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**DRAFT LEGISLATION
ON CONTINGENT
AMOUNTS**

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DRAFT LEGISLATION ON CONTINGENT AMOUNTS

Under the Income Tax Act, a cost or expense for the purpose of earning income from a business or property is normally deductible in the year in which it is incurred. An expense is incurred in the year in which you have the legal obligation to pay it, even if it is due in a subsequent year.

If the expense is conditional upon an event that may or may not occur, the expense is not recognized, if at all, until the condition is fulfilled and the expense is unconditional. In other words, a “contingent” liability is not normally recognized.

On March 16, 2011, the Department of Finance released draft legislation that effectively expands the concept of contingencies. The draft legislation provides that where a taxpayer incurring an expense has a “right to reduce” all or part of the expense (say, in a future year), the amount that may be so reduced is a “contingent amount”. This announcement is designed to overturn the effect of a 2010 Federal Court of Appeal decision, *Collins v. The Queen*.

For these purposes, a “right to reduce” an amount includes a right to reduce or eliminate the amount, including a right that is contingent upon the occurrence of an event, or in any other way, if it is reasonable to conclude having regard to all the circumstances, that the right will become exercisable.

The contingent amount of the expense reduces the amount of the expense for income tax purposes. However, if you subsequently pay the amount, it is recognized in the year in which you pay it. The amount you pay is deemed to have been incurred for the same purpose and to have the same character as the original expense. Therefore, for example, if the expense would have been otherwise deductible as a current expense from your business, the amount you subsequently pay should be deductible as a current expense from your business.

The draft legislation can potentially apply to any expense or expenditure, including the cost of capital property.

The draft legislation applies to taxation years that end on or after March 16, 2011. Although it will not be enacted by Parliament for many months, it will almost certainly be enacted in due course.

PENSION INCOME SPLITTING

If you receive “eligible pension income” in a taxation year, you can elect to split up to 50% of the income with your spouse (or common-law partner). The income-splitting will be beneficial if your spouse is in a lower tax bracket. Your spouse does not have to be a “pensioner” in order to split the pension income; in other words, you can split the eligible pension income regardless of your spouse’s age.

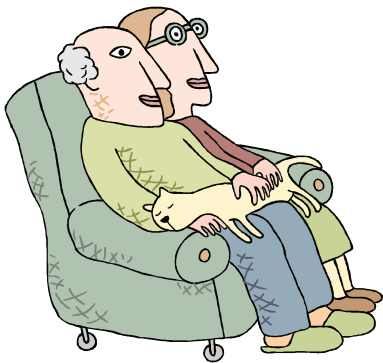
The election to split the income is a joint election (Form T1032, Joint Election to Split Pension Income), filed with both of your tax returns for the relevant year. The joint election applies only to that taxation year, so you must make the election for each year in which you want to split the income.

For these purposes, if you are 65 or older, your eligible pension income includes annuity payments from a registered pension plan (RPP), registered retirement savings plan (RRSP), deferred profit sharing plan (DPSP), and payments from your registered retirement income fund (RRIF). If you are under 65, the eligible pension income is more restricted and basically includes annuity payments from an RPP, and the other payments listed above but only if they are received by you as a consequence of the death of your former spouse or common-law partner.

Any income tax that is withheld from your eligible pension income is allocated to your spouse in the same proportion that the pension income is split. For example, if you included 60% of the pension income and split the remaining 40% with your spouse, 60% of the tax withheld on the pension income is deemed to be withheld on your behalf and 40% of the tax withheld is deemed to be withheld on behalf of your spouse.

In addition to splitting the income, which should in itself save tax, both you and your spouse may be able to claim the pension credit on up to \$2,000 of eligible pension income. Thus, you can effectively double-up on the pension credit, if you both qualify. For these purposes, the income must be eligible pension income in the hands of your spouse for his or her credit, as described above.

For example, if you are 65 or older and receiving payments from your RRIF (not as a consequence of the death of a former spouse), your spouse will qualify for the pension credit on the split pension amount only if she is over 65 years. If she is under 65, she will not qualify for the credit even though you will qualify.



The pension income splitting may also be beneficial if you are subject to the old age security “claw-back tax”. This tax generally applies when you receive old age security benefits and your net income for the year exceeds a threshold amount (\$67,668 for 2011), and it effectively prevents you from receiving OAS benefits. Reducing your net income via the pension income split can reduce or even eliminate your claw-back tax (though in some cases it can have a negative impact, if you are already subject to the full claw-back and the split pension income makes your spouse subject to the clawback!).

There are other considerations that can come into play in determining whether and to what extent you should split your pension income. For example, the federal age tax credit for individuals 65 years of age and over is phased out when net income exceeds a threshold amount (\$32,961 for 2011). Splitting pension income with your spouse could increase your age credit.

Conversely, you could end up putting your spouse over the age income threshold, thus reducing his or her age credit. However, the reduction in your spouse’s age credit, if any, might be more than offset by your tax savings if you are in a higher tax bracket (that is, the age credit is computed using the lowest 15% marginal rate). You will have to calculate the taxes both ways to determine whether the income split is helpful to you.

DEDUCTING PREMIUMS ON LIFE INSURANCE USED AS COLLATERAL

As a general rule, life insurance premiums are not deductible for income tax purposes. However, there is an exception if you assign an interest in your life insurance policy to a financial institution as collateral for a loan.

In particular, premiums payable under a life insurance policy are deductible if the following conditions are met:

- The policy is assigned to a financial institution in the course of a borrowing from the institution;
- The interest on the borrowing is otherwise deductible (e.g. the borrowing is used for the purpose of earning income from a business or property); and
- The assignment of the policy is required by the institution as collateral for the borrowing.



If these conditions are met, the insurance premiums payable in respect of the year is deductible in computing your income, up to a limit of the “net cost of pure insurance” in respect of the year. This figure can be obtained from your insurance company, and reflects the cost of the pure insurance coverage under the policy for the year, so that, for example, it does not include any savings component under the policy.

The deduction is limited to the extent that the above amount can reasonably be considered to relate to the outstanding amount owing from time to time during the year. Thus, if the amount of the borrowing is less than the amount of insurance coverage, the deduction will be limited.

The Canada Revenue Agency (CRA) provides an example where the life insurance coverage under an assigned insurance policy is \$500,000 and the amount owing under the loan throughout a taxation year is \$200,000. In such case, the amount deductible is limited to 40% ($\$200,000 / \$500,000$) of the lesser of the premiums payable and the net cost of pure insurance under the policy for the year.

In order to claim the deduction, it is not necessary that a new life insurance policy be taken out at the time of borrowing. The assignment of an existing policy is acceptable. However, the CRA states that such an assignment must satisfy a “bona fide requirement” of the financial institution and not be an accommodation made to you in an attempt to qualify for the deduction.

Furthermore, it is not necessary that the person claiming the deduction be the person whose life is insured under the policy. Thus, for example, a corporation with a life insurance policy on one of its executives can claim the deduction as long as the above criteria are met.

TRANSFERS TO SPOUSES

You can transfer capital property to your spouse or common-law partner without immediate tax consequences. The transfer is deemed to take place at your cost of the property, and your spouse takes over the same cost of the property. Thus, any accrued gain is not recognized on the transfer (but will be taxed when your spouse disposes of the property). This rule applies to all transfers, including gifts and sales of property. It is sometimes referred to as the “spousal rollover”.

The spousal rollover also applies to transfers made to your former spouse or common-law partner in settlement of rights arising under the marriage



or common-law partnership. Thus, for example, it applies where you are required to transfer property to your former spouse upon your divorce under family law legislation.

However, you can elect out of the spousal rollover. You make the election in your tax return for the year in which you transfer the property. If you make the election, the transfer is deemed to take place at the fair market value of the property, and your spouse's cost is also deemed to be that fair market value.

If you elect out of the rollover and the property has an accrued capital gain at the time of the transfer, you will need to report the capital gain. However, it may be beneficial to trigger the capital gain in some cases. For example, you may have capital losses or net capital loss carryovers that can offset the gain, while bumping up the cost of the property for your spouse. Alternatively, if the property is eligible for the \$750,000 lifetime capital gains exemption (qualified small business corporation shares and qualified farm or fishing property), you can shelter the resulting gain with your available exemption.

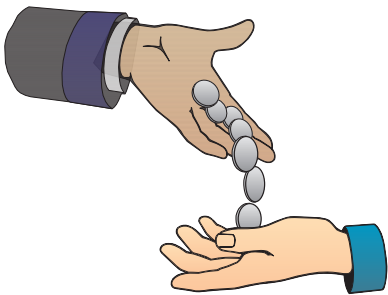
Another reason to elect out of the spousal rollover is to avoid the application of the income attribution rules after the transfer of the property. Generally, those rules can apply and attribute any income from the transferred property back to you, but there is an exception if you sell the property to your spouse for fair market value proceeds and elect out of the spousal rollover.

Lastly, if you elect out of the rollover and there is an accrued loss on the property, your loss will normally be denied under the superficial loss rules. If so, the loss so denied will be added back to your spouse's cost of the property.

CARRYOVER OF LOSSES

The Income Tax Act provides various carryover provisions for losses that cannot be used in a taxation year. These rules apply to both individuals and corporations.

A “**non-capital loss**” generally occurs when your business or property losses for a taxation year exceed your income from all sources for the year. For example, if you have a \$50,000 business loss in a year and \$20,000 of employment income for the year, your non-capital loss will be \$30,000. You can carry back the loss up to three years to offset all sources of income in



those years. In terms of carry-forwards, for losses that arise in 2006 and subsequent years, you can carry them forward up to 20 years to offset income in those years. For losses that arise in taxation years that end after March 22, 2004 and before 2006, the carry-forward period is 10 years, and for losses in years before that the carry-forward period is 7 years.

Farming losses (generally, losses from a farming business) are now subject to the same carryover periods as non-capital losses. However, for farming losses arising before 2006, the carry-forward period is 10 years and the 7 year limit described above does not apply. (There are limits on the amount of “restricted farm losses” that can be claimed; these are generally losses incurred by part-time or hobby farmers.)

A “**net capital loss**” occurs when your allowable capital losses for the year exceed your taxable capital gains for the year. (One-half of a capital loss is an allowable capital loss, and one-half of a capital gain is a taxable capital gain.) A net capital loss can be carried back 3 years and forward indefinitely to other years, but can be claimed only to the extent of your taxable capital gains for the other year. An exception applies in the year of death and the preceding year, in which case the net capital loss can offset all sources of income.

An “allowable business investment loss” (ABIL) is generally one-half of a capital loss on debt or shares in certain small business corporations. Unlike regular capital losses, an ABIL arising in a year can offset all sources of income in the year. An unused ABIL in a taxation year can be carried back 3 years or forward 10 years to offset all sources of income for those years (for losses that arose in taxation years that ended before March 23, 2004, the carry-forward period is 7 seven years). However, any unused ABILs remaining at the end of the 10-year carry-forward period (or 7-year period, as the case may be), become net capital losses, and therefore can be carried forward indefinitely but only to offset taxable capital gains and not other sources of income.

Capital losses on personal-use property are not normally claimable for income tax purposes, except in the case of “listed personal-use property” (LPP), which is art, jewellery, rare books, stamps and coins. If your losses from LPP in a year exceed your gains from LPP in a year, the excess can be carried back 3 years or forward 7 years to offset gains from dispositions of LPP in those other years. Half of your net gains, if any, are then included in your income (i.e., the same as for other capital gains). Losses from LPP cannot be used to offset gains from other types of property.



If you are a limited partner in a partnership, your share of the loss of the partnership for a taxation year is limited to your “at-risk amount” in respect of the partnership. In very general terms, the at-risk amount reflects your cost of your interest in the partnership less amounts you owe to the partnership and any amount or benefit to which you may be entitled for the purpose of reducing the impact of your loss. The limited partnership loss in excess of the at-risk amount can be carried forward indefinitely to future years, but again can only be deducted to the extent of your at-risk amount in each future year. Limited partnership losses cannot be carried back to previous years.

PRESCRIBED INTEREST RATES

The CRA recently announced the prescribed annual interest rates that will apply to amounts owed to the CRA and to amounts the CRA owes to individuals and corporations. These rates are reset each calendar quarter. The following rates are in effect from April 1, 2011 through June 30, 2011 (all are annual rates, compounded daily):

- The interest rate charged on overdue taxes, Canada Pension Plan contributions, and Employment Insurance premiums will be 5%.
- The interest rate on late refunds paid to corporations will be 1%.
- The interest rate on late refunds paid to other taxpayers will be 3%.
- The interest rate used to calculate taxable benefits for employees and shareholders from interest-free and low-interest loans will be 1%.

The same rates applied to the first quarter of 2011 and throughout 2010 (except that interest on late refunds paid to corporations was 3% from January to June 2010).

AROUND THE COURTS

Moving expenses allowed even though same employer

You are normally allowed to deduct moving expenses incurred in moving to a new home if the move enables you to carry on business or employment in a new work location, and your new home is at least 40 kilometres closer to the new work location relative to your former home.

In the recent *Dierckens* case, the taxpayer worked as a school bus driver for 10 years before moving to a new home that was 47 kilometres closer to





her work place. She attempted to deduct her moving expenses. However, the CRA denied the deduction. The CRA was of the view that since the taxpayer had been working for the employer for 10 years before the move, the move did not enable her to work in a new work location.

On appeal, the Tax Court of Canada allowed the deduction. The Court found that the move “enabled” the taxpayer to carry on employment, even though she had been employed before the move by the same employer. The Court held that the wording of the relevant provision in the Income Tax Act does not require the taxpayer to make the move within a certain amount of time after the commencement of the employment: “If a move within one month of commencing such employment enables a person to be employed at that location, then a move within two months of commencing such employment would also enable the person to be employed at that location, as would a move within one year or two years and so on...”

“Donations” did not qualify for charitable tax credit

The Federal Court of Appeal has upheld a decision in a case involving donations to a registered charity, which in turn provided bursaries and scholarships to children or grandchildren of the donors.

In the case, *Ballard (Coleman)*, students who enrolled in certain Christian universities solicited donations from their family members. Each student could earn a bursary of 80% of the amount of donations the student solicited and a scholarship of another 10% to 20% of the amount of those donations, up to a maximum amount that reflected tuition, housing and other educational costs at the university.

The issue in the case was whether the donations made by a parent of a student, which were solicited by the student, were gifts that qualified for the charitable tax credit. The CRA argued that the credit did not apply, because the parent’s “donation” was made with the expectation that the student would receive bursaries and scholarships equal to all or almost all of those donations.

The Tax Court of Canada agreed with the CRA and denied the tax credit, and upon appeal, the Federal Court of Appeal upheld the decision. The Court of appeal found that the facts of the case justified the Tax Court’s conclusion that there was sufficient certainty that each “donation” would result in a bursary or scholarship being awarded to the student, and that they were in fact awarded to students in the vast majority of cases, including the students involved in this particular case.



Note that draft legislation, which was not considered in the case, could apply to similar fact situations. The draft legislation provides that a donation is not disqualified solely on the grounds that the donor receives back an “advantage”, as long as the advantage does not exceed 80% of the amount of the donation. Under the draft legislation, the donation could still qualify for the charitable tax credit, although the amount of the donation for these purposes would be reduced by the amount of the advantage received by the donor.

* * *

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.

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