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JUNE 2011

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CORPORATE TAX RATES GOING DOWN

For business income exceeding the annual small business limit for Canadian-controlled private corporations ($500,000 per corporate group), and for investment income, the federal corporate income tax rate has been gradually reduced from over 29% over the past dozen years. For 2010, the rate was 18%; this year it is **16.5%**; and as of 2012 it will be **15%**. (The reductions are prorated so that the rate applies to the calendar year January-December even for corporations that have a different year-end.) Of course, provincial corporate taxes apply in addition to these rates.

Despite the reductions, it still pays to **defer corporate income** that exceeds the small business limit (or that for any other reason is not eligible for the small business deduction). Where possible, deferring income or accelerating expenses can result in tax savings.

Note also that the reduced corporate tax rate have changed some of the conventional tax planning that has applied to corporations for many years. For example:

- It can be beneficial to earn investment income in a corporation, even though it is not eligible for the small business deduction and is subject to a special 6.67% refundable tax, and to keep the income in the corporation.
- It can be beneficial to deliberately create a non-Canadian controlled private corporation (CCPC) to earn investment income, as it will not be subject to the refundable tax on such income.
- Historically, a sale of a business would be better for the vendor as a sale of shares by the shareholder rather than as a sale of assets by the corporation. With the reduced corporate rates, in some cases a sale of assets can be better for a vendor.
- For an individual who would otherwise be an employee, it can be beneficial to incorporate and provide services through a corporation, even though the corporation will be a “personal services business” and will not be eligible for the small business deduction. The maximum federal+provincial corporate tax rate may be about 25% rather than the 45% or so that would be paid on high levels of employment income (the rate varies by province).

IS YOUR RRSP SAFE FROM CREDITORS?

As a general rule, your registered retirement savings plan (RRSP) or registered retirement income fund (RRIF) is **not** safe from creditors unless there is a specific rule exempting it, which may depend on your province of residence. If you have unpaid debts and there is no exemption, your RRSP or RRIF may be seized along with other assets — whether by the Canada Revenue Agency for tax debts, or by another creditor that obtains judgment against you and enforces collection through the court system.

In a 1999 case, *Whaling*, the Ontario Court of Appeal ruled that a bank was entitled to seize a debtor's RRSP to offset unpaid bank loans. In a 2004 case, *Bank of Nova Scotia v. Thibault*, the Supreme Court of Canada ruled that an RRSP in Quebec could be seized by a creditor. In another 2004 case, Marrazza, the Federal Court found a trust company liable for not honouring a CRA garnishment notice and handing over the taxpayer's RRSP funds.

However, six provinces now have legislation that protects an RRSP from seizure, subject to various rules and conditions: British Columbia (*Court Order Enforcement Act* s. 71.3), Alberta (*Civil Enforcement Act* ss. 81.1, 92.1); Saskatchewan (*Registered Plan (Retirement Income) Exemption Act*), Manitoba (*Registered Retirement Savings Protection Act*), PEI (*Designation of Beneficiary under Benefit Plan Act* s. 10 (only if a beneficiary is designated)), and Newfoundland & Labrador (*Judgment Enforcement Act* s. 131.1).

If you are **bankrupt**, then your RRSP, RRIF or deferred profit sharing plan (DPSP) cannot be seized by creditors (except for contributions made in the 12 months before bankruptcy, though the provincial legislation above can override this exception).

If your RRSP or RRIF is placed with an **insurance company**, it may be exempt from seizure under provincial insurance legislation. The RRSP is part of your life insurance policy, and such policies normally cannot be seized by creditors. In a 1999 case, *Maritime Life Assurance*, the Federal Court of Appeal ruled that tax debtors' RRSPs could not be seized by the CRA, even though the tax debtors were entitled to be paid the "cash value" of their policies if they asked the insurance company.

Putting your RRSP or RRIF into life insurance will not always work to defeat creditors, especially if it is done only a few months or years before

you run into financial difficulty. In a 1996 case, *Royal Bank of Canada v. Ramgotra*, the Supreme Court of Canada ruled that a transfer to a life-insurance RRIF done less than two years before the person went bankrupt did not succeed, and the RRIF could be seized. But if you are in a business or profession where you are concerned that one day in the future you might be sued and lose all your assets, using life insurance for your RRSP may be good long-range planning.

If you die and your RRSP has a "designated beneficiary", the RRSP can be paid out to the beneficiary and likely cannot be seized by your estate's creditors. There may be exceptions, however.

A TAX TIP WHEN YOU MAKE INVESTMENTS

As an individual, any interest you earn is often taxed **in the year you receive it.** If you are buying a short-term investment that will mature towards the end of the year, consider instead **buying a similar investment that matures early in the next year.**

For example, suppose you are buying a six-month Treasury bill in late June 2011 for $99,000, and it will mature at $100,000 in December, effectively paying you $1,000 in interest. That $1,000 will be counted as 2011 income. If you can get the same interest rate for a T-bill that runs just over six months and matures in January 2012, the $1,000 will not be reported as income until your 2012 return, with the tax payable on April 30, 2013. If you are paying $400 in tax on the interest, you will have the use of that $400 for an extra year by deferring the investment maturity date.

As well as postponing the amount of tax you pay, reducing your income in this way will also reduce any instalments you must remit to the Canada Revenue Agency each quarter.

Obviously, tax should not be your only consideration when making investments. But other things being equal, look for investments that pay interest after the end of the year.

You cannot defer tax for more than one year with this technique. If you buy an investment that accrues interest and does not actually pay the interest to you, you are required to **report the accrued interest annually** as if you had received it on the anniversary of your purchase. Suppose, for example, you buy a 4-year term deposit with your $99,000 in June 2011, and it accrues interest of $2,000 a year, giving you $107,000 back in June 2015.

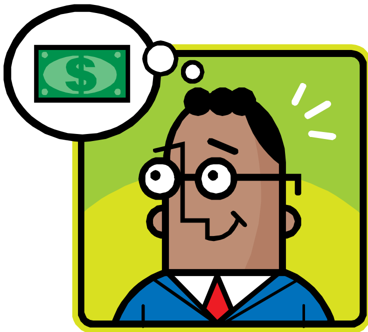
You will have to report $2,000 as interest income **each year** beginning with your 2012 return, even though you have not yet received the money.

CAPITAL DIVIDENDS — A WAY TO GET TAX-FREE DIVIDENDS

If you have your own corporation, you may know about **capital dividends** as a way to get funds out of the corporation free of tax.

As a general rule, capital gains are half-taxed in Canada. That is, one-half of a capital gain is included in income as a "taxable capital gain".

What happens to the other half? It's supposed to be tax-free. (There are various rationales for taxing capital gains at less than full rates; one is that a capital gain usually includes an amount that simply compensates for inflation.)



If a corporation has a capital gain, then half is taxed and half is tax-free. In order to remain tax-free, this "untaxed half" can be paid out to shareholders with no tax whatsoever. This is done by paying it as a dividend and designating the dividend as a "capital dividend". (For capital gains resulting from the corporation donating publicly traded securities to a charity, **none** of the gain is taxed instead of half. In such cases, the **entire** untaxed gain can be paid out as a capital dividend.)

Although the concept is fairly simple, the mechanics of paying a capital dividend include some pitfalls. If you don't get it right, you may find yourself, as a shareholder, having to pay tax on what was supposed to be a tax-free payment!

The rules are found in subsection 83(2) of the Income Tax Act and section 2101 of the Income Tax Regulations. Here are some of the key points to note:

1. The corporation's "capital dividend account", which tracks the amount that can be paid out tax-free, must be calculated, based on past capital gains and losses, capital dividends received from other corporations, and adjustments for changes in the capital gains inclusion rate over the years as well as various other adjustments.
2. The capital dividend declared by the corporation must be for no more than the total in the capital dividend account. (If it exceeds the capital dividend account, the corporation may be subject to a penalty tax.)

3. The corporation must elect in respect of the **full** amount of the dividend. You can't take one dividend and designate part of it as a capital dividend.
4. The directors of the corporation must pass two resolutions, or one resolution covering two matters, **before** the election form can be filed. First, the directors must declare a dividend. Second, the directors must authorize the corporation to elect for the dividend to be a capital dividend, and authorize the corporation's officers (e.g., the President) to execute and file such forms and other documents on behalf of the corporation as are necessary to give effect to the election. Of course, all of this has to be done within the rules imposed by the governing corporate legislation and the corporation's articles and bylaws as to whether all directors' signatures are needed (or just a majority), whether a directors' meeting must be held, etc.
5. The capital dividend election must be made on a prescribed form, Form T2054, which you can obtain from the Canada Revenue Agency's web site (cra.gc.ca).

6. The form must be filed with the CRA **before** the capital dividend is payable, and not later than the day it is paid.
7. Along with the Form T2054, you must file a **certified** copy (not an original!) of the directors' resolution authorizing the election to be made, as well as detailed schedules showing the computation of the corporation's capital dividend account.

Some of the steps described above can be corrected if you make a mistake, with applicable late-filing penalties. Others cannot be fixed. If you are using the capital dividend route to extract funds from a corporation, make sure you understand the details of these rules and do it right.

INCOME TAX ON DEATH

The income tax effects of death are complex and varied, and professional assistance is usually required to deal with both tax and legal issues. The following is a general overview of some of the issues.

Canada does not impose estate taxes, death duties or succession fees. Nor do any of the provinces. (The U.S. does impose estate taxes, on U.S. property as well as on all property of U.S. citizens.) Most provinces do impose probate fees or "estate administration tax", levied as a small percentage of the estate (e.g. 1.5% in Ontario) when a Will is probated through the courts.

Canada does impose a "death tax" of sorts. This is a **deemed disposition** of most of the deceased's property, which is deemed to take place immediately before death. The deceased is deemed to have received fair market value for each such property.

Since capital gains are half-taxed, the top tax rate on capital gains is about 20-23% in most provinces. Where the deceased owned capital property (such as shares or real estate) that increased significantly in value in the years before death, this can be a significant burden — especially if the property in question is not being sold to generate funds to pay the tax.

Property left to spouse or spouse trust

The most important exception to the "deemed disposition" rule is property that is left to the deceased's spouse (or common-law partner). The deemed disposition does not apply. Instead, the spouse inherits the deceased's cost base for the property along with the property. This is called a "rollover".

EXAMPLE

Henry dies in June 2011. He owns shares in a public company that originally cost him $10,000 but are now worth $70,000. In his Will, he leaves the shares to his wife, Elizabeth.

No tax applies to the shares on Henry's death, since he has left them to his spouse. However, Elizabeth will inherit the $10,000 cost base for the shares. If she sells them for $70,000, she will have a $60,000 capital gain, which will be a $30,000 taxable capital gain included in her income for tax purposes.

Note that if Henry had not left the shares to Elizabeth, the $60,000 capital gain ($30,000 taxable capital gain) would be triggered in Henry's hands on his death. His executor would have to report the $30,000 in Henry's income for the year of death, and Henry's estate would pay tax on this $30,000.

The same rollover applies where the property is left to a "spousal trust". This is a trust for the spouse (or common-law partner). All of the income from the trust must be payable to the spouse. As well, no-one other than the spouse must be able to receive any capital of the trust during the spouse's lifetime. Property that is left by Will to a trust that meets these requirements will not trigger the deemed disposition. Again, the trust "inherits" the deceased's cost base of the property together with the property.

In both of these cases (spouse and spousal trust), the executor of the estate can elect for the rollover not to apply to any given property. This may be useful where it is desirable to trigger a capital gain in the deceased's estate, such as where the deceased has unused capital losses.

Special rules on death

Aside from the deemed disposition of capital property, the Income Tax Act has a number of special rules that apply on death. For example:

- Donations made in the deceased's Will are deemed to have been made before death, so they can be used in the same way (as discussed in more detail below). As well, the donations limit of 75% of net income, which applies to living taxpayers, is increased to 100%, so with sufficient donations, all of the deceased's income tax can be eliminated.
- Medical expenses, which can normally be claimed for a 12-month period ending in the year, can be pooled for any 24-month period that includes the day of death. This leads to a larger credit, since the threshold of "3% of net income" or $2,052, below which no medical expenses can be claimed, applies to a full 24 months' worth of expenses.
- The full amounts of the deceased's Registered Retirement Savings Plan (RRSP) and Registered Retirement Income Fund (RRIF) are brought into income for the year of death, unless the beneficiary is the deceased's spouse or certain dependants and certain elections are made. If these funds are not transferred to the spouse's or dependant's own RRSP, the spouse or dependant must then report the funds as income for tax purposes.
- Any balance borrowed by the deceased from an RRSP under the Home Buyer's Plan or Lifelong Learning Plan and not yet repaid must normally be included in income, though an election may be available to have the liability assumed by the deceased's spouse.
- The Alternative Minimum Tax (AMT) does not apply to the year of death.
- Certain kinds of income (called "rights or things") not received by the deceased before death can be reported on a separate return, against which the deceased's personal credits can be claimed a second time.
- Up to $10,000 of death benefits can be paid tax-free by the deceased's employer to the surviving spouse or other family members.

Donations made by Will

Charitable donations made in one's Will can reduce or eliminate the "death tax" that results from a deemed disposition of capital property on death. In addition, there is **no capital gain** on donations of publicly-traded shares or mutual fund units (this applies to all taxpayers, not just those who are deceased). Thus, donating such securities where they have accrued capital gains is far better than selling them, paying tax on the capital gain, and donating the cash.

Any charitable donations made in one's Will that are not used for the deceased's terminal year are considered to have been made by the deceased. As noted above, they can be **carried back** and used on the previous year's return. If that return has already been filed, this can produce a refund to the estate.

Income tax returns

The deceased's terminal return (return for the final year of life) must be filed by the usual deadline (April 30 or June 15), but is extended to **6 months after death** if that date is later than the usual deadline.

The deceased's **estate**, which is considered to be a trust for tax purposes, will be required to file an annual T3 trust return until the affairs of the estate are wound up and all assets are distributed to beneficiaries. If the deceased's Will creates any trusts (known as "testamentary trusts"), those trusts will also normally have to file annual T3 returns for as long as they are in existence. These returns are all due **90 days** after each year-end.

AROUND THE COURTS

'House hopper' gets a GST break

The GST/HST system has special rules to ensure that tax is paid on a new home as soon as someone lives in the home. If the builder builds a new home and then rents it out, or moves in personally, GST or HST is triggered on the value of the new home. This is called the "self-supply" rule.

Some builders make a practise of building a home, moving in with their family, selling it at a profit, and then doing the same thing over and over with other homes. The CRA (and, in Quebec, Revenu Québec) will assess such "house hoppers" for GST or HST on the new homes as well as for income tax on their profits. (The principal-residence income tax exemption

does not apply because it applies only to capital gains, and such a builder's gain is a business profit.)

In the recent *Coates* case, a builder managed to avoid the GST self-supply rule, due to a broad interpretation of an exclusion to the rule. Coates worked for a construction company. Over the course of six years, he built four houses on the same block (all within 130 metres of each other), and moved into each one in turn, selling the previous one. The CRA assessed him on the basis that the self-supply rule applied to the third home, and that he was required to remit GST on the value of that home. Coates appealed to the Tax Court of Canada.

Justice Hogan of the Tax Court allowed the appeal. He ruled that Coates was a "builder" of the home as that term is defined in the GST legislation. However, an exclusion applied, because Coates' primary "use" of the home was as a place of residence, even though he also had the intention to sell it.

The Canada Revenue Agency did not appeal the *Coates* decision. The result differs from a number of earlier cases, which had held that a builder in this situation does not primarily "use" the home as a place of residence because the builder holds the home as inventory for sale. If the Courts follow the *Coates* decision, other builders may get a break from the GST liability that would otherwise apply.

* * *

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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