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TAX LETTER

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THE CAPITAL GAINS EXEMPTION

The capital gains exemption is a deduction in computing taxable income that exempts up to $750,000 of capital gains ($375,000 of taxable capital gains, which is the half of capital gains that is included in income for tax purposes) from taxation during your lifetime. The exemption applies to capital gains from dispositions of shares in a qualified small business corporation ("QSBC shares").

In order for a share to qualify as a QSBC share, it must be a share of a "small business corporation". This is a Canadian-controlled private corporation, all or substantially all of the fair market value of the assets of which is attributable to assets that are (1) used principally in an active business carried on primarily in Canada by the particular corporation or by a corporation related to it, or (2) shares or indebtedness of one or more other small business corporations. For the above purposes, the Canada Revenue Agency (CRA) takes the position that "all or substantially all" means 90% or more.

Furthermore, there are a couple of holding-period tests that must be met.

First, as a general rule, you or a related person must have owned the share for a period of at least 24 months immediately prior to the disposition. (If you incorporate an existing business by transferring all your business assets to a corporation, this requirement does not apply.)

Second, through the 24-month period, more than 50% of the fair market value of the assets of the corporation must have been attributable to (1) assets used principally in an active business carried on primarily in Canada by the corporation or by a corporation related to it, or (2) shares or indebtedness of one or more other Canadian-controlled private corporations (and those other corporations must meet similar tests).

A Canadian-controlled private corporation is generally a private corporation resident in Canada that is not controlled by non-residents, public corporations, or a combination thereof.

The capital gains exemption is reduced by the amount of allowable business investment losses (ABILs) claimed by you in the year or in previous years. An ABIL is generally one-half of a capital loss from certain dispositions of shares or debt in small business corporations.

> *EXAMPLE*
>
> In 2012, you dispose of QSBC shares for a taxable capital gain of $400,000. You have not previously used any of your capital gains exemption. In 2011, you had an ABIL of $10,000.
>
> One-half of your capital gain, or $200,000, is your "taxable capital gain".
>
> Of the $200,000, $190,000 will be exempt. The other $10,000 will be included in your taxable income for 2012.

Additionally, the capital gains exemption that can be claimed in a year is reduced by your cumulative net investment loss (CNIL) at the end of the year, which is generally the total of your investment expenses in excess of your investment income for the year and preceding years (going as far back as 1988).

On a final note, the capital gains exemption also applies to dispositions of qualified farm property and qualified fishing property. There are certain asset and holding period tests that must be met for these properties as well.

NEW RRSP PENALTIES

In last year's budget, the government introduced new penalty taxes that apply to certain transactions with and property invested in a registered retirement savings plan (RRSP) or registered retirement income fund (RRIF). The new penalties effectively piggy-back onto the penalty taxes that already applied to tax-free savings accounts (TFSAs) in respect of "advantages", "prohibited investments", and "non-qualified investments".

There is a special tax that applies when a prohibited investment or non-qualified investment is acquired by an RRSP or RRIF, or where an existing property becomes a prohibited or non-qualified investment. The tax is 50% of the fair market value of the property. The annuitant of the plan (i.e. the taxpayer) is liable to pay this tax.

For these purposes, a non-qualified investment is simply one that does not qualify as an investment for the plan under the rules of the Income Tax Act and regulations.

A prohibited investment is defined more narrowly, and includes a debt of the annuitant of the plan, and a share, interest, or debt of a corporation, partnership or trust in which the annuitant has a "significant interest" (generally, 10% or more of the shares of any class of the corporation, or a 10% or more interest in the partnership or trust based on fair market value). However, a mortgage debt that is administered by an approved lender under the National Housing Act, and insured under that Act or by a qualified lender, is not a prohibited investment and such debt is also a qualified investment for the RRSP or RRIF.

There is also a penalty tax on the amount of an "advantage" conferred upon the annuitant of an RRSP or RRIF. There are several types of advantages. For example, benefits and certain types of loans that are conditional upon the existence of the plan can be an advantage (there are certain exceptions such as loans with arm's length-type terms and conditions). The tax is 100% of the amount of the advantage – for example, the fair market value of the benefit or the amount of the loan.

The new rules add a "RRSP strip" to the list of advantages that are subject to the 100% tax. An RRSP strip is generally an amount used or obtained by the annuitant of an RRSP or RRIF in a transaction where one of the main purposes is to enable the annuitant (or a person not dealing at arm's length with the annuitant) to use or obtain the benefit of property held in connection with the RRSP or RRIF, with certain exceptions. The Department of Finance indicates that one example of an RRSP strip is an artificial loan from the RRSP where there is no expectation of repayment. Specifically excluded from the definition of advantage are withdrawals from an RRSP under the Home Buyers' Plan and the Lifelong Learning Plan (described in the next part of this letter).

Income from prohibited investments in the plan is considered an advantage and subject to the 100% tax described above.

Income earned by an RRSP or RRIF on a non-qualified investment is subject to regular income tax. However, any income earned on that income (so-called second generation income) that remains in the plan can become subject to the 100% tax on advantages if it is not removed within 90 days after receipt of a notice from the CRA directing its removal.

The new penalty taxes generally apply to transactions occurring, income earned, capital gains accruing and investments acquired, after March 22, 2011. There are some transitional rules under which the penalty taxes will not apply.

With the new penalty taxes now in force, the former penalties that applied to non-qualified investments in an RRSP (inclusion in income for annuitant of the fair market value) and the 1% per month penalty tax that applied where a qualified property became non-qualified investment, no longer apply.

RRSP LIFELONG LEARNING PLAN

Normally when you withdraw an amount from your RRSP, the amount is fully included in your income. However, under the RRSP Lifelong Learning Plan (LLP), you can withdraw funds from your RRSP on a tax-free basis for the purpose of studying at a post-secondary educational institution. The funds can also be used to fund the education of your spouse or common-law partner.

The maximum amount that can be withdrawn under the plan is $20,000, although you are limited to $10,000 per calendar year. If you are married or in a common-law relationship, you and your spouse or common-law partner can each withdraw from your RRSPs, for a total of $40,000.

At the time of the withdrawal, you must either be enrolled on a full-time basis, or have received an offer to enroll before March of the following year. If you are eligible for the disability tax credit, or have a mental or physical impairment such that you cannot reasonably be expected to be enrolled as a full-time student (and this condition is certified by a doctor or other qualifying medical specialist), you can be a part-time student.

The amounts withdrawn under the LLP must be repaid to the RRSP over a period not exceeding 10 years. The repayment period begins at the earlier of the second consecutive year in which you are not enrolled in full-time studies and the fifth year after the first year in which an LLP withdrawal was made. A minimum of one-tenth of the withdrawal must be paid in each year or within 60 days after the end of the year. You repay the amounts by contributing to your RRSP (as with a regular contribution) and designating in your tax return for the year the amount you are repaying. The repayments are not tax deductible.

If you repay less than the minimum one-tenth amount in a taxation year, the shortfall is included in your income for that year. Conversely, a payment in excess of the minimum amount required in any particular repayment year reduces the amount that must be repaid in subsequent years.

No interest is payable on the amounts withdrawn under the LLP.

Note that you can withdraw under the LLP even if you have withdrawn from your RRSP under the "Home Buyer's Plan". Under that plan, you can withdraw up to $25,000 from your RRSP on a tax-free basis to purchase a home (provided you repay the funds to your RRSP over 15 years starting the following year). In other words, you can use both the Home Buyer's Plan and the LLP program at the same time.

TRANSFER OF DIVIDEND TAX CREDIT TO SPOUSE

A gross-up / dividend tax credit mechanism under the Income Tax Act provides individual shareholders with a credit meant to compensate them for part or all of the tax paid by the corporation paying them a dividend. The credit applies to dividends received from taxable Canadian corporations.

In the case of an eligible dividend (e.g. most dividends paid by public corporations), the dividend is grossed up by 38% (for 2012), so 138% of the dividend is included in income. The individual then gets a federal tax credit equal to 6/11 of the gross-up. The provincial dividend tax credit varies by province but is typically about half of the federal credit.

For other dividends (e.g. paid by a Canadian-controlled private corporation out of its active business income subject to the small business tax rate), the dividend is grossed up by 25%, and the federal dividend tax credit is 2/3 of the gross up. Again, the provincial credit varies by province.

The dividend tax credit is not refundable, that is, it can only reduce your tax to zero and cannot generate a refund. Furthermore, it cannot be carried forward to another year. Therefore, if you cannot use it, you normally lose it.

However, in certain cases, a low-income spouse ("transferor") with dividend income who cannot use the credit can effectively transfer it to the other spouse ("transferee"). The credit can be transferred if the exclusion of the dividend from the transferor's income (with the corresponding inclusion in the transferee's income) would create or increase the transferee's spousal tax credit. The spousal credit is 15% of ($10,822 minus transferor's income for the year), meaning that it is eliminated once the transferor's income for the year reaches $10,822 (for 2012).

The transferee must elect in his or her tax return for the year to have this rule apply.

EXAMPLE

In 2012, John has part-time employment income of $5,302 and he receives an eligible dividend of $4,000. His spouse Brenda is in the 22% federal tax bracket for the year. Brenda is considering whether to make the election to have the dividend included in her income (we will assume she would still be in the 22% bracket).

Result without election: John pays no tax because of his basic personal credit (15% of $10,822), and cannot use the dividend tax credit. However, Brenda gets no spousal tax credit and of course no dividend tax credit.

Result with election: John still pay no tax because of the basic personal credit. Brenda includes in income the $4,000 eligible dividend plus the 38% gross-up ($1,520), for a total inclusion of $5,520. The initial federal tax on that amount at 22% is $1,214. However, the dividend tax credit of 6/11 of $1,520 equals $829. Furthermore, Brenda's spousal credit becomes 15% of ($10,822 - $5,302) or $828. As such, Brenda ends up saving $443 in federal tax ($829 + $828 - $1,214). (And she will likely save provincial tax as well.) Therefore, the election is advantageous.

DONATIONS OF PUBLICLY-LISTED SECURITIES

Normally, when you donate property to a registered charity, there is a deemed disposition of the property at its fair market value. This deemed disposition can generate a capital gain if the fair market value of the property exceeds your cost of the property, and half of that gain is a taxable capital gain that is included in your income. The fair market value of the property qualifies for the charitable donation tax credit, which applies at the top federal rate of 29% (on the amount of your annual donations over $200). The top provincial rate will also apply on the donation.

However, if the property is a publicly-listed security – for example, shares and bonds listed on a stock exchange and units in a mutual fund – the resulting taxable capital gain on the deemed disposition is zero. Furthermore, the full value of the property qualifies for the tax credit, which can lead to a significant savings in tax.

EXAMPLE

You donate publicly-listed shares to a charity. Your cost of the shares was $1,000 and their fair market value is $10,000. (We will assume you have already donated at least $200 in the year, so that the 29% credit applies to this donation.) Your federal donation credit will be 29% of $10,000, or $2,900. If the provincial donation rate is 15% (this varies by province), your provincial credit will be $1,500. Therefore, you have a total tax credit, or savings in tax, of $4,400.

You will have a capital gain of $9,000 ($10,000 deemed proceeds minus $1,000 cost). Normally, half of that, or $4,500, would be included in your income. If you were in the top federal and provincial tax brackets, the tax on such amount at 44% (29% + 15%) would have been $1,980. However, since the taxable capital gain is deemed to be nil, there is no tax so you effectively save another $1,980 in tax.

Your net donation is effectively: $10,000 minus ($4,400 credit + $1,980 tax savings that would have applied if you had sold the shares) = $3,620.

Note that a new rule introduced last year restricts you from having a tax-free capital gain if you donate flow-through shares that you acquired under an agreement entered into after March 21, 2011. Flow-through shares (used in the oil & gas and mining industries) give you a full deduction when you buy them, and your cost base is normally zero. The capital gain when you donate such shares will be taxed, to prevent excessive tax savings.

PUBLIC TRANSIT CREDIT

The federal public transit credit is meant to encourage people to take public transit (although some have argued that it simply rewards people who were taking public transit anyway). The credit is 15% of the total costs of "eligible public transit passes" or "eligible electronic payment cards" attributable to the year.

An eligible public transit pass means a public transit pass that allows (1) an unlimited number of trips during an uninterrupted period of at least 28 days, or (2) an unlimited number of trips in at least 5 consecutive days, as long as there are at least 4 of those 5-day periods in a 28-day period.

An eligible electronic payment card is a card used by for at least 32 one-way trips during an uninterrupted period not exceeding 31 days.

In claiming the credit, in addition to counting the costs of your passes and cards for the year, you can include those of your spouse or common-law partner and any of your children who have not turned 19 in the year. You can either claim all of the costs yourself, or share them with your spouse or children.

APPRENTICE TAX CREDIT

The apprentice tax credit is meant to encourage and assist in the hiring of apprentices in certain trades. The credit can be claimed by employers for salaries and wages paid to qualifying apprentices. The credit is 10% of the salary or wages paid to a qualifying apprentice for the first 24 months of the apprenticeship, to a maximum credit of $2,000 per year per apprentice (10% of $20,000 of the salary and wages).

For these purposes, a qualifying apprentice is a person in an apprenticeship program designed to certify or license individuals in a trade that is a Red Seal trade for a province under the Interprovincial Standards Red Seal Program (see red-seal.ca).

If the credit is not usable for a year, it can be carried back 3 years or forward 20 years, to offset tax in those years.

If the qualifying apprentice is employed by two or more related employers, the $2,000 limit must be allocated to one employer only.

AROUND THE COURTS

Taxpayer not entitled to deduct spousal support

If you make spousal support payments to your spouse or former spouse (or common-law partner), they are deductible in computing your income if they meet the conditions set out in the Income Tax Act. Two of the conditions are that the amount paid to the recipient must be an allowance payable on a "periodic" basis, and that the recipient must have discretion over the use of the funds. (An exception, where certain expense paid directly to third parties can qualify without meeting these conditions, was discussed in last month's Tax Letter.)

In the recent *Hurst* case, the taxpayer and his spouse separated in July 2008. For the next 11 months, he paid her various amounts for her own use and also some of her property tax and hydro bills ("miscellaneous payments"). On June 10, 2009, the parties agreed upon the spousal support that he should pay, and this was set out in a consent order. Under the order, he was required to pay his spouse a lump sum of $15,000 in full satisfaction of underpaid spousal support up to June 30, 2009 – that is, the amount that the parties agreed should have been the total support paid up until that time minus the amounts he actually paid as set out above. The taxpayer attempted to deduct the miscellaneous payments and the $15,000 lump sum as spousal support.

The CRA denied the deduction and on appeal the Tax Court of Canada agreed with the CRA. In respect of the miscellaneous payments, the Court found that those payments were made voluntarily and not pursuant to an existing order or agreement. Furthermore, the payments for the property taxes and hydro bills did not meet the "discretionary use" requirement described above.

As for the $15,000 lump sum payment, it similarly did not meet the conditions of a deductible support payment. The payment was not periodic and was not made pursuant to a pre-existing order or agreement. As such, it was not deductible.

With proper planning, at least some of the miscellaneous payments could have been made deductible in this case. There is a special rule in the Income Tax Act that allows a taxpayer to deduct payments made prior to the making of the order (or agreement), if the order specifically states that previous payments made in the year of the order or in the preceding year are to be considered support amounts.

* * *

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