TAX SAVER

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About This Newsletter Series

ELECTRONIC TAX FILINGFASTER PROCESSING!FASTER REFUNDS! ENVIRONMENTALLY FRIENDLY!**This newsletter has been prepared to provide a general overview of some of the more common personal income tax planning issues facing taxpayers for 1992. The comments included in this newsletter are of a general nature and should not be relied upon to replace specific professional advice.**

An income tax checklist, together with a discussion of additional tax issues will be discussed in the April newsletter. If you enjoyed reading this newsletter, pass it along to a friend.

Electronic Tax Filing & Direct Deposits

Electronic Tax Filing is available across Canada for about 95% of all taxpayers. Electronic Tax Filing involves preparing a tax return in the usual manner (computerized). Then the return is converted to a data file and sent to Revenue Canada by modem. No information slips are required to be filed, but they must be kept on file, should Revenue Canada request to review them. Among the benefits of EFile are:

- a significant reduction in paper generated;
- faster confirmation of receipt of a taxpayer's return by Revenue Canada; and
- faster assessment and refund (most within 14 days).

Taxpayers that EFile will receive a summary of their return (1-2 pages) and a copy of their information slips. The tax preparer will retain the same information and a form (signed by the taxpayer) that authorizes the return to be filed electronically. For those taxpayers that owe money when their return is filed, a separate form will be provided that may be taken to the bank and used to remit the required payment on or before April 30, 1993.

Taxpayers who expect to receive income tax refunds, GST credits, or child tax benefits may arrange to have these deposited directly into their bank account. The taxpayer must complete and sign a T1-DD form, indicating the name and address of your bank, the branch, institution, and account numbers, and attach either a deposit slip or a voided cheque. Alternatively, a bank officer may sign the form to confirm account details.

Correcting Errors or Omissions

Occasionally, errors or omissions may become evident after a tax return has been filed. If the return has not been assessed, the error or omission should be described in writing to the Taxation Centre where your return was filed. If your return has been assessed, the information should be sent to the Taxation Centre or Office where your return is stored (a T1-Adjustment schedule may be used to organize the adjustments requested).

Provided there is adequate support, it is Revenue Canada's administrative practice to reassess for errors and omissions brought to its attention relating to 1985 and later years. Where the taxpayer disagrees with Revenue Canada's assessment, the taxpayer may try to have the error corrected according to the above adjustment procedure. Technically, the taxpayer is bound to an assessment that is not appealed within one year from the date the return was required to be filed, or 90 days after the date of assessment. Normally, such an appeal will be made by filing a Notice of Objection. For example, this will permit taxpayers to object to an assessment of a 1991 tax return as late as April 30, 1993. The filing of a Notice of Objection within the specified time period protects the taxpayer's rights of appeal.

Normally, tax returns become “statute-barred” if they are not filed within three years from the date that they were due to be filed. In such cases, taxpayers are technically unable to claim refunds if they apply. However, in it’s “Fairness Package”, Revenue Canada has indicated that it will allow taxpayers to claim refunds on returns filed more than three years after they are due, for 1985 and later returns, so long as the taxpayer is able to adequately document a claim.

Alimony/Maintenance Payments

Generally, if alimony or maintenance payments are deductible by the payor, they must be included in the income of the recipient. In general, only payments made pursuant to a decree, order or judgement of a competent tribunal or pursuant to a written agreement, payable on a periodic basis are deductible. In addition, the parties must be living apart pursuant to a divorce, judicial separation or written separation agreement at the time that the payments were made and for the remainder of the year.

Legal advice should be obtained when preparing agreements of this nature, to ensure that the tax treatment of the payments that is desired will be achieved.

Credits for Dependants

A taxpayer is entitled to claim Federal non-refundable tax credits for dependants. To the extent that the spouse’s net income exceeds $538, the tax credit for the spouse will be reduced. To the extent that children under 19 have income in excess of $2,690, the tax credit for dependant children will be reduced.

It may be possible to have dependants make RRSP contributions, or otherwise plan to reduce their net income, so that the dependant tax credits may be maximized.

Moving Expenses

If you move your place of residence, you may be entitled to deduct moving expenses. Generally, if all of the following conditions apply:

1. you move in order to earn salary, wages, or self-employment income at a new location in Canada (even if you work for the same employer);
2. your move results in your new residence being at least 40 kms. closer than your former residence to your new place of work or business; and
3. you cease your business or employment at the former location.

It follows from the above requirements that you must have a change in the employment or business location, and you must move your residence. Therefore, if you move your place of residence, but your employment location remains unchanged, you do not qualify.

If you moved from outside Canada to a location in Canada, you will only be able to claim moving expenses if you were deemed to be a resident of Canada for income tax purposes.

Most reasonable expenses of moving the taxpayer and his/her family members will be eligible for deduction. Any amounts reimbursed by the employer must be deducted from the amount otherwise claimable. The moving expenses claimable may only be deducted to the extent that the taxpayer earns income (employment or business) at the new location. Any amounts not claimable, because of this restriction, may be carried forward for deduction in the subsequent year.

Generally, transportation, storage, meals, and accomodations may be deducted as moving expenses. If you are required to make a payment to be released from a lease, this qualifies. Further, if you owned a home at the

former location, all expenses related to the sale of the home (real estate commissions, legal fees, advertising, mortgage early payment fees) are deductible, and if you purchase a home at the new location, the legal fees and land transfer taxes will also be deductible.

Medical Expenses

A Federal non-refundable tax credit of 17% of medical expenses paid may be claimed by the taxpayer. The credit is limited to the expenses greater than $1,614 or 3% of the taxpayer's net income, whichever is lower. Medical expenses claimable include those incurred by the taxpayer, his/her spouse, or a dependant.

Most medical expenses qualify for the credit, including payments:

- to a doctor, dentist, nurse or licenced hospital;
- for prescription drugs;
- for corrective glasses; and
- for private health care insurance plans.

Any medical expenses reimbursed by a private health care plan do not qualify. Medical expenses may be claimed based on any 12-month period ending in the calendar year. Taxpayers should examine their medical expenses for both the current and the previous year to determine whether a higher claim might be made by using a period other than the calendar year. Don't forget to include the cost of private health care plans, such as Blue Cross and travel health insurance plans.

Either spouse may claim the credit on behalf of the other, but expenses incurred by a dependant may only be claimed by the spouse who is entitled to claim the dependant for tax purposes.

In general terms, the spouse with the lower net income should claim the family medical expenses.

INVESTORS

Capital Gains

Capital Gain or Income?

It is not possible in this newsletter to provide a detailed discussion of what constitutes a capital gain. The following comments are intended to provide a general overview of this issue. Generally, whether a gain on the sale of property is a capital gain or income is a question of fact. That is, the facts surrounding each disposition must be examined to determine whether the "profit" is in the nature of income or capital. In most cases, if it was the taxpayer's primary intention (at the time of acquisition) to profit from the capital appreciation of the property, as opposed to earning a regular return (e.g. interest, rental income, dividends, etc...), the profit will likely be treated as income. The following analogy may be helpful. If the owner of an apple orchard sells the apples, this will be treated as income, but if the owner sells the apple trees, this will be treated as a capital transaction.

Perhaps the most common case, where the capital vs. income issue arises, concerns the sale of real estate. Many taxpayers acquired real estate, which may or may not have been rented during the holding period, and sold the property, hoping to have the profit treated as a capital gain, eligible for the lifetime capital gains exemption. In the vast majority of such cases, the taxpayer's primary intention was to profit from the capital appreciation of the property. The taxpayer's primary intention is to be deduced from the facts. If the taxpayer had no

hope of earning a rental income from the property within a reasonable time period, (because it was heavily financed or rental rates were low), or if the taxpayer's intention was to buy and sell quickly, or if the taxpayer had a history of trading such properties, the facts will generally indicate that the primary intention was to earn a profit, and the profit will be treated as income, instead of capital gains.

Similarly, where the taxpayer acquired the property in hopes of profiting from the potential capital appreciation, but the property has gone down in value, a claim may be made to deduct the loss against other income, achieving substantial tax benefits.

Election

The issue of income vs. capital applies to any property, including shares, bonds, options and commodities. However, for those taxpayers (other than traders), an election may be filed to treat all gains and losses on the sale of Canadian securities as capital gains and losses. Once the election is filed, it cannot be revoked.

Taxable Capital Gains

Three-quarters of net capital gains is included in income and defined as a taxable capital gain.

Principal Residence Exemption

Generally, a capital gain on the sale of an individual's principal residence is exempt from tax. After 1981, only one exemption is available per family. Prior to 1982, any individual could claim the exemption for a principal residence owned by the individual.

If a couple jointly-owned two principal residences prior to 1982 and wishes to sell one (or both) now, it will be necessary to transfer the ownership, so that each spouse will solely own one home. This will ensure that the gain on both homes, accruing prior to 1982, will be exempt. It is the taxpayer's responsibility to support the fair market value at December 31, 1981, where two or more principal residences were owned in the family. The couple must decide which home is to be designated as the principal residence for the years subsequent to 1981, as only one may be designated.

Conversion to Rental Use

Where an individual commences renting of a principal residence, this is considered a change in use of the property. Accordingly, the property is deemed to have been disposed at the fair market value. However, if an election is filed for the year in which the rental use commenced, it is possible to continue to designate the property as a principal residence for up to four years. The four year period may be extended, if the employer requires the individual to relocate and the home is subsequently reoccupied prior to its sale.

Conversion from Rental Use

Where a property is acquired and used for rental or business purposes and is subsequently occupied as a principal residence, this is considered to be a change in use of the property. Again, the property is deemed to have been disposed at the fair market value at that time. The gain or loss and recapture of capital cost allowances claimed, if any, are taxable. However, if no capital cost allowance has been claimed after 1984, the taxpayer may elect to have the capital gain on the deemed disposition deferred until the property is actually sold. Further, an election may be available to designate the property as a principal residence for up to four years prior to the date on which the property ceased to be used for business or rental purposes.

Capital Gains Reserves

Where a taxpayer disposes of a property (other than to a controlled corporation), giving rise to a capital gain, it is possible to defer recognition of part of the gain by taking back a note for part of the proceeds. A reserve may be deducted from

the gain, equal to the proportion of the total proceeds that are not yet due at the end of a tax year. A further limitation is that, on a cumulative basis, at least one-fifth of the gain times the number of years since the sale must be taken into income. The maximum deferral occurs where there is a note taken-back for at least 80% of the total proceeds, with the balance of the note repayable in equal principal amounts over the subsequent four years. This arrangement will allow the total capital gain to be spread over five years (including the year of sale).

A taxpayer does not have to claim the maximum reserve in any year. For example, a taxpayer may include 40% of the total gain in income in one year and 0% in a subsequent year (under the assumptions above for the maximum possible deferral arrangement).

As parts of the reserve are taken into income, the gain recognized will qualify for the capital gains exemption, only where the property was disposed of after 1984.

Capital Gains Exemption

Individuals resident in Canada are eligible to a claim cumulative lifetime capital gains exemption of up to $100,000. An enhanced exemption of up to $500,000 is available for capital gains on the sale of shares of a "qualified small business corporation" and "qualified farm property".

The amount of the capital gains exemption available in a year is equal to the net capital gain for the year, less business investment losses, less cumulative exemptions claimed in prior years, less any CNIL balance (explained below).

Capital Gains Exemption Eligibility -- New Resident

Where an individual takes up residency in Canada in a year and realizes a capital gain, a capital gains exemption may only be claimed if the individual continues to be a Canadian resident throughout the following year. Unfortunately, the individual will not be able to claim the exemption when filing the tax return for the year in which the gain is reported, as it is not possible to prove continuous residency for the following year. Therefore, the taxpayer must receive an assessment of the tax return for the following year, filed as a resident throughout the following year. Then the taxpayer must request an adjustment of the previous year's tax return claiming the capital gains exemption.

Capital Gains Exemption and Real Estate

Gains on real estate acquired after February, 1992 do not qualify for the capital gains exemption. Where the real estate was purchased prior to March, 1992, only a portion of the total gain will be eligible for the exemption. The portion eligible is equal to the total gain multiplied by the number of months the property was held prior to March, 1992 and divided by the total number of months the property was held.

This restriction applies to gains on real estate and gains on shares, partnership or trust interests, where the fair market value of the investment is derived principally from real property, but does not include real estate that is used in an active business by the individual (or a family member), nor does it apply to "qualified farm property".

Cumulative Net Investment Loss (CNIL)

The CNIL amount is a summary of the individual's cumulative net investment losses since January 1, 1988. The purpose of the calculation is to restrict the availability of the individual's lifetime capital gains exemption.

This restriction is not permanent, as the CNIL balance is recalculated annually. It has no other income tax effect.

Generally, the CNIL balance at the end of any year will be the sum of investment expenses claimed after 1987, less investment income after 1987 and capital gains realized after 1984 where the gain did not qualify for exemption.

Investment losses include:

- interest and carrying charges relating to property earning passive investment income (interest, dividends, rent, etc...);
- losses from a limited partnership;
- one-half of most resource flow-through share deductions;
- losses from property and real property leasing.

Investment income includes the taxable amount of investment income, but excludes capital gains other than non-qualifying real estate gains.

Where an individual owns a business, there are several methods of eliminating potential CNIL problems:

- The individual shareholder/manager may receive dividends instead of salaries from a company.
- Shareholders may charge interest on shareholder loans to a company.
- A proprietor or partner of a firm may choose to receive a distribution from the firm, using the proceeds to repay an existing investment loan, or to purchase an investment, and borrow funds for contribution to the firm. The interest on the new borrowing will not be included in investment losses.

Allowable Business Investment Losses (ABIL)

Generally, capital losses on the disposition of shares or debt of a Canadian controlled small business corporation are considered business investment losses, three-quarters of which may be deducted against any income. The loss may be carried back three years or forward seven years. If the loss has not been claimed within these time periods, the loss becomes an ordinary capital loss, which may be carried forward indefinitely to be applied against only capital gains.

In certain circumstances, it is not necessary to actually dispose of the shares or debt to recognize the business investment loss. However, it must be shown that the fair market value of the shares is nil and it is reasonable to expect that the corporation will be dissolved or wound up and not commence business operations again.

Effect on the Capital Gains Exemption

If an ABIL is realized, after 1984, and claimed against other income, the amount of the lifetime Capital Gains Exemption available in future years will be reduced by the amount of ABIL claimed. Where an ABIL is realized after the individual has claimed a capital gains exemption, the ABIL will be treated as an ordinary capital loss, to the extent of the exemption previously claimed.

Alternative Minimum Tax (AMT)

Calculation of AMT Taxable Income
Add regular taxable incomeAdd the non-taxed portion of capital gainsAdd RRSP and RPP contributions (other than plan transfers)Add tax shelter losses created by deducting: Canadian Exploration Expenses, Canadian Development Expenses, Canadian Oil and Gas Property Expenses and Capital Cost Allowances on MURBs and film propertiesAdd employee stock option deductionsAdd Prospectors' and grubstakers' deductionsAdd employee housing relocation loan deductionsAdd the portion of non-capital losses of prior years that are attributable to any of the above itemsDeduct the gross-up on Canadian taxable dividendsDeduct $40,000The AMT is calculated on 17% of the AMT taxable income, after deducting personal tax credits, other than the pension income tax credit and credits transferred from the spouse or other dependants.

The Alternative Minimum Tax is designed to reduce the tax benefits of certain taxable income and deductions. The tax is designed to ensure that taxpayers, who benefit from certain types of income and deductions, pay tax at the rate of 17% of AMT taxable income. The AMT will be payable to the extent that 17% of AMT taxable income exceeds the federal income tax otherwise calculated. The amount of AMT payable may be carried forward for seven years to be applied (as a tax payment) against regular income tax (in excess of AMT for that year).

Taxpayer's may find themselves caught by the AMT, where they have significant capital gains, tax shelter losses and RRSP contributions during the year. The accompanying chart provides a more detailed calculation of the AMT taxable income.

Foreign Currency

Foreign exchange gains or losses realized in the year, in excess of $200, are taxable as capital gains or losses. A gain or loss becomes realized when the foreign currency is converted into Canadian dollars. Therefore, the timing of accrued gains or losses may be controlled by selecting the date of conversion to Canadian dollars.

EMPLOYEES

Employee Benefits

In general, all amounts received in the year relating to employment are included in income from employment. Certain other items paid or provided by your employer may be included in your income from employment. The following are some of the more common examples.

Tuition fees paid or reimbursed by your employer is a taxable benefit in the year paid, unless the course was for the employer's benefit and you were sent by the employer.

If your employer provides housing assistance (low or no rent), the difference between the fair market value of the housing and the amount you paid will be a taxable benefit.

Employer premiums for private health plans are not a taxable benefit (unlike the old OHIP premiums). Similarly, premiums for group life insurance for coverage up to $25,000 are not taxable benefits.

Where an employer provides you with a gift (up to $100) and the employer does not deduct the gift, it will not be taxable to you. Prizes and incentive awards are fully taxable to the employee, regardless of the amount.

Benefits relating to the personal use of an employer's automobile are taxable. See the January issue for details.

Interest free and low interest loans may result in a taxable benefit to the employee. See the section on Employee and Shareholder Loans, below.

Club membership fees will be a taxable benefit, unless the membership was used to enhance the employer's business (i.e. through entertaining).

Stock option benefits will be considered in the next newsletter.

Automobile and Travelling Expenses

An employee may deduct travelling expenses, if the employee:

- is "ordinarily" required to work away from the employer's place of business,
- is required to pay his/her own travelling expenses, **and**
- does not receive a tax-free allowance for travelling expenses.

The employer must certify that the above conditions are met, on form T2200 which is filed with the employee's tax return.

Commission employees may use this provision, **instead** of the commission sales expenses deduction, to deduct their automobile and travel expenses, where such expenses exceed their commission income.

Where a claim for travelling expenses is made, there are certain additional restrictions. **Unless** the employee is away from the employer's municipality for at least 12 hours, the cost of meals is **not** deductible. Where this condition is met, only 80% of the meal cost is deductible.

Automobile expenses are deductible to the extent that they were incurred in relation to the employment. This is usually based on the percentage of employment use of the vehicle. Eligible automobile expenses include: gas, oil, maintenance, licence, insurance, depreciation and loan interest (if purchased), lease payments (if leased), and parking expenses. Eligible automobile expenses (except parking), multiplied by the percentage of employment use during the year, is reduced by the amount of reimbursements received. Parking expenses related to employment (and not reimbursed) is added to this figure, to determine the deductible automobile expenses.

There are further restrictions on the amount of automobile expenses that are eligible (before proration for employment use). These restrictions depend on the date of purchase of the automobile or the date of inception of the lease. For acquisitions or leases entered into after 1990, the restrictions are:

- **for purchased automobiles**, that the maximum amount that may be depreciated for tax purposes is $27,600 (Ontario) and the maximum deductible interest on a loan is $10 per day; and

- **for leased automobiles**, that the maximum deductible lease payment is $747.50 per month (Ontario), including PST and GST, **if** the manufacturer's list price is $28,235 (plus PST and GST) or less and there are no special prepayments or special deposits.

In addition to the deduction for travelling expenses, employees are entitled to a GST rebate on those expenses. Generally, the rebate is equal to 1/107^{ths} of the GST taxable expenses deductible. Of the total travel expenses claimed, adjustments (for insurance, licence, interest, and other expenses on which no GST was charged) are required to reduce the total for calculating the GST rebate. When the GST rebate is received (with the tax refund for that year), the amount received is included in income and/or is applied to reduce the capital cost allowance class of the automobile. Thus,

the GST rebate is taxable in the year received.

Lease or Buy Your Automobile?

Choosing whether to lease an automobile or purchase one with financing depends on many factors. For this reason it is difficult to provide general answers. However, in most cases, it will be beneficial to lease a car, because a greater percentage of the "cost" of the automobile will be deductible over the "ownership period" than is the case where the car is purchased and depreciation and interest is deducted. However, each situation is different, requiring a complex number crunching exercise to determine the "right" answer.

Essentially, the method used to answer the question is a comparison of the present value of the after-tax cash flows under the two scenarios. I have provided an example of this method in the accompanying chart. In this example, the leasing alternative is the correct option, providing a benefit of $624 (in today's dollars). Keep in mind that the assumptions in this analysis may not be applicable to your situation.

The following are some additional factors that should be considered in the decision:

- deductible lease payments are restricted to a maximum of $650 (plus PST and GST) per month;
- large down payments under leases may cause a portion of the payment to be caught by the maximum lease restriction;
- lease payments are further restricted where there is a refundable deposit greater than $1,000, or where the employee receives reimbursements in respect of the lease payments;
- lease payments may be restricted where the cost of the vehicle exceeds $24,000 plus PST and GST;
- the nature and specific terms of the lease may indicate, for tax purposes, that the transaction is the acquisition of an asset, with financing, rather than a lease;
- where beneficial, it may be possible to elect to treat the transaction as the acquisition of an asset, with financing, rather than as a lease;
- there are restrictions on the deductibility of depreciation (CCA), where the car cost exceeds $24,000 plus PST and GST;
- the percentage of deductible use of the automobile, which will alter the present value of the benefits in either situation;
- the taxpayer's marginal tax rate, which will alter the present value of the benefits in either situation; and
- the relationship between the implicit interest rate under the lease and the actual interest rate under a loan.

LEASE vs BUY

ANALYSIS OF AFTER-TAX CASH FLOWS

	Year 1
LEASE CASE	
Lease payments	$ (7,516)
GST refund	457
Tax benefit of lease	3,513
Automobile purchase	
Automobile sale	
Tax on auto gain	
Total cash flows	(3,546)
Discount rate	0.91
PV of cash flows	(3,224)
PURCHASE CASE	
Loan payments	(10,687)
GST refund	271

Employee or Independent Contractor?

This issue can be extremely important, because where an individual can establish independent contractor status, all of the rules relating to business income will apply, rather than the much more restrictive deductions available to employees.

This issue will be discussed as it relates to commission salespeople, but the tests outlined apply to any employee/contractor. The answer to this issue is determined based on how much control the individual has over the performance of his/her work. It is always a question of fact whether a person is employed. However, it is rare that all of the facts will point in one direction. Therefore, various rules have been developed to help arrive at an answer.

Revenue Canada uses the following three rules. Where all three are true, the salesperson is generally considered to be an independent contractor.

- the salesperson is not restricted to selling only one supplier's products and is free to sell other products, even if these are competitor's products;
- the salesperson is not required to personally perform the sales services, but may hire assistants to help him/her; and
- the salesperson is unrestricted in terms of clients, territories, and methods of selling.

Where the above rules don't provide a conclusive answer, the issue must be examined from the individual's point of view. Two further sets of rules have been established through the courts. The first test looks at the following four factors:

1. whether the individual was controlled by the "employer", in terms of how and when the services were to be performed;
2. whether the individual was required to use his own "tools" to perform the services;
3. whether the individual had an opportunity to profit from his work (as opposed to earn a wage); and
4. whether the individual had a risk of loss from his/her efforts.

The second test is the "organization" test, which examines whether the individual was offering the services as part of a business enterprise or whether he/she was simply putting himself/herself at the disposal of the employer.

It should be noted that Revenue Canada has been fairly aggressive in ruling that individuals are employees. However, the courts have tended to side with the taxpayer. Where an individual stands to gain significantly from being treated as an independent contractor, he/she may wish to request a determination from Revenue Canada, prior to becoming an independent contractor.

PROPRIETORS & PARTNERS

Business Expenses

This section is intended to provide an overview of some of the business expenses that may be deducted (with or without restriction). There are many additional items that may or may not be fully deductible. When in doubt, seek professional advice. In general, all reasonable expenses, incurred in the process of earning income from a business, are deductible.

However, certain specific items are subject to overriding rules for tax purposes.

For example, certain expenses are not deductible, or have limited deductibility. Interest expenses are deductible under certain conditions (See January, 1993 issue). Automobile expenses are deductible, subject to certain maximum amounts and the percentage of business mileage use. Depreciable and intangible assets are not deductible, but “depreciation” of these items is deductible (under the tax rules). Entertainment and meals expenses are only 80% deductible. Club dues are not deductible. Most fines, penalties, and illegal payments are not deductible.

Certain reserves may be deducted. For example, insurance agents are able to take a reasonable reserve for unearned commissions. Similarly, a business may take a reserve for income received, where the products have not been delivered and/or services not rendered at the year end. Another common reserve is for accounts receivable that are doubtful of collection. Generally, this reserve is allowed for the amount of specific accounts that are doubtful of collection. The previous year’s reserves are added back to income for the current year and new reserves are calculated at the year end.

Office in the home expenses are deductible, under certain conditions, but cannot be used to create or increase a loss from the business. Where this latter restriction applies, the home office expenses may be carried forward to a year in which this restriction is not applicable. See the January issue for more details.

Certain payments, such as insurance, taxes, rent, and interest, may be made which cover a time period after the year end of the business. The portion of such payments that relates to a period after the year end must be deferred and expensed in the subsequent period.

Salaries paid to your spouse or dependants, where reasonable, are deductible. Normal payroll deductions and benefits should be calculated and remitted. Note that these salaries paid may reduce the amount of claims you may make for these dependants.

Partners of businesses often incur expenses related to the partnership that are not reimbursed or expensed in the partnership. Often these relate to client entertainment and/or automobile and travel expenses. In such situations, the partners should individually adjust their portion of the partnership income allocated to them to deduct expenses paid personally. Such expenses must be reasonable, be incurred for the purpose of earning income from the business, and be deductible for tax purposes.

Is it Time to Incorporate?

Most self-employed individuals will be faced with the questions of whether to incorporate their business. Many business books provide good descriptions of the more obvious advantages and disadvantages of incorporating a business. Therefore, these will be covered only briefly in this article.

The primary non-tax benefit of incorporation is the protection of the owner from unlimited liability for the debts of the company. However, this protection is usually reduced where lenders require personal guarantees from the shareholder. Other potential benefits are the lower tax rate enjoyed by small business corporations and the potential use of the “enhanced” lifetime capital gains exemption.

The usual disadvantages are the setup and ongoing costs of incorporation, the more stringent and formal accounting and administrative procedures required, and the restriction that corporate losses can only be deducted against corporate income.

The remainder of this article will cover the following advantages of incorporation:

- Tax rate savings (costs)
- Tax deferral aspects
- Death benefit opportunities
- Retiring allowances
- Club membership dues, and
- Private health care plans

The use of corporate loans is described in the Owner/Manager section, and the "enhanced" lifetime capital gains exemption will be discussed in a subsequent issue of this newsletter.

Tax Rate Savings (Costs) -- 1993

In many cases, corporate business income under $200,000 is taxed at a rate of 22.34%. Where an individual is taxed at the highest marginal tax rate of 49.50%, there is a potential tax differential of 27.16%. This difference in tax rates exists, because for the individual to gain access to the after-tax cash in the company, some form of taxable distribution will be required (usually dividends). When a dividend is paid to the shareholder, personal taxes become payable. Using the highest marginal tax rate, the personal taxes partially offset the above tax rate differential, leaving an absolute tax savings of only 1.20%. The actual tax savings will be somewhat higher than this percentage, because not all of an individual's income is taxed at the highest marginal tax rate.

Where the corporation's business income exceeds $200,000, the tax rate jumps to 48.34%, reducing the potential tax rate differential to only 1.16%. Where the shareholder receives the after-tax corporate cash by way of a dividend, there is an absolute tax **cost** of 16.11%. Therefore, it will **always** be preferable to pay salaries to the owner to reduce the corporate taxable income to $200,000. The remaining after-tax income is paid out by way of dividends, if necessary.

Tax Deferral Aspect

While the absolute tax savings (income less than $200,000) are quite small, the differential in tax rates (27.16%) provides a more substantial potential benefit. This benefit (all or part) can be realized, if the owner does not pay out all of the corporate after-tax cash flow. If this occurs, the personal taxes, that would have been payable presently, are deferred. Accordingly, this "unpaid tax" can be invested by the company to earn further income. The longer the funds are retained in the company (with partial compounding), the greater the benefit of the deferral. Further, when the funds are eventually distributed to the owner, the personal taxes will be paid using "inflated" dollars, creating further benefits to the owner.

Death Benefit Opportunities

Where the employee/owner dies, the corporation may pay a death benefit to the surviving spouse, of up to $10,000. The death benefit is taxable in the spouse's hands, rather than in the deceased's hands. This will provide a benefit where the spouse is in a lower marginal tax bracket than that of the deceased. Further, the death benefit may be transferred into an RRSP to defer the tax that would otherwise be payable at that time.

Retiring Allowance

When the owner/manager retires, the corporation may pay a retiring allowance. This allowance can be transferred directly to the individual's own (not a spousal) RRSP, providing another tax deferral benefit.

Club Membership Dues

Where the corporation is taxed at a lower rate than that of the owner, there will be an absolute tax saving by having the corporation pay the club dues. This is true if the corporation stands to benefit from the employee's use of the club (entertainment and promotion). In this case, the club dues, paid by the corporation, are not considered to be a taxable benefit to the employee, and the dues are not deductible by

Employee and shareholder Loans

EMPLOYEES

Where a corporation provides a loan to an employee, a shareholder, or one of their relatives, and interest is charged at less than the “prescribed rate”, a benefit will be added to the employee or shareholder income. It should be noted that “loan” includes any type of indebtedness, such as advances.

In general, the benefit will be equal to the difference between the interest that would have been paid, had the loan borne interest at the prescribed rates, and the amount of interest paid on the loan within 30 days of the end of the year.

Home Purchase and Home Relocation Loans

Where the loan is a “home purchase loan” or a “home relocation loan”, the prescribed rate used to calculate the loan benefit will not be greater than the rate at the time the loan was received. Such loans are deemed to mature on the fifth anniversary, which results in the setting of a new prescribed rate.

A home purchase loan is one that is used to acquire a dwelling for the employee or a relative. Such loans can also be used to repay an existing loan that was used to acquire the dwelling. A home relocation loan is similar to a home purchase loan, but also requires that the employee change his/her work location (either new employer or job transfer), the difference between the distance from the old residence to the new work location and the distance from the new residence to the new work location must be at least 40 kms., the new residence must be in Canada, the loan must be related to your employment, and you must designate the loan as such in your return.

Where the loan qualifies as a home relocation loan, the interest benefit may be reduced by the benefit on the first $25,000 of such a loan. You may only have one home relocation loan outstanding at any point in time. Such loans are terminated after five years, unless repaid sooner. Such loans cannot be rolled over into new home relocation loans.

Forgiveness of Loans

Where any loan balance is forgiven by the employer, the remaining balance of the loan becomes a taxable benefit at that time.

SHAREHOLDERS

Where a shareholder (or someone related to a shareholder) receives a loan from a corporation (or a related corporation) and it is not repaid within one year from the year end of the corporation, the amount of the indebtedness will be included in income at the time the loan was made, unless:

A. the loan was made by a corporation whose business is the lending of money; OR

B. the shareholder was also an officer, director or employee (or the spouse of an employee) of the corporation, and the loan was made to the person purchase:

- an owner-occupied home,
- shares of the corporation (or a related corporation), or
- an automobile to be used in performing his/her employment duties.

A further condition, to avoid the income

inclusion on the full amount of the loan, is that there must be a *bona fide* arrangement to repay the loan within a reasonable time.

Where a loan is repaid within one year, to avoid the income inclusion, the repayment cannot be part of a series of loans and repayments.

Where a loan does not meet one of the above exclusions, the loan will be included in income for the year. When this loan is repaid, the employee will be able to get a deduction for the amount paid, unless the repayment is part of a series of loans and repayments.

Nature of the Loan Benefit

Finally, it should be noted that the income included from shareholder loans is **not** considered to be a dividend. Consequently, it is fully taxable, without the benefit of the dividend tax credit that applies to dividend income.

Forgiveness of the Loan

Where a shareholder loan is forgiven, the amount included in the shareholder's income is the amount forgiven, less any amounts previously included in income using the above rules.

Imputed Interest on Loans

Where a shareholder loan has been included in the shareholder's income, there will be no additional amount for "imputed" interest, where the loan had an interest below the "prescribed rate".

Where the interest benefit relates to a loan that was used to purchase shares, or to acquire an automobile, and you are entitled to claim employment expenses, the interest benefit may be deductible, at least partially offsetting the imputed interest income.

Benefits Conferred on shareholders

There are numerous rules designed to tax benefits received by shareholders from their companies. The most common examples are purchasing cars for the shareholder, paying for renovations of a shareholder's residence, providing a rent-free or low rent home for the shareholder, and giving the shareholder money.

The rules are similar to those for shareholder loans, in that the amount of the benefit will be included in the shareholder's income, at the time the benefit is received. However, the major differences between shareholder loans and benefits conferred on a shareholder are that the benefit cannot be reversed by repaying the benefit to the company, and the company will not get a deduction for the amount of the benefit included in the shareholder's income. Therefore, there will be an element of double taxation on such benefits.

These punitive rules make it important to ensure (at all times) that corporations do not inadvertently confer benefits on their shareholders. Where there is a potential concern about this issue, it will be prudent to seek professional advice **prior** to undertaking a transaction.

IN THE NEXT ISSUE

SOMETHING FOR EVERYONE

- **EFILE and Direct Deposit**
- **RRSPs and the Home Buyer Program**
- **Penalties and Interest**
- **Child Care Expenses**
- **Accounting and Tax Preparation Fees**

INVESTORS
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- **Leased Automobile Expenses (Example)**

PROPRIETORS & PARTNERS
- **Business or Just a Hobby?**
- **Inventory Valuation**

OWNER/MANAGERS
- **Purchased Automobile Expenses (Example)**

ALSO INCLUDED IN THE NEXT ISSUE...

The long awaited Personal Income Tax Checklist for 1992 Income Tax Returns.

If you would like to be added to my mailing list for future copies of this Newsletter, please mail or fax your name, address and telephone number.

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