



# Facts & Tax

From Hilborn Ellis Grant LLP

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## Year-End Tax Planning

### Deductibility and Timing of Expenditures

Individuals must make the following expenditures by December 31, 2005, in order to be eligible for 2005 tax deductions/credits: moving expenses, child care expenses, safety deposit box fees, charitable donations, political contributions, investment counsel fees, accounting fees, deductible legal fees, professional dues and medical expenses.

### Registered Retirement Savings Plans (RRSP)

Your 2005 eligible RRSP contribution limit is noted on your 2004 personal income tax return assessment notice. You have until March 1, 2006, to make tax-deductible RRSP contributions for the 2005 taxation year.

Consider contributing to a spousal or common-law partner's RRSP to achieve income splitting in the future.

Consider carrying forward your RRSP contribution and deducting the contribution in a subsequent year if you expect your marginal tax rate will be higher in that subsequent taxation year than in 2005 (generally will be beneficial if your 2005 year is a low income year).

The maximum addition to your RRSP contribution limit for 2006 and 2007 is \$18,000 and \$19,000, respectively. Therefore, \$100,000 of 2005 earned income and \$105,556 of 2006 earned income is required to reach the maximum for 2006 and 2007, respectively.

Individuals turning age 69 in 2005 must convert their RRSP into cash, an annuity or a Registered Retirement Income Fund (RRIF) by December 31, 2005. Selecting the RRIF or annuity option will require you to be paid a minimum yearly amount starting in 2006. The minimum yearly amount will be based on your age at the beginning of each year. However, you can elect to have the payment based on your spouse's or common-law partner's age at the time you establish your RRIF or annuity.

## Payment of Salaries

If you own a business, consider paying a reasonable salary to family members for services they render to the business during the year. Ensure that withholdings for income tax, Canada Pension Plan, Employment Insurance and any applicable provincial payroll taxes are remitted as required. The amount of the salary and the amounts withheld for 2005 must be reported on T4 statements, which are due on or before February 28, 2006.

## Social Security Clawback

For the 2005 taxation year, an individual's old age security pension benefit and age amount will be reduced by an amount equal to 15% of the individual's net income in excess of \$60,806 and \$25,193, respectively. At income levels of \$98,850 and \$56,146, the full amount of the old age security pension benefit and age amount, respectively, will be reduced to nil.

## Utilization of Capital Cost Allowance

Consider purchasing assets eligible for capital cost allowance before the year-end. For example, employees may claim capital cost allowance on automobiles required to be used in their employment.

## Consider Tax Loss Selling

While you're thinking about steps to take before December 31 to minimize your tax liability, you may want to consider tax loss selling if you realized capital gains in 2005 or you reported taxable capital gains in one or more of the last three years and if your investment portfolio now contains investments with unrealized capital losses.

Though tax loss selling is worth considering toward the end of any year in which you have realized capital gains, keep in mind that you must offset all of your capital gains for 2005 before you can carry any losses back to previous years.



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The more capital gains tax you paid in the last three years, the more you should consider the tax advantages of tax loss selling before the end of the year so you can carry back the losses to offset those gains and recover income taxes previously paid (bearing in mind that tax considerations are only one of many factors that should influence your investment decisions).

If you engage in tax loss selling, make sure you don't run afoul of the special tax rules designed to stop the artificial creation of tax losses. For example, a capital loss will be disallowed if you sell an investment at a loss, and the same investment is acquired during this period (30 days before and 30 days after the sale of the original investment) by you, your spouse or a corporation controlled by you or your spouse. If the capital loss is denied due to artificial creation thereof, the denied loss will be added to the cost of the repurchased security.

Remember that most stock and bond transactions normally "settle" three business days after the trade is entered. Because weekends and public holidays may affect the determination of "business days", if you intend to do any last-minute 2005 trades, consider completing all trades before Christmas and be sure to check the settlement date with your broker. The last official date for clearing trades of the Toronto Stock Exchange and TSX Venture Exchange is December 23, 2005. The last official date for clearing trades on the U.S. stock exchanges is December 27, 2005.

## Gifts of Qualifying Securities to Charities

Consider donating securities with accrued gains directly to a charitable organization rather than selling the securities and donating the proceeds.

The income inclusion rate for capital gains realized as a result of a gift of qualifying securities to charities is 25% (i.e., one half of the general inclusion rate of 50%). Qualifying securities include shares and debt obligations listed on a prescribed stock exchange, shares of mutual fund corporations and units of mutual fund trusts.

If given the option of donating the cash or an equivalent value of qualifying security, it is more beneficial to donate the security as opposed to donating the cash, as there exists an additional tax savings of 11.6% of the capital gain realized on the disposal of the qualifying securities.

## Payment of Income Through a Trust

If income in an inter vivos trust is to be taxed on a beneficiary's return, the income must be paid or payable to the beneficiary by December 31, 2005.

## Registered Education Savings Plan (RESP)

A Canada Education Savings Grant (CESG) for RESP contributions will be permitted equal to 20% on the first \$2,000 of annual contributions made to an eligible RESP of a qualifying

beneficiary who is under the age of 18 throughout the year. The maximum CESG amount that a beneficiary can receive is \$7,200.

The annual limit for contributions to an RESP for each beneficiary is \$4,000 and the lifetime limit is \$42,000. Ensure that you take advantage of the CESG by making RESP contributions before December 31, 2005.

## Health and Dental Premiums for the Self-Employed

Individuals will be allowed to deduct, in computing business income, amounts payable in respect of the 2005 taxation year for Private Health Service Plan Coverage paid for themselves and their family. Some of the conditions that are required to be met in order for the individual to obtain the deduction include:

- a) the individual is actively engaged alone, or as a partner in their business; and
- b) either self-employment income is their primary source of income or their income from other sources does not exceed \$10,000.

The maximum amount of the deduction that can be claimed by the individual for themselves and their family is limited to \$1,500 per person over 18 and \$750 for those under the age of 18.

## Instalment Reminder

If you are required to pay tax instalments for the 2005 taxation year, remember that your final instalment must be paid by December 15, 2005.

Your first instalment for the 2006 taxation year must be paid by March 15, 2006.

## Pay Interest on Employee Loans before January 30, 2006

If you were provided with a non-interest bearing or low-interest bearing loan from your employer during any part of the year, you are deemed to have received a taxable employment benefit. In the case of a low interest bearing loan, the amount of this benefit is reduced by any interest actually paid on the loan. However, the interest must be paid within 30 days of the end of the calendar year, i.e., January 30, 2006, in order to reduce any deemed taxable employment benefit. If the loan was used to purchase an automobile or acquire investments, the amount of the benefit including any amount of interest actually paid may qualify as deductible interest expense.

## Claim a Capital Gain Reserve

If you are planning to sell property for a capital gain and can arrange not to receive all the proceeds right away, you may be able to claim a capital gain reserve to defer recognition of part of the gain for tax purposes. (keep in mind the tax consideration is only one factor to consider with any contemplated sale of property).



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In general, you can claim a reserve on the capital gain reflecting the fraction of the purchase price you haven't received (provided you realize a minimum of one-fifth of the gain cumulatively each year). For example, if you sell a capital property in 2005 and you can arrange to defer half of your proceeds of the sale until after December 31, 2005, you will only have to recognize half of the gain in your 2005 tax return.

In addition, to the tax deferral advantage, this technique can save taxes by "smoothing" your income level from one year to the next.

If you have a large one-year increase in your income because of a capital gain, you may end up paying tax in a higher marginal tax bracket. If you can spread the gain over two or more years, the portion of the gain recognized each year, along with other income, may be subject to tax in a lower tax bracket than the tax bracket that would apply if the entire gain and the other income were reported in one year.

If you are eligible for Old Age Security payments, spreading the gain over two or more years may reduce the clawback of these payments. If you are claiming the \$500,000 capital gains exemption on the disposition of shares of a qualified small business corporation, you may be able to avoid triggering alternative minimum tax if you spread the gain over two or more years.

## Benefit from Patience for Short-Term Investments

When you're considering buying short-term investments, keep in mind an easy way to defer taxes on their maturation. As a general rule, buy investments that mature or pay interest after the end of 2005, rather than before. That way, you will not have to pay the tax on the investment income until you file your 2006 return in 2007. Additional cash flow benefits may arise in the form of lower quarterly tax instalments for next year.

## "Mini-budget" Highlights

On, November 14, 2005, Finance Minister Ralph Goodale presented the government's economic and fiscal update. As suggested or rumoured, the update included several personal tax changes which would take effect as of January 1, 2005. On the corporate side, the government proposes to reinstate the 2% corporate tax reduction and the surtax elimination that were announced in the 2005 federal budget. In addition, the government now plans to eliminate the federal capital tax in 2006, two years earlier than previously scheduled.

Given the current government's minority status, it should be noted that these proposals must be enacted by Parliament before they will have effect. The next federal election outcome will dictate whether the measures presented will be enacted as proposed or altered some form. Some of the highlights are summarized below.

## Personal Tax Changes

- The lowest personal tax rate would be lowered to 15% (from 16%). Additional marginal tax rate reductions are proposed to take effect starting in 2010.
- Coinciding with that tax rate reduction, the basic personal credit amount will increase by \$500 to \$8,649. These two measures combine to create a \$350 savings to all taxpayers earning \$35,600 or more. In 2006, the basic personal credit will further increase by \$200 to \$8,849 (plus indexation)
- The spousal/partner credit amount will increase by \$425 to \$7,345, and will further increase by \$170 to \$7,515 for 2006 (plus indexation)
- The government proposes to increase the maximum credit available under the refundable medical expense supplement to \$1,000 (from \$750) for 2006

Although several of the above measures are retroactive to January 1, 2005, the benefit of the tax reductions once tabled in the House of Commons will probably not be received by taxpayers until they file their 2005 personal income tax returns in 2006, at the earliest.

## Corporate/Business Tax Changes

- The 2005 fiscal update proposes to reinstate the 2005 federal budget's 2% corporate tax rate reduction. The 2005 budget scheduled the reduction to be phased in starting in 2008.
- Also reinstated is the elimination of the corporate surtax for all corporations in 2008. Under the current legislation, small and medium-sized businesses are already set to benefit from the elimination of the corporate surtax as of January 1, 2008.
- The government proposes to eliminate the Large Corporations Tax ("LCT") two years earlier than previously scheduled. Currently, the 2005 LCT rate of 0.175% is decreasing each year until it is eliminated on January 1, 2008. The fiscal update proposes to eliminate the federal LCT two years earlier, as of January 1, 2006.

The 2005 fiscal update proposes to extend the carryforward period for non-capital losses to 20 years (from 10 years). This measure would apply to losses including non-capital losses, farm losses, restricted farm losses, and losses applied under Part IV. This extended carryforward period will also apply to Investment Tax Credits. These measures are proposed to apply to losses incurred and credits earned in taxation years ending after 2005.



## Finance Proposes to Reduce Tax on Dividends

On November 23, 2005, Finance Minister Ralph Goodale issued a press release ending the government's consultations on income trusts and proposed a reduction in the amount of personal tax on dividend income from public corporations and Canadian controlled private corporations ("CCPCs") paid out of income that is subject to tax at the highest corporate tax rate. The new regime of tax on such dividends would apply for eligible dividends paid in 2006 and later years.

The measures are intended to make the total tax paid on dividends received from corporate profits subject to the highest corporate tax rates more comparable to the tax paid on distributions from income trusts. If the provinces follow suit and similarly reduce their provincial personal tax on dividend income, the federal government believes this measure will help achieve its goal of leveling the playing field between corporations and income trusts. The provinces have yet to react to the federal proposal put forth.

In light of the proposal, qualifying corporations should consider delaying the payment of discretionary dividends until 2006 rather than late 2005.

The implications on the owner-manager are such that the most appropriate salary/dividend mix may have to be re-determined. That is "bonusing out" income in excess of the small business deduction limit may no longer be as beneficial as it once used to be as such income could be prematurely taxed at the higher personal income tax rates that apply to salary and in effect create a prepayment of tax and reduce the after-tax income that could otherwise be reinvested into the business.

## Quick Tax Facts

### 2006 Rates for Canada Pension Plan ("CPP") and Employment Insurance ("EI") Contributions

For the 2006 year, the maximum contributions that will be made by the employer and the employee as it relates to CPP will be \$1,910.70 respectively which is 4.95% each based on maximum pensionable earnings of \$42,100. Such amounts will be required to be withheld at source by the employer. To the extent that you are self-employed, you will be required to remit \$3,821.40.

For the 2006 year, the employer will be required to withhold from their employee EI premiums for each dollar of insurable earnings up to a yearly maximum for 2006 of \$39,000. The employee portion will be \$729.30 or 1.87% of \$39,000, and the employer portion will be \$1,021.80 or 2.62% of \$39,000. To the extent that you are self-employed there is no requirement to remit EI premiums.

## Low Interest Rates Continue to Yield Income Splitting Opportunities

On December 2, 2005 the Canada Revenue Agency ("CRA") announced the prescribed interest rates that will apply for income tax purposes for the first quarter of 2006. The rates that will be in effect from January 1 to March 31, 2006 are:

- 7% on overdue taxes, Canada Pension Plan contributions and Employment Insurance premiums;
- 5% on overpayments; and
- 3% on taxable benefits for employees and shareholders from interest-free loans or low-interest loans.

The rate of 3% above also applies for purposes of the income attribution rules. The income attribution rules, which would deem income received by one party to be reported as income by another party, contain an exception for transfers of property which take place at fair market value. Where property is transferred for a promissory note bearing interest at a rate at least equal to the prescribed rate in effect when the loan was taken out, the transfer will be considered to have taken place at fair market value. Using this exemption, money or other assets can be transferred to a spouse, children or a trust for a spouse and/or children, without the income attribution rules applying. The recipient invests the money and hopefully obtains a rate of return higher than 3%. The net profit that results, after paying interest to the lender, is not subject to the income attribution rules. The transfer of assets in this manner, allows family members to utilize their marginal tax rates on income that could otherwise be taxed at an individual top marginal rate.

Once a loan is put in place at the prescribed rate (i.e., 3%), the arrangement can stay in place indefinitely (or until the loan is repaid) and the interest rate does not need to be adjusted if rates go up in the future. However, the interest must be paid on the promissory note by the spouse, child or trust within 30 days of year-end (i.e., January 30) otherwise attribution applies.

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