

## TAX LETTER

January 2012

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### INDEXATION OF AMOUNTS FOR 2012

Every year, the federal tax brackets and most personal credit amounts are indexed for inflation. The Canada Revenue Agency (CRA) recently announced the changes from the 2011 taxation year to the 2012 taxation year, which reflect an increase of 2.8%. Some of the notable changes are indicated below.

The 2012 federal tax brackets will be:

- 15% tax bracket for the first \$42,707 of taxable income (up from \$41,544 in 2011)
- 22% tax bracket begins at taxable income above \$42,707
- 26% tax bracket begins at taxable income above \$85,414 (up from \$83,088)
- 29% tax bracket begins at taxable income above \$132,406 (up from \$128,800)

The 2012 federal tax credits will be 15% of the following:

- Basic personal amount of \$10,822 (up from \$10,527 in 2011)
- Spousal or common-law partner amount of \$10,822\* (reduced if spouse or common-law partner has income)
- Age (65 and over) amount of \$6,720 (up from \$6,537), reduced beginning when net income exceeds \$32,961
- Children under age 18 amount of \$2,191\* (up from \$2,131)
- Canada employment amount of \$1,095 (up from \$1,065)
- Disability amount of \$7,546 (up from \$7,341)
- Caregiver credit amount of \$4,402\* (up from \$4,282), reduced if dependant's income exceeds \$15,033

- Infirm dependant amount of \$6,402, reduced if dependant's income exceeds \$6,420
- Qualifying medical expenses exceeding the lesser of 3% of net income and \$2,109 (up from \$2,052).

\* Increased by \$2,000 if the dependant is infirm and you qualify for the family caregiver amount.

The amount at which the Old Age Security "claw back" tax starts to apply is increased for 2012 to \$69,562 of net income, up from \$67,668.

The provinces and territories also index similar amounts for provincial and territorial income tax purposes, with slightly different amounts and indexation rates in each province.

### CHANGES FOR ELIGIBLE DIVIDENDS IN 2012

Individuals who receive an "eligible dividend" from a Canadian corporation are required to include in income the dividend plus the "gross-up" amount of the dividend. However, a dividend tax credit is applied, which results in a rate of tax payable on the dividend that is less than the regular rate that applies to other income.

The purpose of the gross-up and dividend tax credit mechanism is to give shareholders a credit for the tax paid by the corporation on its income from which the dividend is paid.

The general federal corporate tax rate for large businesses will be reduced in 2012 to 16.5% (down from 18% in 2011). As a result, the gross-up and tax credit amounts will change in 2012. In 2011, the gross-up was 41% of the dividend, and the

dividend tax credit was 13/23 of the gross-up. In 2012, the gross-up will be 38% of the dividend, and the dividend tax credit will be 6/11 of the gross-up.

#### *Example*

You receive a \$100 taxable dividend in 2012. You must include \$138 ( $\$100 \times 1.38$ ) in your income. If you are in the 22% federal tax bracket, your initial tax on the grossed-up dividend will equal \$30.36 ( $22\% \times \$138$ ). However, you will get a federal dividend tax credit of 6/11 of \$38, or \$20.73. Therefore, your federal tax on the dividend will be \$9.63 ( $\$30.36 - \$20.73$ ).

On the other hand, if you receive a non-eligible dividend in 2012, the gross-up is 25% of the dividend, and the dividend tax credit is 2/3 of the gross-up. These amounts remain unchanged from 2011. A non-eligible dividend is any dividend that is not an eligible dividend – the main type of non-eligible dividend is one paid by a Canadian-controlled private corporation out of its business income that was subject to the small business deduction (i.e. the first \$500,000 of its active business income for the year, which is taxed at a much lower rate at the corporate level). Almost all dividends paid by public corporations are eligible dividends.

The corporation paying you the dividend must indicate whether it is an "eligible dividend" or not. In other words, the onus is on the corporation, and not the shareholder, to provide such information. The T5 slip issued by the corporation after year-end will clearly put the dividend in either the "eligible dividend" or "non-eligible dividend" box.

The provinces have similar gross-up and dividend tax credit mechanisms for provincial tax purposes. The amounts vary by province, and are indicated in the provincial calculations on your tax return.

## **CHANGES TO EMPLOYEE AND SHAREHOLDER BENEFIT RULES**

### **Employee benefits**

Under the current wording of the Income Tax Act, a benefit received by an employee in respect of, in the course of, or by virtue of an office or employment, is included in the employee's income. (There are various exceptions, where benefits are not included.)

Technical amendments released by the Department of Finance on October 31, 2011 propose to amend this rule, to "clarify" that employment benefits received by a person who does not deal at arm's length with the employee are included in the employee's income. These amendments apply to employment benefits received or enjoyed on or after October 31, 2011. This will catch, among other things, university tuition for adult children of employees, although a limited exception is provided for certain employer-provided scholarships.

### **Shareholder benefits**

Similarly, current rules provide that a benefit conferred upon a shareholder of a corporation by the corporation is included in the shareholder's income.

The same technical amendments will amend this rule, by providing that a benefit conferred by a corporation on an individual who does not deal at arm's length with, or is affiliated with, a shareholder of the corporation, is included in the shareholder's income (unless the individual is also a shareholder, such that the benefit is included in his or her income). The amendments also "clarify" that a benefit conferred by a corporation on a member of a partnership that is a shareholder is included in the member's income. These amendments also apply in respect of benefits conferred on or after October 31, 2011.

## **SHAREHOLDER LOANS**

Under the shareholder loan rules, if you receive a loan or otherwise become indebted to a corporation in which you are a shareholder, the amount of the loan or debt is included in your income, unless it falls within one of the exceptions discussed below.

The same rules can also apply to a person that is not a shareholder, if the person does not deal at arm's length with a shareholder of the corporation. Therefore, for example, if your corporation lends money to your child, the rules can apply to your child even if he or she is not a shareholder.

If the shareholder loan rules apply, you will be allowed a deduction if and when you repay the loan. The deduction is not allowed if the repayment is part of a series of loans and repayments.

Fortunately, there are various exceptions, where the shareholder loan rules do not apply.

### **Exception: Loan repaid within one year after the corporation's taxation year**

The shareholder loan rules do not apply if the loan is repaid to the corporation within one year after the end of the corporation's taxation year in which the loan was made. For example, if you borrowed money from your corporation in March 2011 and the corporation's taxation year (fiscal period) ends on January 31 of each year, you can repay the loan any time up to the end of January 2013. In this example, you have almost two years to repay the loan.

This exception does not apply if the repayment of the loan is part of a series of loans and repayments. For example, if you take out a loan, repay it next year but take out another loan in that year, and repeat the process, the exception will likely not apply.

### **Exception: Loan or debt made in the ordinary course of business**

The loan rules do not apply to a debt that arose in the ordinary course of the corporation's business, or a loan made by a corporation in the ordinary course of the corporation's

business of lending money. However, in each case, *bona fide* arrangements must be made for repayment within a reasonable time.

### **Exception: Loan made to employee**

The shareholder loan rules do not apply to a loan made to an employee of the corporation who is not a “specified employee” of the corporation. Generally, an employee will not be a specified employee if the employee deals at arm’s length with the corporation and, together with non-arm’s length persons, owns less than 10% of the shares of any class of the corporation. As well, in order to fall within this exception, the employee must receive the loan because of the employee’s employment rather than shareholdings, and *bona fide* arrangements must be made for the repayment of the loan within a reasonable period of time.

If the shareholder is a specified employee, this exception will still apply if the loan was used to acquire a residence, to acquire newly issued shares in the corporation or a related corporation, or to acquire an automobile to be used in the duties of employment. As above, the employee must receive the loan because of the employment rather than the shareholdings, and *bona fide* arrangements must be for the repayment of the loan within a reasonable period of time.

### **Possible taxable benefit where shareholder loan rules do not apply**

If the shareholder loan rules **do not** apply, you may still be taxed on a deemed interest benefit if you receive a loan from the corporation that bears low or no interest. The deemed benefit will be computed using the prescribed rate of interest that applies during the year in which the loan remains outstanding. The prescribed rate of interest is set quarterly and is computed on the outstanding principal amount of the loan during each quarter. Subtracted from the deemed benefit for the year is any interest that you pay during the year or by January 30 of the following year. Therefore, if you pay the prescribed rate of interest on the loan, there will be no net deemed benefit.

The prescribed rate for these purposes was, throughout 2010 and 2011, only 1%. The rate for the first quarter of 2012 (January through the end of March) remains at 1%.

## **TAX BENEFITS FOR FIRST-TIME HOME BUYERS**

There are certain tax benefits for first-time home buyers, as well as those who have not owned a home in the current year or the previous four years. The benefits are provided under the RRSP Home Buyers' Plan, and the first-time home buyer's credit.

### **RRSP Home Buyers' Plan**

Under the RRSP Home Buyers' Plan, you can withdraw up to \$25,000 from your RRSP to purchase a qualifying home in which you will reside. Your spouse (or common-law partner) can also withdraw \$25,000 from his or her RRSP for the same

home, for a total of \$50,000. Unlike most RRSP withdrawals, tax is not payable on these amounts.

Although the plan applies to first-time buyers, it is actually somewhat broader in its application. You can withdraw under the plan as long as you or your spouse did not own and reside in a home in any of the preceding four calendar years or in the year of withdrawal more than 30 days prior to the withdrawal (effectively, the 30-day period allows you to acquire your new home up to 30 days before withdrawing the funds from your RRSP).

Furthermore, if the property is being purchased for a related disabled person (or you, if you are disabled), generally meaning a person eligible for the disability tax credit, a home can qualify regardless of previous ownership – that is, there is no four-year look-back rule. In this case, the home must be a dwelling that is more accessible by the disabled person or in which the person is more mobile or functional, or in an environment better suited to the personal needs and care of that person. Furthermore, you cannot acquire the home more than 30 days prior to the withdrawal.

The rules provide that you must acquire the home by October 1 following the year of the RRSP withdrawal. You must either inhabit the home at the time of withdrawal or intend to inhabit it within one year of acquiring it.

The withdrawn amount must be repaid to your RRSP over a 15-year period, beginning with the second year following the year of withdrawal. You do not have to pay interest on the amounts. At least one-fifteenth of the withdrawn amount must be repaid in each of those 15 years, although early repayments are allowed.

A repayment for a year can be made in the year or within 60 days after the end of the year. The repayment is made like a regular contribution to your RRSP. Then, in your tax return for the year, you designate the amount of the repayment for the year. The designated repayment amount is not deductible from your income.

If you do not repay an amount that it is required to be repaid in the year, that amount will be included in your income for that year.

### **First-time home buyers' credit**

This federal credit is 15% of \$5,000, or \$750, in the year in which you acquire a qualifying home. In order to qualify, you and your spouse (or common-law partner) cannot have owned and lived in another home in the calendar year of purchase or any of the four preceding calendar years. Similar to the RRSP home buyers' plan, the four-year look back period is waived if the home is acquired for the benefit of a related disabled person. In either case, you (or the disabled person) must intend to inhabit the home within one year after its acquisition.

The credit can be claimed by you or your spouse or common-law partner. Otherwise, you can share the credit, but the total credit claimed by both of you cannot exceed the \$750 amount.

## **POLITICAL DONATION TAX CREDIT**

The Income Tax Act provides a generous tax credit for donations to federal political parties. The credit is allowed in a year in which you make a donation to a registered federal party, a provincial division of a registered party, or a registered association or a candidate. The credit applies only to donations to *federal* parties, associations, and candidates – that is, it does not apply to provincial parties or candidates (but see below regarding provincial credits).

The federal credit for a year is 75% of the first \$400 of donations in the year, 50% of the next \$350 of donations in the year, and 33-1/3% of the remaining donations. Note that individuals are limited to the amounts they can donate to a party in a year – the limit has been \$1,100 per year, and is being increased to 1,200\$ in 2012.

Most provinces provide provincial tax credits in respect of donations to provincial parties, associations, and candidates in a provincial election. The credits vary by province. For example, in Ontario, there is a maximum tax credit of up to \$1,240 a year, which is reached when your political donations total \$2,821 or more in the year. Some municipalities also provide rebates for donations to candidates in municipal elections.

## **CRA WARNS OF “TAX PROTESTER SCHEMES”**

The CRA recently reiterated its warning about individuals who try to convince Canadians that they do not have to pay tax on the income they earn. The CRA refers to these individuals as “tax protesters”.

One of the most common false arguments tax protesters use is the “natural vs. legal person” argument, in which they treat themselves as two separate people for income tax purposes. Those people claim that the natural person is the individual who performs the labour required to earn income, and that the legal person is an entity that the federal government creates through the issuance and use of the Social Insurance Number. Tax protesters allege that only the legal person has to file an income tax and benefit return, and that income received belongs to the natural person and is therefore not subject to Canadian income tax.

As the CRA correctly points out, these arguments are legally incorrect, and you should ignore them if someone tries to convince you otherwise.

On its website, the CRA states that those involved in tax protester schemes will be reassessed income tax and interest, and assessed penalties. In some cases these individuals will be prosecuted for tax evasion. If convicted, they face significant fines and possibly jail time. In fact, the CRA regularly issues press releases reporting on convictions of such persons.

However, the CRA goes on to say that individuals who would like to correct their tax affairs can voluntarily come forward, and they may not be penalized or prosecuted if they make a valid disclosure before they become aware of any compliance action being taken by the CRA against them. These

individuals will have to pay only the taxes owing, plus interest, under the CRA’s “voluntary disclosures” program.

## **AROUND THE COURTS**

### **Wholly dependent credit denied**

The “wholly dependent person” credit (sometimes referred to as the equivalent-to-spouse credit) can be claimed if, among other things, you are single and support your minor child who lives with you. However, you cannot claim the credit if you are required to pay support for that child to a former spouse and you live separate and apart from your former spouse for the entire year.

In the recent *Roy* case, the taxpayer was under a court order to pay to his former wife child support for their son during the taxation years in question. Subsequently, the couple reconciled, after which his wife renounced her entitlement to the support payments, and filed a written form with the court, withdrawing her previous instruction to the court to enforce collection of the amounts.

The taxpayer claimed the wholly dependent credit for the taxation years in question, but the CRA denied the deduction. The CRA argued that he was still legally obligated to make the support payments, and therefore could not claim the credit.

On appeal, the Tax Court of Canada agreed with the CRA. The Tax Court Judge held that only the original court that made the support order had the jurisdiction to terminate the taxpayer’s obligation to make the support payments. Since that court had not done so, the taxpayer was still legally required to make the support payments. As a result, the CRA’s argument was correct.

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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.