KOZAK THOMAS LUCK
Chartered Accountants

PETER M. KOZAK DAPHNE J. THOMAS GREG D. LUCK
Practicing Through Professional Corporations

TAX LETTER

February 2011

REGISTERED EDUCATION SAVINGS PLANS
EMIGRATING FROM CANADA
CAPITAL GAIN ELECTION FOR CANADIAN SECURITIES
FILING REQUIREMENT FOR PARTNERSHIPS – NEW CRA POLICY
2011 AUTOMOBILE DEDUCTION AND BENEFIT LIMITS
GENERAL CORPORATE TAX RATE REDUCTION
AROUND THE COURTS

REGISTERED EDUCATION SAVINGS PLANS

A registered education savings plan (RESP) is a great vehicle for saving for your children’s (or grandchildren's) future post-secondary education.

Although your contributions to the RESP are not tax-deductible, the income earned in the RESP is exempt from tax until paid out to the child for educational purposes. Furthermore, assuming that your child is in a lower tax bracket than yours when the income is withdrawn, the tax paid by your child (if any) will be lower than the tax that would have been payable by you, had the income been taxed to you.

The contributions made by you to the RESP can be paid out tax-free, either to your child or to you as the “subscriber” of the plan.

There are some limits and restrictions on an RESP and the contributions that can be made to the plan. Some of these are summarized below.

There are restrictions on the type of property that can be held in the RESP – the property must be a “qualified investment”. However, this category of investments is quite broad, and generally are the same as the investments that can be held in your registered retirement savings plan (RRSP), such as mutual funds, GICs, and many types of stocks and bonds.

There is a $50,000 lifetime limit for contributions per beneficiary of the plan (e.g. your child). There is no annual limit (the former annual limit was lifted in 2007).

The RESP must be wound up or terminated by the 35th year following the year in which the plan was created. This deadline is extended to the 40th such following year, generally for a plan (specified plan) with a sole beneficiary who is entitled to the disability tax credit.

Contributions to the plan are generally not allowed after the 31st year following the year in which the plan was created. This deadline is extended to the 35th such following year for a specified plan.

If there is more than one beneficiary of the plan (e.g. more than one of your children or grandchildren), a contribution in respect of a beneficiary cannot normally be made once the beneficiary is 31 years old. An exception allows a contribution to such a plan from another RESP that has more than one beneficiary.

Income in the plan cannot normally be paid to anyone but the beneficiary (who must be pursuing post-secondary education). However, the income can be paid out to you as subscriber of the plan, generally if

SUITE 204 (NORTH TOWER) 5811 COONEY ROAD, RICHMOND, B.C. V6X 3M1 • TEL: (604) 276-2636 • FAX: (604) 273-9304

Members of
Institute of Chartered Accountants of British Columbia
Canadian Institute of Chartered Accountants

- the income is paid out after the 9th year following the year in which the plan was created, and each beneficiary of the plan is 21 years old or more and is not pursuing post-secondary education;
- the income is paid out in the year in which the plan must be terminated (as noted above); or
- each beneficiary is deceased.

The CRA may waive the first condition if it is reasonable to expect that the beneficiary of the RESP will not be able to pursue post-secondary education because he or she suffers from a severe and prolonged mental impairment.

If the income from the RESP is paid out to you as subscriber, it is included in your income. Furthermore, to compensate the government for the deferral of taxes, you must pay an extra **20% penalty tax** on the income. However, the penalty tax can be avoided by contributing the income into your RRSP, to a maximum amount of $50,000 of income, but subject to your regular RRSP contribution limits. The contribution to the RRSP will be deductible, so that regular income tax will also not be payable in respect of that amount (the inclusion because of the payment from the RESP will be offset by the deduction because of the contribution to the RRSP).

Canada Education Savings Grant and Canada Learning Bond

There is another benefit to opening up an RESP for your children. The federal government pays into the RESP a **Canada Education Savings Grant** (CESG) of 20% of your contributions each year up to the year in which your child turns 17 years old, to a maximum annual grant of $500. Thus, for example, an annual contribution of $2,500 or more will attract the full $500 grant. The lifetime limit of grants per beneficiary is $7,200. (If your child is 16 or 17, you cannot get the grant unless you made a certain minimum amount of contributions prior to the year in which they turned 16.)

The CESG and the income earned thereon can be paid out to your child once they are pursuing post-secondary education, and will be included in the child's income. If your child does not pursue post-secondary education, the CESG must be returned to the government.

The annual CESG is increased to 30% or 40% for the first $500 of annual contributions for certain low and modest-income families.

There is also a **Canada Learning Bond** (CLB) available to certain low-income families opening up an RESP for a child. Generally, a family that is entitled to the National Child Benefit supplement for their child will receive an initial CLB of $500 into the RESP if the child was born on or after January 1, 2004. A further $100 annual amount will be paid into the RESP for up to 15 years, in each year in which the family remains entitled to supplement.

EMIGRATING FROM CANADA

Under the Income Tax Act, if you cease to be resident in Canada, you are deemed to have disposed of your property at fair market value, with some exceptions noted below. As a result, any accrued gains and losses will be triggered at that time for income tax purposes. You will be deemed to acquire the property at a cost equal to the same fair market value.

(Note that the question of whether you cease to be "resident in Canada" may not have an obvious answer. If you move to another country you usually have to «cut your ties» with Canada to become non-resident, unless you establish close enough ties with the other country to override your Canadian residence and Canada has tax treaty with that country. For the purposes of this article we assume you have ceased to be a resident of Canada.)

The reason for the deemed disposition rule is to tax any net accrued gains on your property that have not yet been subject to tax. Without the rule, you could potentially move from Canada and avoid Canadian tax on gains that accrued while you were resident.

The deemed disposition rule does **not** apply to:

1. real property situated in Canada, a Canadian resource property or a timber resource property,
2. capital property used in, and property of the inventory of a business carried on in Canada through a permanent establishment, and
3. an "excluded right or interest", which includes items such as interests in deferred income plans like RRSPs and registered pension plans, among other rights and interests.

Furthermore, if you were not resident for more than 60 months during the 120-month period prior to your emigration from Canada, the deemed disposition rule does not apply to property that was owned by you when you last became resident in Canada, or that was inherited by you after you became resident in Canada.

You can elect that the properties listed in items 1) and 2) above (that are otherwise exempt from the deemed disposition rule) be subject to the deemed disposition rule. You might make this election if such properties had an accrued loss, so as to trigger that loss to offset any gains

that resulted from deemed dispositions of other properties.

If the deemed disposition of a property results in tax payable, you can elect to defer paying the tax until the property is actually sold, without interest. To make this election, you must normally post security with the Canada Revenue Agency (CRA). The election must be made, and the security provided, by April 30 following the year in which you leave Canada. However, security is not required in respect of the tax on the first $50,000 of taxable income resulting from the deemed disposition rule (actually, the tax that would result, using the highest marginal rate of tax). In other words, the deferral is normally available, without security, in respect of the first $100,000 of net capital gains ($50,000 net taxable capital gains, since one-half of capital gains are taxable).

Relief from double taxation

In some cases, if you were subject to the deemed disposition rule in respect of a property and therefore subject to Canadian tax, you may be subject to tax in another country (say, your new country of residence) if you sell the property at a gain. There is some relief in these circumstances.

First, the Income Tax Act allows a credit for Canadian tax purposes, in the year of your emigration, generally for the foreign tax paid on the later (actual) gain to the extent that it relates to the pre-emigration portion of the gain. The credit is limited to the Canadian tax payable in respect of the deemed disposition of the property. The credit is generally available if the foreign tax is paid to a treaty country (a country that has a tax treaty with Canada) in which you reside, and, in the case of real property located outside of Canada, if the foreign tax is paid to the country in which the real property is located.

Second, some of Canada's tax treaties have been modified to account for the deemed disposition rule. For example, under the Canada-US treaty, if you move from Canada to the United States and are subject to the deemed disposition rule in Canada, you can now elect that the property is also deemed to be disposed of and re-acquired at its fair market value for US tax purposes. If the resulting gain is not subject to US tax, you will have a stepped-up cost base of the property equal to its fair market value, which should eliminate the double tax issue when you ultimately sell the property. If the resulting gain on the deemed disposition is subject to US tax (e.g. the property is real property in the United States), you will be eligible for a tax credit in the year of emigration to avoid double tax. (Special rules apply to Canadian residents who are US citizens and are moving to the US.)

CAPITAL GAIN ELECTION FOR CANADIAN SECURITIES

Normally when you sell a security, such as a share, and realize a gain, it will be a capital gain. One-half of the gain will be included in your income as a taxable capital gain.

On the other hand, if you are found to be in the business of buying and trading securities, any gain will be **fully** included in your income. For these purposes, you will be deemed to have a business if your purchase and sale is an "adventure or concern in the nature of trade" (e.g. you bought shares intending to sell them fairly quickly rather than as an investment).

However, you can make an election under the Income Tax Act that has the effect of ensuring that gains from the dispositions of "Canadian securities" are capital gains and not business income. The election is made with your tax return for a year, and is effective for all dispositions in that year and for the rest of your life. The election is made in Form T123 "Election on Disposition of Canadian Securities", and cannot be revoked once it is made.

A "Canadian security" includes a share of a corporation resident in Canada, a unit of a Canadian mutual fund trust, and a bond, debenture, bill, or similar debt obligation issued by a person resident in Canada. It does not include certain "prescribed securities", such as shares in private corporations whose value is wholly or primarily attributable to real estate.

One of the downsides of making the election is that any losses on the dispositions of Canadian securities are deemed to be capital losses.

The election does not apply to dispositions made by certain taxpayers, such as a trader or dealer in securities, a financial institution, and a corporation whose principal business is the lending of money or the purchasing of debt obligations.

FILING REQUIREMENT FOR PARTNERSHIPS – NEW CRA POLICY

A partnership is not required to file a tax return. Rather, the partners report their share of the partnership income on their own tax returns.

However, regulations under the Income Tax Act provide that a partnership that is a Canadian partnership or that carries on a business in Canada in a fiscal period must file an information return for the fiscal period. The information return (Form T5013) includes information

such as the names and addresses of the partners, the income or loss of the partnership, and the partners' shares of such income or loss.

If all of the partners are individuals, the partnership return must be filed by March 31 following the year in which the fiscal period ended. If all the partners are corporations, the return must be filed within 5 months after the end of the fiscal period. In any other case, the return must be filed by the earlier of the two above dates.

Notwithstanding the regulations, the CRA has historically waived the filing requirement for partnerships with fewer than six partners throughout the fiscal period, as long as none of the partners were other partnerships.

On September 17, 2010, the CRA announced a new policy, applicable to partnership fiscal periods that end after 2010. The new policy does away with the five-or-fewer partner exception described above. The new policy requires an information return for a fiscal period if:

1) at the end of the fiscal period, the partnership has an "absolute value" of revenues plus an absolute value of expenses of more than $2 million, or has more than $5 million in assets; **or**

2) at anytime during the fiscal period,

    a) the partnership is a tiered partnership (has another partnership as a partner or is itself a partner in another partnership);
    b) the partnership has a corporation or a trust as a partner;
    c) the partnership invested in flow-through shares of a principal-business corporation that incurred Canadian resource expenses and renounced those expenses to the partnership; or
    d) the CRA requests the return in writing.

The CRA states that it will provide an updated T5013 information return, along with a new tax guide for partnerships, which will be available on its website some time in 2011.

2011 AUTOMOBILE DEDUCTION AND BENEFIT LIMITS

Deduction limits for car expenses

As a general rule, you are allowed to deduct car expenses incurred in the course of your business. Similarly, subject to certain conditions under the Income Tax Act, you may be able to deduct your car expenses incurred in the course of employment.

In particular, for cars purchased or car leases entered into after 2000 and through 2011, the following limits apply:

- The maximum cost of your car on which CCA that can be claimed is $30,000 plus GST / HST and any provincial sales tax;
- The maximum allowable interest deduction for car loans is $300 per 30-day period in the year; and
- The general limit on deductible leasing costs is $800 per 30-day period in the year plus federal and provincial sales tax. However, the deductible lease payments may also be reduced if the manufacturer's list price of your car exceeds $39,822.

Deduction for tax-free allowance to employee

If you use your own car for employment purposes, your employer can normally pay you a deductible tax-free allowance in respect of the employment use of the car, subject to the certain monetary limits.

For 2011, the dollar limits remain the same as last year: 52 cents per kilometre for the first 5,000 km driven in the course of employment and 46 cents for each additional kilometre driven. For Yukon, Northwest Territories and Nunavut, the deductible tax-exempt allowance limit remains at 56 cents for the first 5,000 km driven and 50 cents for each additional kilometre driven.

GENERAL CORPORATE TAX RATE REDUCTION

Effective January 1, 2011, the general federal corporate tax rate is being reduced from 18% to 16.5%. Starting in 2012, the rate is scheduled to be reduced to 15%. (However, we could see a federal election within the next year, and a new government might choose to postpone or eliminate the reduction.)

The federal corporate tax rate on the first $500,000 of small business income of a Canadian-controlled private corporation remains at 11% for 2011.

The provincial general and small business corporate tax rates vary depending on the province.

AROUND THE COURTS

Medical expense credit for travel to parents' hot tub and UVB unit

The medical expense tax credit applies to certain medical expenses that are specified in the Income Tax Act. One of the specified medical expenses includes travel costs incurred for the transportation of an individual (patient) from the locality where the patient lives to a place where medical

services are normally provided, and back. However, the travel costs can be claimed only if, among other things, the medical services are at least 40 kilometres from the patient's locality, substantially equivalent medical services are not available in the patient's locality, and the patient actually obtains those "medical services".

In the recent *Sienema* case, the taxpayer suffered from psoriatic arthritis and psoriasis. Following his doctor's advice, the taxpayer received UVB phototherapy from a UVB phototherapy unit and used a hot tub to relieve the symptoms. The UVB unit and hot tub were installed at his parents' house, which was 51 kilometres from his home. The taxpayer claimed the medical credit for his travel and meal expenses incurred in travelling to his parents' home three times a week. The CRA denied the claim, primarily on the grounds that the taxpayer was not receiving "medical services" at his parents' home.

On appeal, the Tax Court of Canada allowed the taxpayer's claim. The Court defined the term "medical services" fairly liberally, holding that the term "includes any services relating to the scientific diagnosis, treatment and prevention of disease, not just those provided by a medical practitioner or medically trained person." The Court concluded that the taxpayer "was obtaining medical services when he used the hot tub and UVB unit because he was receiving medical treatment." Accordingly, his travel and meal expenses qualified for the medical tax credit.

Individual with daily seizures did not qualify for disability credit

There are various requirements that must be met for an individual to claim the disability tax credit. In the recent *Pakarinen* case, the requirement at issue was whether the taxpayer's basic activities of daily living were "markedly restricted", meaning that all or substantially all of the time, the taxpayer was unable or required "an inordinate amount of time" to perform a basic activity of daily living.

The taxpayer suffered from prolonged seizure disorder, and averaged three seizures a day. During each seizure he would lose consciousness and, according to his doctor, was not able to do anything that required any cognitive function. The doctor also stated that the taxpayer "has frequent seizure episodes during which time he is totally disabled". The taxpayer tried various medications to control his seizures, but to no avail. The taxpayer's doctor also certified that the taxpayer's ability to perform mental functions was not likely to improve.

Despite the taxpayer's condition, the CRA denied his claim for the disability tax credit, and the Tax Court of Canada denied his appeal. The Court found that the taxpayer did not require an inordinate amount of time to perform a basic activity of daily living, and therefore did not meet all of the requirements for the credit.

As the *Pakarinen* case illustrates, certain individuals will not be eligible for the disability credit even if they suffer from a significant illness. The specific requirements of the Income Tax Act must be met in all cases.

* * *

This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.