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# CURRENT DEVELOPMENTS

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### YEAR END TAX PLANNING

November 2004

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**RRSP  
contributions  
must be made  
by March 1,  
2005  
to be deductible  
for 2004**

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**T**ax planning is most effectively carried out throughout the year, and the latter part of the year is an appropriate time to review various income tax and financial planning techniques that are available to individual and corporate taxpayers. Most tax planning transactions require analysis before being implemented so that they can be applied properly and in the right circumstances. For this reason, and since certain matters affected by the Federal and various provincial budget proposals could differ from the actual law when enacted, all taxpayers should consult with their financial and tax advisors before initiating any of the strategies outlined in this issue.

#### Registered Retirement Savings Plan (RRSP)

The 2004 contribution is limited to the lesser of 18% of 2003 earned income or \$15,500 (\$16,500 for 2005), minus the pension adjustment (PA) which applies to members of registered pension plans or deferred profit sharing plans. Some taxpayers may benefit from a pension adjustment reversal (PAR) in certain circumstances.

An individual who does not contribute his/her deduction limit for a year can carry forward this unused deduction room indefinitely.

Contributions do not have to be deducted in the year they are made, but can be carried forward and deducted in a future year.

A contribution in excess of the annual limit can be carried forward to be applied against the deduction room for any subsequent year. No penalty applies where an RRSP overcontribution (cumulative) is not more than \$2,000, any excess being subject to a 1% per month penalty.

Earned income for RRSP purposes is the total of all salaries (net of employment expenses), alimony, net research grants, income (loss) from a business, rental income (loss) and disability payments received under the Canada and Québec Pension Plans. Support (alimony and maintenance) payments made by the taxpayer will reduce earned income for RRSP purposes, if deductible for tax purposes.

The foreign property rule in respect of deferred income plans (including RRSPs) generally limits the amount of foreign property that a plan can hold to 30%.

All or part of an RRSP contribution may be made to a spousal plan (without affecting the contribution available to the spouse) if the spouse is under age 70. This can serve as an income splitting method upon the eventual withdrawal of the funds, provided the funds are left in the plan for a sufficient period of time.

RRSP contributions should, where possible, be made early in the year to benefit from the longer period that income is earned on a tax-sheltered basis within the RRSP.

Employees can ask their employer to pay a portion of their salary directly into an RRSP without deduction of income tax at source.

Contributions other than in cash are also permissible to self-administered RRSP plans. However, a non-cash contribution may result in a gain or loss for tax purposes. A capital gain would be taxable while a capital loss would be non-deductible.

A recipient of certain payments, most notably amounts received on leaving employment which are categorized as "retiring allowances", can transfer all or a portion (based on specific limits) to their **own** RRSP on a tax deferred basis.

Individuals who have RRSP deduction room after age 69 will be able to contribute to a spousal RRSP up until the end of the year in which their spouse turns age 69.

**If you turn 69 this year, you must mature (wind-up) your plans by December 31, 2004.**

In order to avoid paying tax immediately upon the maturity of an RRSP, an annuity can be purchased and/or the RRSP can be transferred to a RRIF.

If you turn age 69 this year and consequently cannot contribute to an RRSP in 2005 (assuming a spousal plan contribution is not available), you may contribute your 2005 - available RRSP deduction in December 2004 (before winding-up your RRSP) and pay a maximum penalty of \$145 (1% of \$14,500).

## **RRSP Education Withdrawals**

Eligible individuals are able to make tax free withdrawals from an RRSP to finance full-time training or education for themselves or their spouses. Withdrawals may not exceed \$10,000 in a year and will be permitted for a period of up to four calendar years, provided that the total amount withdrawn does not exceed \$20,000. Withdrawals under the plan will be repayable by the recipient in equal instalments over a period of 10 years, with the first payment due no later than 60 days after the fifth year following the first withdrawal.

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

Subject to certain conditions, an individual who is a first-time home buyer can borrow up to \$20,000 in a year from his or her RRSP, repayable over a 15 year period. If you intend using the Plan towards year-end, consider deferring your withdrawal until after December 31. This will extend by one year the time period for repaying the amounts withdrawn.

## **Registered Education Savings Plan (RESP)**

Under an RESP, contributions are made to a plan intended to pay for the post-secondary education of designated beneficiaries, usually the taxpayer's children or grandchildren. Although contributions are not tax-deductible, income earned in the plan is not taxable until distributed, at which time it is taxed in the hands of the beneficiary. Annual contributions are limited to \$4,000 per beneficiary to a lifetime total of \$42,000.

The Federal government will provide a grant (CESG) equal to 20% of the annual contributions made to RESPs for each child up to age 18. A social insurance number must be provided for each child. The CESG will be payable on contributions made in the year to a maximum of \$400 per child per year. Small increases in the amount of CESG are scheduled for 2005.

## **Capital Gains Exemption**

The capital gains exemption continues to be available to individuals who have not fully utilized it, but only in relation to gains realized on qualified small business corporation shares (or a family farm property).

Notwithstanding the income attribution rules, it may be advantageous to transfer a certain portion of qualifying growth assets to children to enable future capital gains to be exempt from taxation by utilizing the child's capital gain exemption.

Consideration should be given to crystallizing a gain that qualifies for the exemption. Because of AMT, however, a crystallization may be more beneficial if spread over two years.

Be aware of the possible disadvantage of selling investments eligible for the \$500,000 capital gains exemption and those with offsetting losses in the same year. Capital losses realized in the year must be offset against capital gains of that year. Consequently, the disadvantage arises primarily if there is no other property on hand likely to be eligible for the \$500,000 exemption in the future.

### **Capital Gains and Losses**

Capital losses realized in 2004 (net of any capital gains realized) can be carried back up to three years and carried forward indefinitely to offset capital gains reported in other years.

Capital losses will not be recognized at the time of disposition where, during the period that begins 30 days before and ends 30 days after the disposition of the property, the taxpayer or a person affiliated with the taxpayer acquires an identical property (a "superficial loss").

Corporations should consider paying a dividend out of the Capital Dividend Account (essentially the tax-free portion of net capital gains) prior to the realization of capital losses.

We encourage our clients to contact us before implementing any of the strategies described above, as the specific facts in a particular situation may indicate an alternate strategy. And remember that taxation concerns are only one aspect of a complete investment plan - before realizing losses attention should be given primarily to the quality of the investments involved and their place in one's investment plan.

### **Capital Gains Rollovers for Small Business Investors**

To improve access to capital for small businesses with high growth potential, there exists a tax measure which, subject to certain conditions, permits individuals to defer capital gains on eligible small business investments to the extent that the proceeds are reinvested in another eligible small business.

### **Income Splitting**

Investment income earned by an individual who is related to a lender who has made a low or non-interest bearing loan to them, will be attributed to the lender. This will not apply where the loan is to a related person other than a spouse or minor child if it can be shown that none of the "main" reasons for the loan was to reduce or avoid tax.

Since the attribution rules are extremely complex, caution is advised when contemplating a transfer of property or a loan to a spouse or a child (including transfers indirectly through a corporation in which they are shareholders). That being said, some basic planning ideas would include:

- gifting growth assets to a minor child, as the resulting capital gain is not attributed to the donor;
- gifting property to a child who is not a minor;
- segregating and re-investing "attributed" income of a spouse or minor child;
- segregating and investing family allowance and child tax benefit payments;
- using the higher-earner's income to pay all family expenses and segregating and investing the lower-earner's income;
- using a trust for the benefit of family members to hold shares of a closely-held corporation. However, there are restrictions in regard to income-splitting with minor children.

Income splitting may be achieved by having your spouse be your business partner or by having a business owner pay reasonable salaries to his or her spouse or children.

Spouses can choose to share their QPP and CPP retirement pensions.

## Personal Income Tax Instalments

Individuals who are required to make quarterly instalments should review the amounts paid, to avoid or reduce the non-deductible interest charged (which can be onerous) on late or deficient instalments. Individuals are required to remit their Federal and Québec instalment payments on or before March 15, June 15, September 15 and December 15.

If the tax liability for 2004 will be less than originally estimated, the December remittance can be reduced accordingly.

Canada Revenue Agency and Revenue Québec will continue to notify individuals required to remit instalments of the amount of each instalment determined on the basis of tax information from prior years. Payments made in accordance with these notifications will always avoid interest charges.

Commencing in 2005, Québec requires that a 16% tax deduction be withheld from RRSP annuity payments and minimum amounts withdrawn from a RRIF. Québec instalments can be adjusted accordingly.

## Tax Assisted Investments

When considering tax assisted investments, it should be noted that most are speculative in nature. While they may result in significant tax savings, there remains a cost to the investor.

The decision to invest should be based on the quality of the investments as well as the favourable tax treatment they receive.

### Film Investments

The purchase of an ownership interest in certified Canadian films continues as a tax deferral vehicle by allowing the investor certain tax credits.

### Investment in the Petroleum and Gas and Resource Industries

These investments, whether made directly, through a partnership or by the purchase of shares, allow the investor a deduction from income of varying amounts depending on whether the investment is in oil and gas or mining.

The income tax rules and financial implications relating to such investments are extremely complex and should be reviewed on an individual basis.

## Québec Stock Savings Plan (QSSP)

A percentage (50%, 75% or 100%) of the cost of certain eligible shares will be deductible in computing taxable income for *Québec income tax purposes only*. Interested individuals should contact their broker for a current listing of eligible shares, however, there is currently a moratorium on new offerings as Québec studies the issue. The maximum annual deduction is limited to 10% of the taxpayer's net income less the capital gains exemption being claimed.

Capital gains and losses resulting from the disposition of QSSP shares are taxed in the ordinary manner and interest expense on funds borrowed for the purchase of QSSP shares is tax deductible.

## Pension Income Credit

An individual may be entitled to a tax credit (Federal and Québec) on up to \$1,000 of pension income. OAS and QPP (CPP) pensions are not eligible for the pension income credit. The Québec credit is reduced when "family income" exceeds \$27,635.

If there is not sufficient pension income to qualify for the full amount of the credit, additional qualifying income can be created by commencing to receive pension income in the form of a life annuity and, if age 65 or older, also by converting all or part of your RRSP plan into an annuity, or by simply purchasing an ordinary (unregistered) life annuity contract with other funds.

## Donations

If planning to make any donations to a public charity, consider contributing marketable securities that have inherent gains, as the income-inclusion rate of the resulting capital gain is one-half of what it would otherwise be if the security were sold. The donation credit is based on the market value of the securities.

## Alternative Minimum Tax (AMT)

The AMT imposes a minimum tax on certain individual taxpayers and could adversely affect those high-income individuals who have significant deductions arising from investments in tax shelters. Certain shelters such as flow-through shares of mining companies, etc. as well as large capital gains and dividends may subject the individual to the AMT in 2004.

Taxpayers who have paid the AMT in the past may have an opportunity in 2004 (and following years) to recover part or all of the AMT previously paid.

Recently announced changes to the Québec AMT system will result in individuals (including trusts) being far less likely to be subject to AMT. The changes will also make it easier to recover AMT paid in prior years.

### Salary/Dividend Planning

Many aspects must be considered in determining the most beneficial combination of remunerating the owner/manager of a closely-held corporation.

As with other planning, each case must be examined separately and no one “rule of thumb” can apply to all situations.

Some factors to be considered are:

- The tax rate of the corporation
- The tax rate of the individual
- The need for salary income by the individual to qualify for RRSP and CPP/QPP contributions
- New Québec restrictions on the deductibility of investment expenses by individuals.

Some planning techniques include:

Remuneration that is accrued and expensed by a corporation must be paid to the employee within 179 days of the corporation’s year-end. Where that year-

end falls in the latter half of the calendar year (actually, after July 6), the corporation can cause the owner/manager’s remuneration to fall into either the current or subsequent calendar year.

The payment of dividends can be used to reduce or eliminate the owner/manager’s CNIL, thus maximizing the amount of capital gains exemption which may be available to the taxpayer.

### Timing of Acquisition of Assets

Accelerate the acquisition of depreciable property used in carrying on a business otherwise planned for the beginning of the next year. This will allow additional depreciation to be available to be claimed in the current year. The “available-for-use rules” should be considered (generally requiring the depreciable property to be used in operations for the depreciation deduction to be allowed).

Consider delaying until the subsequent year the acquisition of depreciable property in a class that would otherwise have a terminal loss in the current year.

### Shareholder Loans

If contemplating a loan from a corporation to a shareholder, the potential taxability should be evaluated.

#### **TO OBTAIN CURRENT DEDUCTIONS AND TAX CREDITS, THE FOLLOWING EXPENDITURES MUST BE PAID BY DECEMBER 31, 2004**

- Investment counsel fees
- Safekeeping fees (not deductible for Quebec purposes)
- Certain legal and accounting fees
- Safety deposit box rentals (not deductible for Quebec purposes)
- Deductible interest expenses, including interest on student loans
- Child care expenses
- Charitable donations
- Political contributions
- Medical expenses in excess of the lesser of 3% of net income or \$1,813 (for Federal only; the threshold cap is unlimited for Quebec)
- Professional membership fees and union dues
- Support payments (child support payments are non-deductible for new and revised agreements after April 30, 1997)
- Deductible moving expenses
- Expenses associated with an objection or appeal related to a tax assessment
- Tuition fees

## Corporation Tax on Capital

A tax on capital may be imposed on certain large corporations for Federal tax purposes and all corporations in certain provincial jurisdictions. This tax may be reduced for a corporation that has cash on hand by using it before the end of its fiscal year to (a) reimburse shareholder loans, (b) reduce existing borrowing, or (c) acquire eligible investments.

In regard to Québec tax on capital, eligible investments must also meet the following criteria:

Investments in bonds, commercial paper and bankers' acceptances of other corporations have to be held for a continuous period of at least 120 days including the date of the taxation year end;

On June 30, 2004 the 120 day holding period was extended to cover **shares** of banks and related corporations;

Shares of and loans to other corporations are generally not restricted.

## Employee Stock Options

Employees are able to defer the income inclusion of benefits that result from exercising eligible employee stock options for publicly listed shares until the disposition of the shares, subject to an annual \$100,000 limit. Employees disposing of such shares will be eligible to claim the stock option deduction in the year the benefit is included in income.

The income inclusion of the benefit from a share acquired under an employee stock option will be deferred until the time the employee disposes of the share.

## Gifts and Awards To Employees

The CRA and Revenue Québec have liberalized their approach towards employee gifts and awards.

Employers can now give their employees on a tax-free basis two non-cash gifts and two non-cash awards each year. The total cost of the gifts and the total cost of the awards must not exceed \$500. Certain conditions apply.

# Other Matters to Consider

## Interest Deductibility

Whenever possible, ensure that debt is structured so that the interest expense is deductible. When repaying an existing debt, pay off the debt that has non-deductible interest before debt with deductible interest.

The Québec budget of March 30, 2004 proposed major changes to the deductibility of investment expenses including interest and advisor fees. Henceforth, investment expenses will only be deductible by individuals to the extent of investment income, including taxable dividends and taxable capital gains. In 2004, the restriction will be prorated on the basis of the number of days in the year after March 29. For further details see the BGK Québec Budget *Current Developments*. The Federal government is considering certain restrictions commencing January 1, 2005.

Contact your BGK advisor to discuss ways to minimize the impact of these measures.

## Wills and Mandates

Wills should be reviewed and updated on a periodic basis, taking into consideration changes in family circumstances, financial position and legislation.

## U.S. Citizens in Canada

A U.S. citizen resident in Canada must file Canadian and U.S. income tax returns, reporting world-wide income. These tax returns should usually be prepared by a competent professional advisor due to the complicated interplay of foreign tax credits.

U.S. citizens and residents with Canadian RRSPs or RRIFs are able to elect to defer recognition of the income arising in the plans until it is received. Recent IRS announcements have significantly increased the U.S. reporting requirements for such plans. Individuals affected by these announcements should contact us for more details.

## Single Purpose Corporations

CRA policy has allowed personal-use real estate such as a vacation property to be held in a single purpose corporation without adverse Canadian tax consequences, however this policy has been revised. Consult your BGK advisor to discuss alternative planning techniques.

### Logbook for an automobile - Québec

For 2005 and onward, an employee who benefits from an automobile made available by his employer will have to supply the employer with a copy of the detailed logbook he or she maintains with respect to the automobile so as to allow the employer to accurately determine the employee's taxable benefits. The copy of the logbook has to be provided within ten days from the end of the year or from the end of the period in which the automobile was made available to the employee. Failure to provide the logbook to the employer will result in a penalty to the employee of \$200.

### Manpower Training

Québec employers with a payroll in excess of \$1,000,000 are required to spend the equivalent of 1% of their payroll on job training.

Employers subject to this 1% requirement that do not expend that amount will be required to contribute the shortfall as a "tax". Consequently, employers should evaluate their manpower training programs and facilities in order to determine how they can meet the criteria that will enable them to reduce or eliminate the tax.

Eligible training expenses incurred in a year in excess of the 1% required can be used in the following year.

### Construction Industry Reporting

Businesses whose principal activity is construction must ensure they are keeping the name, address, amount paid, and goods and services tax (GST) registration number or Business Number of their subcontractors. This information must be reported to Canada Revenue Agency (CRA) annually.

## Mutual Funds

Many funds make distributions at the end of the year. If you are thinking of purchasing fund units at this time, you may be receiving an unexpected income inclusion without the benefit of the growth in value of the units through the year.

### Foreign Withholding Taxes

Foreign withholding taxes are only creditable at the rate allowed for in the particular treaty. Ensure that, for example, withholding taxes on U.S. dividend income do not exceed 15%.

Any excess may have to be recovered from the source country.

### Taxpayer-Requested Adjustments

Currently an individual or testamentary trust can request a reassessment for a taxation year as far back as 1985. For requests received after 2004, such adjustments will be limited to taxation years that end in any of the ten preceding calendar years.

### Government Pensions

For persons who have turned or are about to turn 65, assure that OASP and QPP/PPP retirement applications are prepared.

**Reduced** QPP/PPP retirement benefits are available to persons between age 60 to 65 **and** retired.

**Enhanced** QPP/PPP benefits are available if the application is delayed until after age 65 (up to 70).

Old age spousal or widow(er)'s allowances may be available, based on an income test, to a person aged 60 to 64:

- whose spouse is a GIS (OASP Supplement) recipient, or
- who is a widow(er)

**The matters described herein, as well as other techniques used in tax planning, should be subject to ongoing review and analysis and, frequently, some decisions may more appropriately be implemented earlier, rather than later, in the year.**

## Québec Drug Insurance Plan

When Québec residents turn 65 they are automatically enrolled in the Québec Drug Insurance Plan and are subject to the \$477 annual maximum premium. If you are in this situation and are also a member of a group insurance plan that covers prescriptions, you may request to the Régie de l'assurance maladie du Québec that you not be covered by the Québec plan. If you opt out of the Québec plan, ensure that you use the group plan **only**, and for **every** prescription purchased during the year. However, the associated costs and benefits must be evaluated before opting out.

## Child Care Expenses

Effective 2005, Québec is instituting a mechanism to pay the refundable tax credit for child care expenses in advance - but the application must be filed before November 30, 2004.

## Did You Know.....?

This and other issues of *Current Developments* are available on our web-site - <http://www.bgk.ca>

## DATES TO REMEMBER



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|--------------------------|--|
| <b>December 15, 2004</b> | Fourth personal income tax instalments for 2004 are due.   |
| <b>December 15, 2004</b> | Deadline for filing the annual Québec Registration Declaration for corporations.   |
| <b>December 24, 2004</b> | Final day of trading on Canadian stock exchanges so that the transaction will be recognized in 2004 for the calculation of capital gains and losses.   |
| <b>January 30, 2005</b>  | Final day for paying any interest on employee loans for 2004 in order to avoid the taxable benefit.  |
| <b>March 1, 2005</b>     | Deadline for 2004 contributions to an RRSP.  |
| <b>February 28, 2005</b> | Deadline for filing 2004 remuneration slips to employees (T4/Relevé1) and independent sales representatives (T4A/Relevé1), slips for payments of dividends and interest (T5/Relevé3); and the related summaries. |
| <b>March 15, 2005</b>    | Commission de la Santé et de la Sécurité du travail du Québec (CSST) filing due date.  |
| <b>March 31, 2005</b>    | Deadline for filing trust income tax returns for trusts with a December 31, 2004 year end.   |

**CURRENT DEVELOPMENTS** is issued periodically by **BESSNER GALLAY KREISMAN**, Chartered Accountants, to clients, staff and other interested parties, to provide information of interest to the reader. The comments are of a general nature and are not intended to cover all aspects of the subject matter. Prior to implementing any planning based upon information in the attached commentary, the specific facts pertaining to any particular situation should be carefully considered. Our firm will be pleased to assist in this regard and to provide further details pertaining to the matters discussed herein.

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