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TAX LETTER

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MAKING TAX INSTALMENTS
TAX CREDITS FOR PEOPLE SUPPORTING INFIRM DEPENDANTS
TRUSTS FOR MINORS
TAXATION OF EMPLOYEE STOCK OPTIONS
REDUCTIONS TO INVESTMENT TAX CREDITS
PRESCRIBED INTEREST RATES
AROUND THE COURTS

MAKING TAX INSTALMENTS

If an individual has significant income from sources where there is no tax withheld, such as dividends, interest, capital gains, business, or rental income, he or she may have to make quarterly instalments of tax. The instalments are due on the 15th day of March, June, September and December of the year.

Generally speaking, you are required to make quarterly instalments in the current taxation year, if in the current year **and** one of the two preceding years you have federal and provincial net tax owing of more than $3,000 (**not** including tax withheld at source such as from your pay cheque). For Quebec residents, the same rules apply but the threshold is $1,800 of federal tax owing.

Assuming you are required to pay them, the quarterly instalments can be calculated in one of three ways, and you are entitled to choose the method that leads to the lowest instalments.

Method 1:
Each quarterly instalment equals ¼ of your tax owing for the current year. (Since you normally won't know your tax owing until the end of the year, if you use this method and estimate too low, you may be charged interest.)

Method 2:
Each quarterly instalment equals ¼ of your net tax owing for the preceding year.

Method 3 (the CRA method):
The first two instalments each equal ¼ of your net tax owing for the second preceding year. The last two instalments each equal ½ of (preceding year net tax owing minus the first two instalments that were based on the second preceding year).

Of course, the instalments are not necessarily the end of your tax liability for the year. If your instalments (plus any tax withheld) for the year are less than your actual tax owing for the year, you must pay the balance by April 30 of the following year. If your actual tax owing ends up being less, you will get a refund.

Late or insufficient instalments (based on the lowest amount under the three methods) are subject to interest charges, as is the late payment of the balance of tax owing, if any. However, to the extent you pay instalments early, you earn "contra" interest which can offset interest payable on any late instalments.

Example of 3 methods

Mary had the following amounts of net tax owing (not including tax withheld):

2010: $12,000
2011: $16,000
2012: Expected to be $20,000.

Under method 1, she would remit $5,000 each quarter ($20,000/4).

Under method 2, she would remit $4,000 each quarter ($16,000/4).

Under method 3, she would remit $3,000 for each of the first two quarters ($12,000/4). For each of the last two quarters, she would remit $5,000, being ½ of ($16,000 minus $6,000).

As can be seen, methods 2 and 3 end up with the same total instalments for 2012 ($16,000). However, in this example, Mary might prefer method 3 because the first two instalments are lower and the last two instalments "catch" up to make the difference.

TAX CREDITS FOR PEOPLE SUPPORTING INFIRM DEPENDANTS

If you are supporting someone who has a physical or mental infirmity and who is dependent upon you for support, there are various tax credits that may be available for you. The credit rates shown are the federal 2012 figures; in some but not all cases there is a parallel provincial credit worth somewhere in the range of half of the federal credit, but varying by province.

Equivalent to spouse (wholly dependent person) credit

Among other instances in which the credit applies, this credit is available if you are unmarried or living apart from your spouse, and a related person 18 years of age or over whom you support resides with you in the year and is dependent by reason of physical or mental infirmity. (See next section for minor children residing with you.)

The federal credit is 15% of $12,822 and is reduced by 15% of the net income of the dependant for the year (so that it is phased out if the dependant's income is $12,822 or more). The credit is 15% of $10,822 in respect of non-infirm dependants.
You can claim only one equivalent to spouse credit per year.

Child credit

The basic child credit is 15% of $2,191 for each of your children who is under the age of 18 at the end of the year. If the child has a physical or mental infirmity and is likely to be dependent upon others for assistance for a long and continuous period of duration, the credit is increased by 15% of $2,000.

If you are unmarried or living apart from your spouse, and your minor child lives with you, you can claim the equivalent spouse credit noted above in the amount of 15% of $10,822.

Spousal credit

The basic spousal credit of 15% of $10,822 is increased to 15% of $12,822 if your spouse (or common-law partner) is dependent upon you by reason of physical or mental infirmity. The credit is decreased by 15% of every dollar of your spouse's income for the year.

Caregiver credit

If a related adult (over 18) lives with you and is dependent upon you because of physical or mental infirmity, the caregiver credit is 15% of $6,402. It is reduced by 15% of the dependant's income over $15,033. (A credit of 15% of $4,042 is available if the dependant is your parent or grandparent 65 or over who is not infirm.)

This credit cannot be claimed for a dependant if the equivalent to spouse credit can be claimed for the same dependant. However, if the caregiver credit would have been larger, you are entitled to a topped-up credit for the excess.

The caregiver credit can be claimed in respect of more than one dependant.

Infirm dependant credit

If a related adult is dependent upon you for support because of mental or physical infirmity, the infirm dependent credit is 15% of $6,402, reduced by 15% of the dependant's income over $6,420. Unlike the caregiver credit, the dependant does not have to live with you.

The credit is not available in respect of a dependant if you can claim either the equivalent to spouse or the caregiver credit in respect of the dependant.

The credit can be claimed in respect of more than one dependant.

Disability credit

The disability credit is, in the first instance, claimed by the person with the disability. It equals 15% of $7,546. However, if the disabled person cannot use the credit, it can be transferred to the supporting person who claims the person as a dependant.

TRUSTS FOR MINORS

If you set up a trust, income earned in the trust is taxed either to the trust or to the beneficiaries of the trust. Generally, the income is included in a beneficiary's income only if the income is paid or payable to the beneficiary in the year in which the income arises. Otherwise, the income will be taxed in the trust.

However, a special rule in the Income Tax Act (subsection 104(18)) allows the trust to retain the income while having it included in

a minor beneficiary's income (actually, any beneficiary under the age of 21). The rule can be employed to accumulate income in the trust while having it taxed at the beneficiary's rate of tax, which will be beneficial if that rate of tax is lower than the trust's rate of tax. This will often be the case for minor beneficiaries of "inter-vivos" trusts, since such trusts are subject to a flat tax on all income at the highest marginal rate of tax. An inter-vivos trust is basically any trust set up during your lifetime.

In order for the rule to apply, the following conditions must be met.

- The trust must be resident in Canada;
- The trust's income for the year is not otherwise payable to the beneficiary;
- The income is held in trust for the beneficiary, who must be under 21 years of age at the end of the relevant year;
- The beneficiary's ultimate right to the income cannot be subject to a discretionary power (e.g. of the trustee); and
- The beneficiary's right to the income cannot be subject to any condition, other than a condition that provides that the beneficiary live to a specified age up to 40 years.

If the income is retained in the trust, it will be added to the capital of the trust. As noted, the beneficiary must have the right to receive this amount at some time in the future, subject, if at all, to a condition that the beneficiary lives to a specified age as indicated above.

Once the beneficiary reaches 21, any income earned by the trust must actually be paid or payable to beneficiary in order to have it included in the beneficiary's income. Otherwise, it will be taxed to the trust. However, the income earned in the trust prior to that time does not necessarily have to be paid out at that time.

Note however that if this rule is being used, the "kiddie tax" can still apply to tax the child at high marginal rates, such as where a parent's income is being diverted to the child through the trust.

TAXATION OF EMPLOYEE STOCK OPTIONS

Employee stock option benefits are given preferential tax treatment in most cases. In particular, as discussed below, typically only half of the benefit is included in the employee's taxable income, so that it is taxed similar to a capital gain.

The amount of the stock option benefit for income tax purposes is the amount by which the value of the share at the time of exercise exceeds the exercise price (plus any amount paid to acquire the option, which is usually zero).

No benefit is included in income at the time the option is *granted* to you.

Except in the case of an option to acquire shares in a Canadian-controlled private corporation (CCPC), the benefit is included in the year in which the option is *exercised* and the share is acquired.

In the case of an option to acquire shares in a CCPC employer with which the employee deals at arm's length, the benefit is deferred and is included in the year in which the share is *sold*.

As noted, in many cases a one-half deduction of the benefit is allowed in computing taxable income, meaning that

only one-half is included in taxable income. This deduction is allowed in the following circumstances.

- The shares (prescribed shares) must be common shares or shares very similar to common shares in terms of their attributes;
- The fair market value of the shares at the time the option was *granted* must not have been greater than the exercise price (plus any amount paid to acquire the option); and
- The employee must deal at arm's length with the corporation.

The full amount of the benefit (not just the one-half amount) is added to the cost of the shares, in order to avoid double taxation when the share is ultimately sold.

Example

You are employed by a public corporation and are granted a stock option to acquire 1,000 shares in the corporation at an exercise price of $10 per share. In 2012, you exercise the option and purchase the shares when they are worth $17 per share. In 2013, you sell the shares for $20 per share.

On your 2012 return, you will include a benefit of $7,000 (1,000 x ($17−$10)). Assuming you qualify for the one-half deduction discussed above, you will deduct half of the benefit in computing taxable income, so a net of $3,500 will be included in your taxable income.

The $7,000 benefit is added to the cost of your shares, which becomes $17,000. When you sell the shares for $20,000, you will realize a capital gain of $3,000, half of which (the "taxable capital gain") will be included in your 2013 income under the usual rules for taxing capital gains.

On a final note, if you sell the shares at a loss, half of the loss will be an allowable capital loss. However, such losses can normally be deducted only against taxable capital gains. Therefore, for example, if you sold the shares in the above example at a loss, that loss could not be used to offset the stock option benefit (which is considered employment income and **not** a capital gain). One taxpayer succeeded in the Tax Court with the argument that when he exercised the option he intended to sell the shares right away, so that his loss was an income loss that could be claimed; but two other taxpayers lost in Tax Court with the same argument.

REDUCTIONS TO INVESTMENT TAX CREDITS

The Income Tax Act provides investment tax credits to encourage taxpayers and businesses to make certain expenditures or investments. One of the primary expenditures qualifying for an investment tax credit is an expenditure on scientific research and experimental development (SR&ED). However, as a result of the March 2012 federal Budget, some of the credits are being reduced or eliminated, as summarized below.

SR&ED expenditures

SR&ED expenditures are deductible in computing income. Furthermore, they currently generate an investment tax credit at the rate of 20%. However, under changes first announced in this year's federal budget, the rate will be reduced to 15% for taxation years that end after 2013.

There is also an enhanced 35% investment tax credit for certain Canadian-controlled private corporations on up to $3 million of qualified SR&ED expenditures. This rate is not being reduced.

Under current rules, SR&ED *capital* expenditures are deductible in computing income and they also qualify for the investment tax credit. However, capital expenses incurred after 2013 will not be deductible and will not generate the credit. At that time, they will simply be subject to the regular capital cost allowance provisions (tax depreciation provisions).

In computing SR&ED overhead expenditures, taxpayers can use a "proxy method" instead of using actual expenditures. The current proxy rate is 65% of the portion of salaries and wages of employees directly engaged in SR&ED activities carried on in Canada. This rate will be reduced to 60% for 2013 and to 55% after 2013.

Mineral exploration expenditures

Currently, there is a 10% investment tax credit for Canadian corporations incurring qualifying mineral exploration expenditures, also known as "pre-production mining expenditures".

However, this credit is being phased out and eliminated. For so-called pre-production exploration expenditures, the credit will be reduced to 5% for expenses incurred in 2013, and it will be eliminated for expenses incurred after 2013.

For pre-production development expenditures, the 10% credit will be reduced to 7% for expenses incurred in 2014 and to 4% for expenses incurred in 2015. The credit will be eliminated for expenses incurred after 2015.

Atlantic province oil and gas and mining assets

Currently, there is a 10% investment tax credit for certain qualified property used in oil and gas and mining activities carried on in the Atlantic Provinces. However, the credit rate will be reduced to 5% for assets acquired in 2014 and 2015, and it will be eliminated for assets acquired after 2015.

PRESCRIBED INTEREST RATES

The rates for the last quarter of 2012 are the same that applied to the previous three quarters of 2012 and throughout 2011.

AROUND THE COURTS

Trust income attribution rule not applicable to beneficiary

In general terms, subsection 75(2) of the Income Tax Act can attribute income or capital gains from a property of a trust to the person who transferred the property to the trust. The provision can apply if the property (or property substituted for it) could, under the terms of the trust, revert or return to that person.

In the recent *Sommerer* case, the taxpayer was a beneficiary of a non-resident trust that has been settled by his father. The trust purchased some shares from the beneficiary using money that had been provided by the father. The trust later sold the shares at a gain. The CRA applied subsection 75(2) to attribute the gain to the taxpayer on the grounds that under the terms of the trust, the proceeds of disposition of the shares could

be distributed to him as a beneficiary under the trust and therefore revert to him. (The proceeds were considered substituted property for the shares.)

The Tax Court of Canada previously held in favour of the taxpayer, primarily on the grounds that subsection 75(2) does not apply to property acquired by a trust in a *bona fide* purchase from a beneficiary, and that it should apply, if at all, only to the settlor of the trust property. The Federal Court of Appeal recently upheld the decision. The Court concluded that since the taxpayer did not settle the trust with the shares, the provision did not apply to him.

ABIL denied

An allowable business investment loss (ABIL) is a type of capital loss that is given special treatment under the Income Tax Act. In particular, unlike regular capital losses, it can be deducted against all forms of income, and not just taxable capital gains.

An ABIL can be claimed for certain dispositions of shares or debts in a “small business corporation”. Generally speaking, the corporation must have carried on an active business in Canada (or owned shares in another small corporation that carries on an active business) at the time of the disposition or at any time in the 12 months preceding the disposition.

In the recent *McDowell* case, the taxpayer made a $1.15 million loan to her husband’s corporation in 2002. The corporation carried on a business of manufacturing and leasing and selling certain types of equipment. However, after losing litigation with a creditor, the business slowed down and, based on the facts of the case, appeared to cease some time in 2004.

For her 2007 taxation year, the taxpayer claimed that the loan had become bad. Under an elective provision in the Act, she was deemed to have disposed of the debt at the end of that year for nil proceeds, thus generating a loss that she attempted to claim as an ABIL. The CRA denied the ABIL treatment primarily on the grounds that the corporation did not carry on an active business during the 12 previous months.

The taxpayer’s appeal to the Tax Court of Canada was denied. In particular, the Court rejected the taxpayer’s argument that the business was temporarily dormant such that it could still be regarded as carrying on a business. The Court simply found on the evidence that no such business was being carried on in the 12 month period preceding the deemed disposition of the loan. (Presumably, the ABIL treatment would have been allowed if the taxpayer had claimed it in 2004 or perhaps 2005.)

This case is a reminder that taxpayers need to get professional advice on an ongoing basis to ensure that they make claims on time, as otherwise the opportunity can be lost.

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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.