesy, to help her out with her disability.

Upon appeal to the Tax Court of Canada, the taxpayer was allowed to claim the credit. The Court held that the taxpayer's conduct showed that the couple was no longer living separate and apart. As noted, he spent about five days a week at his spouse's home, often for twelve hours or more, and he sometimes stayed the entire night (albeit in the extra bedroom). He cooked her meals, fed her, helped her with her medication, bathed and dressed her, and generally looked after her. The Court was satisfied that the taxpayer was looking after his spouse as "a husband and not just a caregiver", and was therefore entitled to the credit. The fact that the taxpayer still had a separate residence did not affect this result.

* * *

This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with us before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.





Please contact me to discuss my financial and tax needs.

Please add my name to your tax letter mailing list.

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