# TAX SAVER

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## Paul S. Hewitt, Chartered Accountant

45 St. Clair Avenue West • Suite 200 • Toronto • Ontario • M4V 1K6
Telephone: (416) 944-3571 • Facsimile: (416) 967-3945 • Cellular: (416) 407-6100

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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 has been included at the end of this newsletter. Additional tax issues are discussed in issues 1 and 2 of this newsletter. If you enjoyed reading this newsletter, pass it along to a friend. This is the final newsletter about 1992 income taxes. Subsequent issues may be distributed in 1993 -- golf weather permitting!**

## 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.

## RRSPs and the Home Buyer Program

This plan came into effect on February 26, 1992, and has been extended to March 1, 1994. Under the plan, any individual may withdraw up to $20,000 from any number of his/her existing RRSP plans. That is, a husband and wife may withdraw up to $40,000 (if each has at least $20,000 in RRSPs). The following discussion is intended to provide an overview of the rules in this area. The technical rules under the Plan are quite complex. Taxpayers who intend to use the Plan, who have used the plan, or who have made “prohibited” contributions should seek professional advice.

If the funds are withdrawn prior to March 2, 1993, they must be used to purchase a principal residence (in Canada) by September 30, 1993, and you must intend to occupy the home within one year of purchase. Where these conditions are met, the funds may be withdrawn from the RRSP(s) without withholding tax. Under the extended plan, the funds must be withdrawn prior to March 2, 1994, the home must be acquired by September 30, 1994, and you must intend to occupy the home within one year of purchase.

### Restrictions

If you withdrew funds from one or more RRSP plans for this purpose, but were unable to acquire a principal residence prior to the deadline, or you did not intend to occupy the home within one year of purchase, you may return the funds to the RRSP(s), without penalty or deduction. If you took advantage of the initial Home Buyers’ Plan, you are not entitled to take advantage of the extended plan.

### Repayments

Once you have met the conditions for the plan (initial or extended), the amount withdrawn must be returned to the RRSP at a minimum rate of 1/15th per year, commencing on or before December 31, 1995. Note that those who took advantage of the initial plan have a one year extension for repayments. All repayments must be properly designated (form T1037) when the payments are made.

Where the minimum repayment is not made in a year, the amount that was required to be repaid will be included in income for that year. Where overpayments are made in any year, the remaining instalments will be reduced (in simple terms the overpayment will be spread over the remaining repayment years). That is, you cannot make a double payment in one year and skip the next year's payment.

### Restrictions on RRSP Contributions

In general, you will not receive the benefit of any contributions after February 25, 1992 and before March 2, 1993 ("prohibited period"), if funds were withdrawn prior to March 2, 1993 under the Plan. An exception is made where a contribution prior to March 1, 1992 is deducted on your 1991 tax return. Additional rules with respect to the extended plan are not discussed here.

This restriction does not affect the normal rules with respect to RRSP contributions and deductions. Instead, the rules provide for an "add-back" to your 1992 income equal to the lesser of the RRSP contributions in the "prohibited period" and the withdrawals under the Home Buyers' Plan. More complex rules apply where there are spousal RRSPs, ordinary RRSP withdrawals and certain RRSP transfers. Where a "prohibited" contribution is made, it may be deducted under the normal RRSP rules. However, this is **not** advisable, because the contribution will have to be withdrawn prior to 1994 (to avoid being taxed on their withdrawal).

The bottom line is that any prohibited contributions should not be claimed as a deduction for 1992 and form T3012A should be completed (and certified by Revenue Canada) and used to withdraw the funds **prior** to 1994. Such withdrawals may be re-contributed to the RRSP **after** March 1, 1993 (to obtain a deduction for 1993).

## Penalties and Interest

It is important to be aware of the various penalties and interest that may be charged by Revenue Canada, because such charges are not deductible. The following discusses some of the financial penalties and interest charging provisions.

### Date of Receipt by Revenue Canada

For taxpayers, a payment or filing is considered to be received by Revenue Canada on the date that it is mailed (by first class mail or courier). If payments are made at a financial institution, payment is considered received on the date evidenced by the teller's stamp. Where a payment or filing due date falls on a weekend or a statutory holiday, the next working day is considered to be the due date for filing purposes.

### Deficient Instalments

As explained in the January issue, certain taxpayers are required to make quarterly income tax instalments. Where the minimum instalments are not made or are paid after the due dates, interest will be charged at the "prescribed rate" **plus 2%**, compounded daily. If you have incurred an interest charge on late or deficient instalments, you may correct the problem by either overpaying the remaining instalment(s) or paying the remaining instalment(s) early. Either of these methods will generate an interest credit, which may be used to offset the interest charged by Revenue

Canada. Where the net interest charged is $25 or less for the year, the interest will not be charged. If you are mathematically inclined, you can have some "fun" calculating your required overpayment or payment date on subsequent instalment(s) to avoid deficient instalment interest already incurred!

In addition, a penalty may be charged where the deficient instalment interest (net of offsets) exceeds either $1,000 or 25% of the interest that would have been charged had you made no instalments, whichever is greater. The penalty is equal to 50% of this excess amount.

### Interest on Unpaid Taxes

Where the taxpayer owes taxes and/or penalties, interest on the balance will be charged at the prescribed rate plus 2%, compounded daily. This interest is not deductible. This interest will continue to accrue until the entire balance is paid, or the taxpayer is successful in an appeal that gave rise to the interest and/or penalty. Taxpayers should note that while they are appealling an assessment, the interest will continue to accrue, even though they are not required to pay the amount until the appeal is resolved. If the appeal is resolved in the taxpayer's favour, any interest relating to the appealled items will be reversed. Where there is a risk of losing an appeal, taxpayers are advised to pay the amount owing and seek a refund if the appeal is successful. In certain specific situations, Revenue Canada **may** waive interest and/or penalty charges.

### Penalties

Where a taxpayer fails to file a tax return, there is a penalty of 5% of the unpaid tax, plus 1% per month that the return is not filed (up to a maximum of 12%). If the taxpayer is assessed this penalty **and** fails to file a return by the due date a second time within three years (**and** the Minister issues a formal demand to file a return), a "second occurrence" penalty may be imposed. The penalty is 10% of the unpaid tax, plus 2% per month (up to a maximum of 40%) that the return is not filed.

For more serious cases of failing to file a return, the taxpayer may be convicted of an offense, which carries an additional fine of between $1,000 and $25,000 **and** face up to 12 months in jail.

Where a taxpayer fails to complete required information on a return, **each** failure may result in a fine of $100, unless reasonable attempts were made to obtain the information.

Where a taxpayer fails to report income, **and** there had been a previous failure to report income in the last three years, there is a penalty of 10% of the income that was not reported.

Where there is a deliberate evasion of taxes, there is a fine of 50% of the taxes evaded. In serious cases, criminal charges may be laid, which carry fines of between 50% and 200% of the taxes evaded **and** up to five years in jail.

## Child Care Expenses

Certain child care expenses incurred to allow the taxpayer, or another supporting person of the child, to earn income from employment or a business, may be deducted. The deduction must be claimed by the person with the lower income. The courts have ruled that where one supporting person has **no** income (or a loss), that person cannot be said to have the "lower income". Accordingly, where one parent has no income, the other parent is entitled to claim the expenses for child care. Taxpayers should note that this is a fairly rare occurrence, as most people have **some** income.

The amount eligible for deduction in 1992 is the least of the following amounts:

- the actual child care expenses incurred;
- Child care expenses of $2,000 per child ($4,000 if the child is less than 7 years old at the end of the year or has a severe medical

or physical impairment); and

- two-thirds of the taxpayer's earned income.

Where child care services are provided by an individual, support for the expense must include the individual's name, address and social insurance number.

### Accounting and Tax Preparation Fees

In general, accounting fees are deductible, if they are reasonable and incurred in relation to the earning of income from property, a business, or deductible employment expenses. Income tax preparation fees are only deductible in respect of income from a business. "Expenses of representation" are those incurred in the process of objecting to or appealling an assessment of taxes. Such expenses are fully deductible, subject to the overriding requirement that they be reasonable.

## INVESTORS

### Tax Shelters

Various investment vehicles exist that allow investors to defer income taxes. It should be noted that many of these investments involve a substantially higher risk than other investments that are not tax-assisted. Investors should consider the potential return on such investments, given the higher risk they are assuming.

Generally, only those investors who are subject to the highest marginal tax rates, who are able to make a long-term commit of the funds required for the investment, and who are able to withstand a complete loss of their investment should consider investing in tax-shelters.

The following factors should be seriously investigated prior to investing in a tax-shelter:

- the potential income and cash flows that may accrue to the investor;
- the compensation to be paid to the promoter or general partner (throughout the investment holding period);
- the reputation of the promoter;
- the reputation of the general partner or manager;
- the liquidity of the investment (most have few, if any, provisions for cashing-out until the underlying investment assets are sold);
- the potential for future cash calls if additional funds are required;
- the fair market value of the underlying assets of the investment, at the time of investing;
- the promoter's estimated growth in value of the underlying assets of the investment in the projection;
- the certainty of the projected tax write-offs;
- the potential effects (tax and financial) of bankruptcy, dissolution, or winding-up of the company or partnership, and disposition of, or foreclosure on, the underlying assets of the company or partnership;
- the existence of a Revenue Canada tax-shelter identification number, if required;
- the potential effects of the "at-risk" rules on limited partnership investments;
- the potential effects of the Alternative Minimum Tax; and
- the General Anti-Avoidance Rules (GAAR), which may reduce or eliminate certain tax benefits that are considered to be an abuse of the tax legislation.

Finally, each investor should consider the discounted rate of return on the investment, based on the after-tax cash flows relating to the investment. Certain additional assumptions must be made during this analysis, such as the expected future value of the underlying assets (if they are to be sold). The resulting rate of return, given the risk level of the investment, should be compared with other alternative investments in the market.

## Investment Income from Foreign Sources

Investment income received from foreign sources has additional income tax implications. If the income is received in a foreign currency, it should be translated into Canadian dollars as at the date of receipt. Where the amounts are not significant, Revenue Canada will accept the use of an average exchange rate for the year. Similarly, foreign taxes withheld would be translated into Canadian dollars.

Dividends received from foreign sources are not subject to the 25% gross-up and dividend tax credit rules.

If foreign taxes are withheld on the income, they may be deducted from Canadian taxes, with certain restrictions. If the foreign taxes withheld exceed 15% of the foreign income, the excess is deducted from the foreign source income (not tax). You also have the option to deduct all (or part) of the foreign taxes against the foreign income, but this will only be beneficial where you are unable to deduct the foreign taxes from Canadian income taxes (under the foreign tax credit calculation). The foreign tax credit calculation is made on Schedule 1 of the income tax return. The calculations can be complex. Professional advice should be sought, where the amounts involved are significant and a full deduction against Canadian income taxes cannot be achieved.

## Negative Adjusted Cost Base

Given the method of calculating the adjusted cost base (ACB) of an asset, it is possible to arrive at a negative adjusted cost base at some point in time. Except for property that is a partnership interest, when the ACB becomes negative (at any time), the negative amount will give rise to a capital gain. This is true, even if the ACB becomes positive at some later point in time.

The amount of the capital gain, resulting from the negative ACB is added to the ACB, bringing it back to a nil ACB, after reporting the capital gain.

Where a partnership interest has a negative ACB, the above rules do not apply. A capital gain will arise if the partner disposes of all or part of the partnership interest, in which case that part of the negative ACB that was disposed, together with the proceeds, would give rise to a capital gain.

Where a partner retires from a partnership and his/her residual interest is disposed, the interest is deemed to be disposed at the end of the partnership's year end. If the interest has a negative ACB at the partnership's fiscal year end, it will give rise to a capital gain.

Where a partnership is wound-up, but not all of the partnership assets have been distributed, each former partner is deemed to continue to hold a partnership interest. If this partnership interest becomes negative, the negative amount will be a capital gain at that time.

# EMPLOYEES

## Stock Option Benefits

### General Rules

Where an employee received a stock option and the option is exercised at a price below the fair market value of the stock (at that time), a taxable benefit may arise. The benefit will be equal to the fair market value of the shares acquired, less the amount paid for the shares and the amount paid for the option.

Qualifying Stock Options

Where the employee deals at arm's length with the employer, the option price is not less than the fair market value of the shares at the time the option was granted, and the shares are considered to be common shares, a special rule applies. The benefit will be calculated in the manner described above, but a deduction of 25% of the benefit will be allowed.

## CCPC Stock Options

These options relate to the shares of a Canadian Controlled Private Corporation (CCPC). Where an employee of a CCPC (or a related CCPC) receives an option that is exercised after May 22, 1985, **and** the employee deals at arm's length with the employer immediately after the option is granted, the following rules apply.

If the shares are acquired under the option and disposed within two years, the benefit (fair market value, less option price and option cost) will be considered employment income in the year the shares are disposed. The 25% deduction (noted above) will be allowed, if the shares are "qualifying" (i.e. have common share attributes).

If the shares acquired under the option are disposed after two years, the benefit (fair market value, less option cost), at the time the option was exercised, will be included in employment income for the year the shares are disposed, with a deduction of 25% allowed. Any difference between the proceeds of disposition of the shares and the fair market value of the shares (at the date when the option was exercised), will be treated as a capital gain or loss, which may be eligible for the capital gains exemption.

## Pension Rollovers

Where an employee, who belongs to a company pension plan, terminates his/her employment, a decision is usually required as to the disposition of pension benefits that have accrued during the employment. The options are one or more of the following:

- to leave the funds in the pension plan and receive a deferred pension at normal retirement;
- to transfer the funds to another pension plan or RRSP; or
- to receive a cash refund of benefits.

Generally, pension benefits accrued up to the end of 1986 may be received in cash (taxable when received) and/or transferred to an RRSP or other pension plan. If the proper forms are completed and the funds are transferred directly to another plan, no withholding taxes will be required. Any funds transferred to an RRSP will be available for withdrawal at any time.

Pension benefits accrued since 1986 may only be transferred to another pension plan or to a "locked-in" RRSP. Funds in a "locked-in" RRSP may not be withdrawn by the beneficiary until he/she reaches the age of 65. Again, such transfers may be made without withholding taxes, if the required forms are completed and the transfer is made directly from the pension plan to the new plan.

Taxpayers should be aware that pension plans vary significantly in their terms and each taxpayer's circumstances are different. Therefore, it is advisable that taxpayers consult their financial advisors prior to selecting one of these options, should the situation arise.

**AUTOMOBILE EXPENSE EXAMPLE**

| | | |
|---|---|---|
| **Gas & oil** | | **$ 2,140** |
| **Maintenance** | | **2,568** |
| **Insurance** | | **2,000** |
| **Licence** | | **100** |
| **Lease payments** | | **9,095** |
| **Sub total** | | **15,903** |
| **Less personal use** | **20%** | **(3,181)** |
| **Sub total** | | **12,722** |
| **Less: reimbursements** | | **(6,300)** |
| **Net automobile expense** | | **6,422** |
| **Add: Parking** | | **375** |
| **Total deductible expenses** | | **$ 6,797** |

## Leased Automobile Expense Example

In the accompanying example, it is assumed that the employee leased a vehicle that would have cost $50,000 to purchase. The lease term is assumed to run for three years and the monthly payments including PST and GST are $1,304.89. Such a lease is restricted by the maximum deductible lease payment rules, such that only $9,095 of the total lease payments of $15,659 are deductible (before proration for the percentage of employment use). Further, it is assumed that the automobile is used 80% for employment purposes and that the employee receives a mileage allowance based on employment usage.

There are several interesting results. The potential lease payment deduction is limited to the maximum amount of $9,095, and the employee is not entitled to a GST rebate on the deductible expenses. This occurs because the employee was in receipt of a non-taxable allowance or reimbursement related to the expenses (mileage allowance). This occurs despite that fact that the employee chooses to include the reimbursements in income and claim the related expenses. This is a change from the law in effect for 1991. Had the employee received a taxable allowance (in the same amount), that was included in income on the T4 slip, the **employee would have been entitled to a GST rebate, provided that the employer certified the GST370E form.**

PROPRIETORS & PARTNERS

## Business or Just a Hobby?

Many taxpayers at one time or another become involved in a hobby or sideline in which some income is earned or expenses incurred. Is the income taxable? Are the expenses deductible? The answer depends on whether the hobby or sideline is a “business”. If the activity is considered to be a business, the income is taxable and the expenses are deductible. If the activity does not constitute a business, the expenses are not deductible, and the income is not taxable, unless “personal use” property is sold for more than $1,000 (results in a capital gain).

So what distinguishes a business from a hobby or sideline? The primary factors are whether there was an intention to earn a profit and whether there was a “reasonable expectation of profit” from the activity, not whether profits were actually earned.

The intention to earn a profit is usually indicated by the actions of the taxpayer. That is, did the taxpayer devote much time and effort to the earning process, or was the selling of products and/or services done “passively”. Did the taxpayer perform the activity primarily for his/her enjoyment, rather than with a deliberate thought toward turning a profit.

The “reasonable expectation of profit” requirement goes a step further. This looks at the ability and resources of the taxpayer and the circumstances under which the activity is to take place, to determine whether it was reasonable to expect to make a profit from the activity. This is a question of fact. For example, if a taxpayer decided to become a professional photographer, but he/she had little experience, few contacts and inadequate financing, and there was no planning as to how these problems were going to be overcome, resulting in eventual profits, there is little chance that this activity would be considered a business.

Similarly, where an activity is started and there are very minimal revenues (or none), it is highly unlikely that this would constitute a business.

An exception might be a business that is at the research and development stage.
Where there is any concern whether an activity is considered a business, it is prudent to document everything that supports the intention to earn a profit and the reasonable expectation of earning a profit. A good example is the preparation of a business plan, together with a projection of revenues and expenses.

## Inventory Valuation

Where a business sells products and maintains an inventory, the cost of goods sold during the year is influenced by the value of the ending inventory. Cost of sales is equal to the opening inventory, plus purchases during the year, less the ending inventory. Accordingly, if the ending inventory value is reduced, the cost of sales is increased and taxable income is reduced.

Taxpayers have some leeway as to how to value their inventory. Inventory may be valued at the lower of cost and fair market value or all at fair market value. Retailers may use the retail method of determining cost, if this is used for financial statement purposes as well. Whichever method is chosen, it must be used consistently from year to year. In very limited circumstances, a change in method may be allowed by Revenue Canada.
While most businesses will use the method used in the preparation of their annual financial statements, there is no requirement to do so. In the first year of reporting income from a business (where there was an ending inventory) it is necessary to make the decision as to which method to use.

Certain businesses may benefit from using the fair market value method. For example, a new computer-related business may choose the fair market value method, because product prices rarely increase. In this case, the first year profit of the business would be increased by the "unearned" profit included in the ending inventory. This might be acceptable, because of other startup expenses in the business, or because the business would otherwise report a loss, resulting in no taxable income. If some of this inventory remains at the end of the next year, it will likely have dropped in value. Accordingly, this decrease in value may be expensed by valuing the inventory at the fair market value at that time. This method works well for very specific businesses, but the decision should be made with care, because there are more factors that influence fair market values than for costs and obtaining and supporting fair market values is much more difficult than for costs.

OWNER/MANAGERS

## Purchased Automobile Expense Example

AUTOMOBILE EXPENSE EXAMPLE

| | |
|---|---|
| Gas & oil | $ 2,140 |
| Maintenance | 2,568 |
| Insurance | 2,000 |
| Licence | 100 |
| Capital cost allowance | 4,140 |
| Loan interest | 3,650 |
| Sub total | 14,598 |

| | | |
|---|---|---|
| Less personal use | 20% | (2,920) |
| Sub total | | 11,678 |
| Less: reimbursements | | -- |
| Net automobile expense | | 11,678 |
| Add: Parking | | 375 |
| Total deductible expenses | | $ 12,054 |

The accompanying example shows the calculation of deductible automobile expenses, where the automobile is purchased by the owner/manager of a business. The particulars are similar to that in the lease example, above. The automobile is purchased for $50,000, plus PST and GST, and is financed by a loan at 10% interest over three years. Since the cost of the car (including taxes) exceeds $27,600, the car is depreciated at the maximum allowable rate, based on $27,600. While the actual interest paid is $4,972 for the first year, only $3,650 is deductible.

The owner/manager does **not** receive a mileage allowance from the company, because the owner's marginal tax rate is higher than that of the company. Therefore the owner gets a greater tax deduction for the expenses than the company. Also, the owner is entitled to claim a GST rebate for the GST included in the deductible expenses, because no reimbursement or allowance was received in respect of these expenses.