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TAX LETTER

December 2012

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YEAR-END TAX PLANNING IDEAS

It's December, and time to think of some tax planning ideas. If you wait until your tax return is due next April or June, it will generally be too late to change your tax situation for this year.

Below, in no particular order, are some ideas and tips which may be useful to you before year-end.

1. Charitable Donations

Charitable donations have to be made by December 31 to be counted for this year.

Charitable donations receive special tax assistance. Once your donations exceed $200 per year, they give you a tax credit calculated at the highest marginal rate. If your taxable income for 2012 (after all deductions) exceeds $132,406, the charitable donations credit is worth the same as a deduction. If your taxable income is lower, then the donations credit is *better* than a deduction, as the credit is usually around 45% of the donation. (In Alberta, a special high credit for donations brings the value of the donation up to 50%.)

In fact, if you are not in the top tax bracket, you can benefit by receiving income and donating the excess to a charity. This may be possible if you already volunteer for a charity. If the charity pays you for your volunteer work, and you donate the income back to the charity, your tax bill will go down.

For example, suppose you are in a 30% tax bracket (including provincial tax), and you have already made over $200 in donations this year. If the charity pays you $10,000 for work you have done for it, your tax bill will go up $3,000 (maybe a bit higher, if you move up to the next bracket). If you donate the same $10,000 back to the charity, your tax bill will go down about $4,500 (varying slightly by province). The net is a saving of about $1,500 after tax.

An even simpler technique is to have the charity reimburse you for expenses you incur as a volunteer (e.g., travel and parking costs). Such reimbursements, provided they are reasonable, are not taxable to you. You can then donate the reimbursed amount back to the charity and get a tax credit.

Another idea to consider is donating publicly-traded shares or mutual fund units to a charity. If you do this, you do not report any taxable capital gain on the securities, but the donation is valued for tax purposes at its current fair market value. If you are considering making a donation to a charity, and you have some securities that have gone up in value, donating the securities will be very tax effective.

You can claim charitable donations up to 75% of your "net income" for tax purposes. Net income is basically your income after most deductions, but before claiming the capital gains deduction (capital gains exemption) or any loss carryovers from other years.

There are proposed laws to prevent "art flip" schemes but they have not been enacted into law.

2. Owner-manager remuneration

If you own a small business that is incorporated and has a December 31 year-end, you will want to make year-end decisions about paying yourself (or family members) a bonus to reduce the corporation's income and possibly split income. Traditionally, private corporations used to "bonus out" their income over the small business deduction threshold, which is now $500,000. However, the calculations have changed in recent years. Dividends from income taxed at the high rate (so-called "eligible dividends") now generate a higher dividend tax credit, and the corporate tax rate has gone down.

3. RRSP contributions

If either you or your spouse are not yet 71 this year, then you can normally make contributions to a registered retirement savings plan (RRSP) and deduct them from your income for tax purposes.

Your available RRSP contribution room should be printed on the Notice of Assessment that you received from the Canada Revenue Agency (CRA) after you filed your 2011 return in the spring of 2012. Your maximum contribution room for 2012 is:

18% of your 2011 earned income
(maximum $22,970 if your 2011 earned
income exceeded $127,611)
minus
your pension adjustment
plus
any contribution room from earlier years
since 1991 that you have not yet used up.

Your deadline for contributions for 2012 is **March 1, 2013**. However, if you have any excess cash you should consider planning

for your 2013 contribution as well. You can make that contribution any time from January 1, 2013. Putting funds into an RRSP will allow them to grow tax-free, rather than you having to pay tax on any income on the funds that you earn during the year. (You can also put $5,000 per year, cumulative since 2009, into a tax-free savings account, or TFSA, for which you get no deduction but the income will not be taxable.)

Consider also a contribution to a **spousal RRSP**. (This also applies to a common-law partner or same-sex partner even if you are not legally married.) Your maximum deductible contribution is the same regardless of whether you contribute to your RRSP or your spouse's, or some combination of the two. If your spouse is likely to have lower income than you in future years, then a spousal RRSP contribution will allow your spouse to take the income out down the road (once the third year has passed from when you make any spousal contributions). Your spouse will then pay tax on that income at a lower rate than you would if you withdrew the funds from your own RRSP.

A spousal RRSP is also useful if you are already over 71 but your spouse is younger. Once you reach the year in which you turn 71, you cannot contribute to your own RRSP and must convert your RRSP to an annuity or a registered retirement income fund (RRIF) from which you draw income every year. However, you can still make contributions to a spousal RRSP if your spouse is under 71 at year-end.

4. Trigger capital losses

If you have capital gains this year — for example, from selling some shares for a gain earlier in the year — you may wish to trigger capital losses by selling securities that have gone down in value.

Make sure the transaction is completed in time for it to settle before the end of the year. Depending on your broker, the security and the market on which it is traded, the settlement date may be from one business day to several business days after you instruct your broker to complete the sale.

You should also ensure that you are not caught by the "superficial loss" rules. If you (or an "affiliated person", which includes your spouse or a corporation you control) acquire the same (or identical) securities within 30 days of selling them, then your capital loss will be disallowed.

There are numerous other special rules for capital gains and losses. This is just a general overview.

5. Pay your instalments

To avoid interest from applying, instalments should be paid on March 15, June 15, September 15 and December 15. Prepaid or "early" instalments earn credit (called "offset interest") against interest that applies to late instalments for the same year.

You are allowed to calculate instalments based on any of three methods, without interest applying. The instalments can total your tax payable (on income from which tax is not withheld at source) for this year, or for last year, or based on the amounts that the CRA advises you. The CRA's notice to you for March and June is based on the amounts you paid two years ago, and then for September and December the suggested instalments are adjusted so that the total for the year equals the amount you paid last year.

If you have not been paying your instalments, you should estimate as best as you can the tax that will be owing for the year on your self-employment and investment income (and other sources from which tax is not withheld). You should then make a catch-up instalment payment as soon as possible, to reduce interest charges.

Where interest does apply to late instalments, it is calculated at 5%, compounded daily. (The rate changes each quarter based on market rates, but has been the same since July 2009.) You do not get interest on overpaid instalments, other than as an offset to late instalments for the same year as explained above.

BE CAREFUL ABOUT NOT REPORTING ALL YOUR INCOME!

If you fail to report an amount of income in **any two years out of four**, you are subject to a special penalty under subsection 163(1) of the *Income Tax Act*. This penalty is 10% of the unreported income. There is also a parallel 10% provincial penalty which the CRA will assess in every province other than Quebec (where Revenu Québec will assess it). The combined penalty is 20% of the unreported income in the later year.

Note that this penalty applies <u>even if you paid tax on the income</u>, such as by having tax withheld at source on employment income.

Consider the following situation, which is essentially what has happened:

> In 2009, you had $70,000 of employment income from two different jobs, and $3,000 of interest income on investments. When you gave your records to an accountant in April 2010 to have your return done, you overlooked one T5 showing $500 of the $3,000, and so your return reported total income of $72,500 instead of $73,000. You signed the return without noticing this oversight.
>
> In 2012, you have $80,000 of employment income from three different jobs, and tax is withheld at source on each one. One of the employers doesn't send you a T4 (or perhaps sends it to a wrong address), for $15,000 of income. When you give your records to your accountant in April 2013, you don't realize that you only have two T4s instead of three. The accountant prepares your return (and E-files it, as is now required), and when you review it, you again don't notice that $15,000 of income is missing. However, since tax of $4,000 was withheld on the $15,000 of income, and the T4 showing the amount withheld wasn't included with your return, you aren't actually underpaying your tax because you aren't claiming credit for that $4,000.
>
> A harmless oversight, since no tax was underpaid? Think again.
>
> The CRA, if it finds the missing income (quite likely since it has the T5 from 2009 and the T4 from 2012), will assess you a penalty of **20%** of the unreported $15,000, or **$3,000**. This penalty will apply even though your under-reporting in 2009 was only $500, unless the taxpayer can prove acting with due diligence.

So be very careful to report all your sources of income — especially small amounts of investment income that might count as the "first" of the two years of non-reporting!

GST ON FIRST NATIONS RESERVES

Many people are unclear as to how sales taxes apply on First Nations reserves. Can you buy goods or gas cheaper on a reserve, because GST and HST don't apply?

The answer is no — at least if the vendor is following the law.

Status Indians are eligible for special benefits under the *Indian Act*, including that their "property" on a reserve is not subject to tax. (Legally they are still called "Indians" under the *Indian Act*, even though the term First Nations is now considered preferable.)

This means that status Indians can in many cases earn income that is not subject to income tax. It also means that they can buy goods that are tax-free when delivered to them on a reserve. For a purchase such as a car or truck, this can save them very substantial amounts of sales tax. (See CRA Technical Information Bulletin B-039 for details.)

However, these rules do not apply to goods that status Indians *sell* to other persons who are not status Indians. A store on a reserve can sell goods free of GST or HST to status Indians, but *not* to others. The store must charge and collect the tax. Otherwise the CRA will assess the store for the taxes not collected, plus interest and penalties.

YOU CAN BE LIABLE FOR A FAMILY MEMBER'S TAX DEBTS!

If a tax debtor transfers money or property (e.g., cash or the family home) to you, during a year in which, or for which, the debtor owes money to the CRA, or during any later year, the government can assess you under section 160 of the *Income Tax Act* for the net value of what you have received. (The same general rule applies under section 325 of the *Excise Tax Act* for any GST or HST the tax debtor may owe.)

The debt to the CRA could arise in various ways, such as:

- the debtor's own income tax
- a failure to remit payroll withholdings (source deductions) or GST collected by a person carrying on business
- a director's assessment for the failure of a corporation to remit source deductions or GST/HST.

EXAMPLE

Neil and Murielle jointly own their home, which is worth $200,000 and is mortgage-free. In April 2012, Neil transfers his half-interest in the home to Murielle, so that she now owns all of it.

Neil is a director of a corporation with a December 31 year-end. In November 2012, the business starts running into financial trouble, and it uses $130,000 in employee source deductions and GST collections to pay creditors rather than remitting the funds to the CRA. Eventually the corporation goes bankrupt, leaving a trail of unpaid creditors including the CRA.

The CRA will be able to assess Neil for $130,000, as a director of the corporation, for the unremitted source deductions and GST. To escape liability he will normally have to show that he "exercised the care, diligence and skill that a reasonably prudent person would in comparable circumstances" (the "due diligence" defence).

Suppose Neil is found liable, but he has no assets to pay the $130,000?

The CRA can assess Murielle under section 160 for $100,000 — the value of what Neil transferred to her, since the transfer took place during the same year. She will be personally liable for this amount, and if she has no other assets, the CRA will register a lien against the home (and could even force it to be sold).

Neil has thus made things much worse by transferring the house to Murielle. All of her assets are now subject to seizure, not just the home.

Murielle can be assessed at any time — even 5, 10 or 20 years after Neil's liability arose. **There is no limitation period on this assessment**.

As noted above, the transfer need not be to a spouse to be caught. Transfers to other family members will fall into the net. So can transfers from a corporation to a shareholder.
Here are some other examples of cases where this rule has been held by the Courts to apply — some of them surprising:

- David and Diane live in a home that is registered in Diane's name (and has been for years). David is the sole income earner in the family. David makes all the **mortgage payments** on the home. He is reassessed for income tax of an earlier year.

  The mortgage payments can be considered a transfer of money from David to Diane, so Diane can be assessed for David's tax debts. (Some court cases have allowed a reduction for the value of the free rent David has received from Diane, but others have not.) If she doesn't have any money, the CRA may put a lien on her home.

- Simone is the sole shareholder of SimoneCo, a small business corporation. SimoneCo pays a $20,000 **dividend** to Simone. SimoneCo ends up without enough money to pay its $15,000 tax owing for the year. The CRA tries to collect the debt from SimoneCo but is unable to.

- Daniel is a majority shareholder of DanCorp, a corporation. Daniel owes $10,000 to Ivan from a personal loan. Daniel arranges for DanCorp to pay $10,000 to Ivan to pay off Daniel's debt. DanCorp is then unable to pay its income tax or make its GST remittances for the year.

  The CRA can assess Daniel for up to $10,000 of DanCorp's tax debts.

- Keith **leaves Canada** and moves to the Bahamas with unpaid tax debts. The CRA cannot enforce its claim because he is outside Canadian jurisdiction, though they periodically contact him to ask him to pay. Twenty years later he dies, leaving money to his children, who still live in Canada. The CRA can assess the children to collect the ancient debt owing by Keith, plus 20 years' interest — perhaps seizing their entire inheritance.

- Kevin transfers property to his brother Joe and then goes **bankrupt**. The bankruptcy wipes out Kevin's tax debts — but it does not wipe out Joe's debt. (However, if the bankruptcy took place before the transfer of property, then there is no liability because Kevin was not liable for tax at the time of the transfer.)

Exceptions

There are some exceptions to the "tracing" rule in section 160.

First, the rule does not apply to the extent the transferor **receives payment** for the property transferred. Thus, in the first example above, if Murielle had paid Neil $30,000 for the $100,000 interest in the home that he transferred to her (or if the payment wiped out a previous loan of $30,000 Murielle had made to Neil), then the CRA would only be able to assess Murielle for $70,000 — the net value of what he transferred.

Second, the rule generally does not apply to a transfer on **marriage breakdown**, if the transfer takes place under the terms of a court order (e.g., a divorce decree) or a written separation agreement. Thus, if Neil transferred his interest in the house to Murielle because they had separated or were divorcing, the CRA might not be able to assess Murielle. These rules apply to common-law partnerships as well as legal marriages.

AROUND THE COURTS

Guindon case — third-party advisor penalty is a criminal penalty

Since 2000, third-party advisors such as accountants, lawyers and tax shelter promoters have been subject to a special "third party advisor" penalty in section 163.2 of the *Income Tax Act*. This penalty is imposed on advisors and promoters who are involved in another person's misrepresentations on their tax return, where the advisor engages in "culpable conduct" such as wilful or reckless disregard for the law.
The CRA has only assessed about 50 people so far under this new penalty, and until recently the penalty had not yet been considered by the Courts. The *Guindon* case, decided on October 2, 2012, is the first Court decision on this penalty.

Julie Guindon was a lawyer and the president of a charity. Her cousin was involved in putting together a tax shelter involving charitable donations, and asked her to provide a legal opinion that the shelter worked. She did so, even though she did not practice tax law and had no expertise in this area. She also got her charity involved in the shelter, and issued false receipts to numerous taxpayers. She was assessed a penalty of some $500,000, and appealed to the Tax Court of Canada.

The Tax Court judge ruled that Ms. Guindon had engaged in "culpable conduct", so she should be liable to the penalty. However, he also ruled that because the penalty is so open-ended (being based on the potential false reporting by other persons), it was really a *criminal* sanction. As such, it could not be simply assessed by the CRA and appealed to the Tax Court. Instead, charges would have to be brought in provincial criminal court, and guilt proven beyond a reasonable doubt as is the case for other criminal penalties. The government has appealed the decision.

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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.