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PERSONAL TAX

58(1)

SAME-SEX COUPLES

A Canada Customs and Revenue Agency (CCRA) website (www.ccra-adrc.gc.ca/tax/individuals/faq/same_sex-e.html) has a nine-page Release on *same-sex couples* including fourteen questions and answers on the general *tax implications* and four questions and answers on the Canada Child Tax Benefit and the GST/HST credit.

These new *same-sex couple tax rules* are effective in 2001 and, may be used on an *elective* basis in 2000, 1999 or 1998.

MEDICAL EXPENSE - CELIAC DISEASE

In a March 22, 2002 *Federal Court of Appeal* case, the Federal Court found that Mr. H was entitled to the *disability tax credit* on the basis that his "*celiac disease*" markedly restricted his activities of daily living by requiring an *inordinate amount of time* to feed himself because of the requirements to prepare gluten-free diets. However, the Court also noted that persons with celiac disease, or other medical conditions that impose dietary restrictions, are eligible for the disability tax credit *only if* they establish that they require an *inordinate amount of time* to find, procure and prepare foods that can be safely eaten. Differences in the severity of the disease could result in different conclusions.

CANADA CHILD TAX BENEFIT (CCTB)

The Income Tax Act provides for a *non-taxable* monthly CCTB payment to the custodial parent (who is usually the mother) of children under the age of 18. The CCTB is reduced by 5% of the parents' net family income over \$32,000.

In a March 8, 2002 *Tax Court* case, the Court found that the *male parent* was the one *entitled* to the CCTB because the children resided with him and, he was the primary caregiver. This became an issue when his *former spouse* claimed that she was the primary caregiver.

EMPLOYMENT INCOME

58(2)

PHANTOM STOCK PLAN

In a 2001 *Advance Income Tax Ruling*, a public corporation introduced a *performance incentive plan* for certain employees. For example, if the bonus is \$210 and the employer's shares are valued at \$21 per share, the employee would be *allocated ten "Deferred Stock Units"* which may be *redeemed* and included in *income* at a *later date* (say retirement).

If the shares are worth \$30 per share at retirement, the employer would pay \$300 - which would only be taxable *at that time*. This provides *incentive* to the employee to grow the share value.

GIFTS AND AWARDS

In a new CCRA website (www.ccra-adrc.gc.ca/tax/busi

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[ness/payroll/gifts/examples-e.html](#)),

CCRA includes a five-page explanation of the new policy effective January 1, 2001 on *non-taxable/tax deductible* gifts or awards of up to \$500. For example, a wedding *gift* (crystal vase of \$230) and an *award* for twenty-five years of service (a watch of \$350) would both be *non-taxable* because the gift and the award are each under \$500. They would be *deductible* to the employer. This implies that an employee may receive up to \$500 of bona fide gifts *and*, up to \$500 of bona fide awards on a *non-taxable* basis each year.

However, a *gift certificate* would be *taxable* because it is considered to be *near-cash* and not subject to this policy.

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Also, ten other questions and answers on gifts and awards are included on CCRA website www.ccra-adrc.gc.ca/tax/business/payroll/gifts/faq-e.html.

Caution

In a January 10, 2002 *Technical Interpretation*, CCRA notes that this *new policy* may *not* apply to gifts and awards given by *closely held corporations* to their *shareholders* or their relatives, since these gifts and awards are *normally* considered to be received in their capacity as *shareholders* - not employees.

EMPLOYEE VS. INDEPENDENT CONTRACTOR

An article in the Beausejour newspaper highlights the problem that a *local trucking corporation* (Lakeland Inc.) had with CCRA. In a CCRA reassessment against Lakeland, CCRA took the position that any *truck operator who leased equipment from Lakeland* was an *employee* of Lakeland and, therefore, reassessed Lakeland for *payroll deductions*, plus interest and penalties for all leases entered into by Lakeland back to 1997. Even though Lakeland plans to *appeal* the case to the Tax Court, *CCRA seized their bank accounts and receivables* of \$380,000 which, "rendered Lakeland incapable of meeting their financial obligations".

Also, a *Tax Court* case was heard in Calgary in September, 2001 where CCRA had assessed for unremitted *CPP and EI* on the basis that over *one hundred sales and cable T.V. and internet installers* for Shaw Communications Inc. were employees rather than independent contractors. The decision is pending.

RETIRING ALLOWANCE

In a February 15, 2002 *Technical Interpretation*, CCRA note that a payment on employment termination for *unused sick leave*

credits may qualify as a *retiring allowance*.

A retiring allowance is eligible for a *roll-over* to an *RRSP*, within prescribed limits, for years of service *before 1996*.

Alternatively, an accumulated *vacation leave* payment is considered to be ordinary employment income, and *not* a retiring allowance.

BUSINESS/PROPERTY INCOME

58(3)

REASONABLE EXPECTATION OF PROFIT (REOP)

In a January 9, 2002 *Tax Court* case, the Court noted that the *rental losses* on a condominium at Whistler, British Columbia should be *allowed* because:

1. There was *no personal element*. Neither the taxpayer, their friends or family used the property.
2. CCRA is simply *second-guessing* the appellant's business judgment.
3. CCRA *did not allow a reasonable period of time* to earn income.

In a September 5, 2001 *Tax Court* case, Mr. W commenced to carry on a *lawn maintenance* business in 1989 but suffered losses each year, including losses of \$39,000, \$40,000 and \$41,000 in the years 1994, 1995 and 1996. CCRA *disallowed* the 1994 to 1996 losses on the basis that there was *no REOP*.

Good News!

The Court noted that there were no expenditures that were even "blurry" as between business and personal - there were no entertainment expenses, no personal car usages, no convention and promotion expenses. Every



expense was directly applied to a "*business*" activity. *The fact* that losses *may not be recovered* in the foreseeable future is *not a bar* to the claiming of such losses. When there is a *genuine business*, losses can be sustained, depending on the circumstances, as long as the losses cannot be disallowed for other reasons such as personal or capital.

STRIP BONDS

In a February 27, 2002 *Technical Interpretation*, CCRA note that *interest* must be included in income over the period of ownership of the strip bond.

Generally, the *interest income* will be included in *each taxation year* on the *strip bond's* anniversary day.

UNIVERSAL LIFE INSURANCE

A tax exempt *universal life insurance policy* (UL) provides a tax sheltered investment. The portion of the premium which is used for investments accumulates tax free. Upon death, the *face value* of the policy, plus the *accumulated investments*, may be paid out *tax free* to the beneficiaries.

ULs are often advertised on the basis that *withdrawals* of the accumulated investments may be made during lifetime or, loans could be made against the policy. Upon death, the insurance proceeds would be used to pay off the debt.

This was discussed in the April 20, 2002 issue of the *Financial Post*. Some points noted include:

1. ULs have attracted \$40 billion, or *30%* of the \$134 billion *face amount* of new insurance coverage purchased in 2001.
2. Even though UL is a form of *permanent insurance* which provides a *tax free death benefit* and a *tax deferred investment component*, one potential *problem* is the high commissions and management expense ratios (MERs)

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on the underlying investments in the UL.

3. ULs are sometimes sold with *overly aggressive* return assumptions.
4. There usually are *surrender charges* when a policy is cancelled within the first ten years. Cancellation may even trigger a tax liability.

FOREIGN SPIN-OFFS

A “*foreign spin-off*” is a reorganization where a Canadian resident shareholder of a foreign corporation receives from that corporation shares in *another foreign corporation*.

In an April 16, 2002 CCRA Release, CCRA note that the *election* to allow a *tax deferral* of foreign spin-off shares must have been filed *by September 11, 2001* for taxation years 1998, 1999 and 2000.

Good News!

CCRA also announced that they may accept a *late election*, subject to late-filed penalties, under the “fairness provisions” of the Income Tax Act.

CCRA website www.ccradrc.gc.ca/tax/business/taxtopics/foreign-e.html includes *ten pages* of information.

CAPITAL GAINS

58(4)

CAPITAL GAINS DEFERRAL

In a December 13, 2001 *Technical Interpretation*, CCRA comment on the up to \$2



million *capital gain deferral* on the sale of “eligible small business corporation” (*ESBC*) shares when replacement *ESBC* shares are acquired. Points mentioned include:

1. An *ESBC* share is a *common share* issued *by a Canadian-controlled private corporation* to an *individual* if all, or substantially all, of the fair market value of the assets are used primarily in an *active business* carried on primarily in Canada by the corporation or by a related *ESBC*; shares or debt owing by other *ESBCs* or a combination of the above.
2. A gain on the sale of a share acquired from a third party will *not qualify* for a deferral because it must be a share acquired *from Treasury* to be an *ESBC*.

Also, in a March 25, 2002 *Technical Interpretation*, CCRA note that this does *not apply* where more than *50%* of the fair market *value* of the property of the corporation (net of debts incurred to acquire the property) is attributable to *real property*. Therefore, shares of a *farm corporation* likely would *not qualify* for the deferral unless the farmland was highly leveraged with debt.

Other tests that must be met, include:

1. the shares must have been owned by the individual throughout the 185-day period that ended immediately before the disposition, and
2. the replacement share must be acquired by the individual in the year, or within 60 days after the end of the year, but not later than 120 days after the qualifying disposition.

INCOME SPLITTING

58(5)

2% LOANS

If a person makes a *loan* to a non-arm’s length person and *charges* the *prescribed rate of interest* on the loan, income earned on the money by the borrower is *not attributable* to the lender as long as the interest is

paid within *thirty days* after the end of each year.

The prescribed interest rate for loans made in the *second quarter of 2002* is *2%*. The prescribed interest rate has not been this low since introduced in 1984.

IN-TRUST ACCOUNTS

In-trust accounts are usually funded by the *parents* for a child or grandchild. Most financial institutions



require that the account be opened in the name of a parent with the account designated “*in-trust*”. Even though the *attribution rules apply* on investment income, they do *not apply* on *capital gains*.

In many cases, the “*in-trust account*” is not a legal trust and, therefore, *avoids trust tax filings* and statutory requirements. However, *the child* is now the owner of the asset.

The parent *loses control* of the amounts unless there is a *full fledged “trust” established*. A *trust* could provide the parent with *control* as to beneficiaries, distributions and so on. Therefore, for *large amounts*, it may be advisable to use a *legally structured trust*.

If a full fledged trust is not used, it is important to have *proper documentation* - which is usually provided by the *financial institution*.

Also, the *child’s social insurance number* (S.I.N.) should be used for the account as *problems* with CCRA *may arise* if the parent’s S.I.N. is used because of CCRA’s *computer matching program*.

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DIRECTOR LIABILITY

58(6)

In a January 18, 2002 *Tax Court* case, a furniture retail company was in *financial difficulty* from September 1, 1994 to June 30, 1995 when it *did not remit* its monthly *GST* returns. On July 18, 1995 it made a proposal to its creditors under the *Bankruptcy Act*.

Mr. V, the *director*, was held *personally liable* by CCRA and the



Tax Court for the unremitted *GST* of \$73,869 on the basis that he was *aware* of the financial difficulties and the unreported *GST*. He appeared to have made a deliberate attempt to keep the company alive by using the remittances to *satisfy creditors*. Even though he attempted to put the blame on the accountant, the Court noted it was clear that he was an *inside director*, experienced, knowledgeable and active in the company's business, and should have been, and in the Court's view *was aware*, that the company was not, for an extended period, making its *GST* remittances.

In *another* January, 2002 *Tax Court* case, CCRA assessed Mr. E as a director for unremitted *payroll source deductions* of \$735,736 even though he did not own any stock and served only as an *outside director*.

Good News!

Mr. E was *not liable* on the basis that he acted as a *reasonably prudent* person. Nothing in the financial statements gave Mr. E any idea that the remittances of source deductions were not being made. There was nothing he could have done to prevent the failure.

An *outside director* is only required to use *reasonable care* to prevent defalcation.

MARRIAGE BREAKDOWN

58(7)

LIVING SEPARATE AND APART

In a November 28, 2001 *Tax Court* case, Mr. R claimed certain *tax credits* on the basis that he was "*living separate and apart*" from his spouse by a reason of the *breakdown* of their *marriage*, even though they continued to live in the *same house*. The Court noted that *it is possible* to "live separate and apart" and still be living in the same house however, the *onus of proof* is on the taxpayer and the facts must be strong.

Bad News!

Based on the facts, the spouses were *not living separate and apart* because of the breakdown of their marriage. The *finances* were still intertwined, the *communication* was more than one would normally expect from separated persons, they shared *domestic duties* and their *social activities* were limited, but not non-existent.

THIRD PARTY PAYMENTS

In a November 10, 2000 *Tax Court* case, the Court noted that *third party payments*, such as mortgage payments and municipal and school taxes, are deductible if the *Marriage Breakdown Agreement* refers to *Subsections 60.1(2) and 56.1(2)*. This confirms that both parties know there are *tax consequences* to such an Order. An *Oral Agreement* or consent by the recipient does *not* fulfil this criteria.

ARREARS

In a February 15, 2002 *Technical Interpretation*, CCRA notes that *arrears settled* for an amount *less than* the total unpaid periodic payments, whether as a lump sum or by installments, would *not be deductible* to the payor *or taxable* to the recipient.

Interest in respect of arrears (or in respect

of a reduced amount) would *not be deductible* to the payor but would be *taxable* to the recipient.

CHILD SUPPORT - AMENDING AGREEMENT

In a March 6, 2002 *Technical Interpretation*, Individuals A and B became divorced *prior to* April, 1997. A was required to make deductible/taxable *child support payments* to B. However, after the child support *income tax rules* changed in April, 1997, A and B entered into an *Amending Agreement* which provided for an *increase* in the child support. Therefore, the child support payments were no longer deductible/taxable. The Court noted that even if the *Agreement indicates* that, for income tax purposes, the payments are *deductible/taxable* this is *not determinative* of the tax consequences.

FARMING

58(8)

RETIRING ALLOWANCE (RA)

In a 2001 *Advance Income Tax Ruling*, CCRA ruled that where Farmer A *employed his spouse* in the farming operation, even though *salary* was *not paid* in *all* the years, Farmer A may pay the spouse a *retiring allowance* to be rolled over to an RRSP within the prescribed limits for pre-1996 employment.

The employment duties of the spouse were picking rocks, harrowing/packing during seeding, cultivating, summer fallow, combining and truck driving during harvest, and numerous other farm-related duties.

INVESTMENT TAX CREDITS (ITCs)

In a February 6, 2002 *CCRA News Release*,



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CCRA notes that *ITCs* will be available to *farmers* who make financial contributions towards *scientific research and experimental development* (SR&ED) through agricultural organizations often referred to as *check-offs, assessments, or levies*. More information may be obtained at www.ccra-adrc.gc.ca/newsroom/releases/2002/feb/agrifood-e.html.

RRSP/PENSIONS

58(9)

RRSP BENEFICIARY

If the *beneficiary* of an RRSP is a *child or a grandchild* of the deceased who is *financially dependent* on the deceased at the time of death as a result of a *mental or physical infirmity*, the RRSP may be transferred to an *RRSP, RRIF or annuity* for that child.

Where the child is a minor who is *financially dependent*, but *not mentally or physically infirm*, the child may use the funds to acquire an *annuity* up to *age 18*.

CCRA normally takes the position that a child is *not financially dependent* if his/her income for the year prior to death was greater than the "basic personal amount" - \$7,634 for 2002, unless the taxpayer can prove otherwise.

INDIVIDUAL PENSION PLANS (IPP)

An *IPP* is a *defined benefit pension plan* for an *owner-manager* of a corporation. However, contributions to an IPP reduce RRSP contribution levels.



The IPP contribution is made on a *tax-deductible* basis by the *corporation* for the owner. It usually provides

higher contributions than RRSPs, based on actuarial evaluations. It also provides *creditor protection* under Provincial Pension Acts.

At retirement, the owner-manager may transfer the accumulated money to a Locked In Retirement Fund (LIRF) or acquire an annuity and take income as needed within certain boundaries. To implement an IPP, an *actuary* will be required. The fees could be in the \$1,000 per year range with initial setup and wind-down fees in the \$2,000 to \$3,000 range and, three year tri-annual valuation reports in the \$1,000 range. Also, an asset manager or pension consultant may be involved in the investment of the funds and required paperwork.

IPPs are *complicated* and require *ongoing consultation* with advisors, such as actuaries.

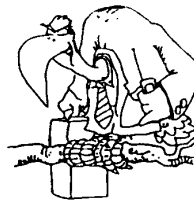
Actuarial calculations show that IPPs make the most sense for individuals aged *fifty plus* having annual personal earnings of \$100,000 or more.

INTERNATIONAL

58(10)

U.S. ESTATE TAXES AND GIFT TAXES - PENALTIES

The U.S. Internal Revenue Code includes *penalties* for unreported taxes based on *valuations* which were *not* entered into in "*good faith*". The Estate and Gift Tax penalties are *20%* if the value claimed on the tax return is *25% to 49%* of the actual value; and *40%* if the value on the return is less than *25%* of the actual value.



For example, in a July 6, 2001 case the

penalties were *\$30 million U.S.* on a tax deficiency of \$76 million.

CANADIAN RESIDENTS

CCRA recently introduced *IT-221R3* which explains their position concerning an *individual's residence status* for income tax purposes. The IT looks at factual residence upon entering or leaving Canada such as *residential ties*, regularity and length of *visits* to Canada, and residential ties *elsewhere*.

GST

58(11)

ALLOWANCES AND REIMBURSEMENTS

Where an employer *reimburses an employee* for costs incurred in employment, there is usually *no taxable benefit* for income tax purposes. The Excise Tax Act usually deems GST to be included in the reimbursement. Therefore, an *input tax credit* (ITC) is allowed to the employer based on the amount of GST payable. However, as an option, the employer may simply claim an ITC for *6/106* of the reimbursement.

Also, where the employer pays a *non-taxable allowance* to an employee (for example, a per-kilometre payment for the *employment use* of a vehicle), the amounts are *not* included in *income* by the employee and are eligible for an ITC to the employer based on *7/107* of the allowance for provinces not participating in the HST system and *15/115* of the allowance in provinces participating in the HST system.

If an allowance is *unreasonable* and, therefore included in *income* by the recipient, *no ITC* will be available to the employer. However, if the employee deducts expenses against this amount he/she would be eligible for a *GST rebate*.

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WHAT'S NEW

Starting in *July, 2002*, CCRA will recalculate the *GST/HST credit* as soon as they are advised about changes to your family situation, such as births, deaths, marriages, reaching the age of nineteen years, and becoming or ceasing to be resident in Canada.



For example, if a taxpayer turns *nineteen* before *April 1, 2003*, he/she may apply for the GST/HST credit on a *2001 Personal Tax Return*. If you became a *resident* of Canada in 2002, you can apply for the GST/HST credit by completing Form RC151.

If there is a change in *marital* status, the taxpayer is asked to inform CCRA *in writing* at their respective Taxation Centre.

The GST/HST credit is available to *lower income* Canadians.

DID YOU KNOW...

58(12)

INSURANCE REFUNDS

In a March 7, 2002 *Supreme Court* case involving *Co-operators General Insurance Co.* (Co-operators), the Court found that motorists who have *written off vehicles* in the last twenty years will have a case to *recover* their *deductibles*, averaging between \$500 and \$1,000, from their insurance companies. More than twenty *class-action suits* have commenced in the six provinces that do not have government car insurance plans - Ontario, Alberta, New Brunswick, Nova Scotia, Newfoundland and Prince Edward Island. As many as two million Canadians could be eligible for refunds of their *insurance deductibles*, dating back more than twenty years.



In this case, Gary McNaughton of Newbury, Ontario wrote off his 1992 Chevy Van in 1998 and lost his \$1,000 deductible when he was only paid \$7,235 (not \$8,235) by Co-operators. Co-operators then sold the van for salvage recovering \$1,419. The Court noted that this is "double dipping". If the insurance company wants the wrecked vehicle, they *cannot withhold* the *deductible*.

CPP BENEFITS - SAME-SEX COUPLES

Two class-action suits were launched in Vancouver and Toronto on behalf of thousands of *same-sex couples* who were *denied survivor benefits* under the *Canada Pension Plan* for *deaths prior* to January 1, 1998. The *January 1, 1998* date was arbitrarily set by CCRA when it introduced Bill C-23 which grants a variety of rights to same-sex couples. Lawyers in Halifax, Winnipeg, Saskatoon and Vancouver had news conferences to announce the *class-action*.

The preceding information is for educational purposes only. As it is impossible to include all situations, circumstances and exceptions in a commentary such as this, a further review should be done. Every effort has been made to ensure the accuracy of the information contained in this commentary. However, because of the nature of the subject, no person or firm involved in the distribution or preparation of this commentary accepts any liability for its contents or use.

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