



BUCHANAN BARRY LLP
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TAX NEWSLETTER
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REDUCTION OF RRIF WITHDRAWALS FOR 2008

On November 27, 2008, the federal government announced that the minimum amount that individuals are required to withdraw from their registered retirement income funds (RRIFs) would be reduced by 25% for the 2008 year. Of course, some individuals may have already withdrawn more than this reduced amount prior to the government's announcement. Therefore, the government will allow these individuals to re-contribute to their RRIFs any amount up to the 25% proposed reduction. The re-contributed amount will be deductible from income for the 2008 year. The re-contribution can be made any time up to March 1, 2009, or 30 days after the day that the proposals are enacted by Parliament, whichever day is later.

Therefore, for example, if your minimum amount before the reduction was \$10,000 and you already had withdrawn that amount from your RRIF before the government's announcement, you can re-contribute up to \$2,500 by March 1, 2009 (or possibly

sometime later) and claim a deduction for 2008.

Currently, the 25% reduction applies only for the 2008 year. The government did not announce a similar reduction for 2009.

The 25% reduction has not yet been passed into law, and readers are no doubt aware that Parliament has been prorogued. Nonetheless, both the Department of Finance and the Canada Revenue Agency (CRA) have confirmed that they will allow individuals to act on the 25% reduction.

HEALTH INSURANCE PREMIUMS FOR THE SELF-EMPLOYED

If you are self-employed and carrying on a business, you can normally deduct, in computing your income from the business, a portion of premiums that you pay for private health and dental insurance. The deductible premiums can relate to insurance coverage for you, your spouse or common-law partner, and any person who is a member of your household. In order to claim the deduction in a year, you must be actively engaged in the business in the year on a regular and continuous basis, either directly or through a partnership.

Not surprisingly, there are certain conditions and limitations that apply to the deduction. Generally speaking, you are allowed the deduction in a year only if your income from such business in the year or in the immediately preceding year exceeds 50% of your total income for that year, or if your income from other sources (your non-business income) in either such year is \$10,000 or less. (For these purposes, your income for the year does not take into account the deduction for the insurance



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premiums and certain other deductions such as for spousal support or RRSP contributions.)

There are also monetary limits that apply to the amount of premiums that may be deducted in a year. The general monetary limit is \$1,500 of premiums per year per person, for you, your spouse or common-law partner, and other household members who are 18 years of age or over. The general limit for household members under the age of 18 is \$750 per year per person.

However, if you have arm's length employees, the monetary limits may be lower, unless you provide the employees with sufficient "equivalent coverage".

EXAMPLE

You carry on a business and employ two full-time arm's length employees. Your personal health and dental insurance premiums for the year are \$1,500 (i.e. the general monetary limit). You also provide health insurance for the employees. However, their insurance coverage is not as extensive, and the "cost of equivalent coverage" for their insurance is only \$800. The deduction of your personal premiums is therefore limited to \$800.

Your deducted health insurance premiums do not qualify for the medical expense tax credit. Conversely, if you use the premiums for the purposes of the medical credit, you cannot deduct them. Typically the deduction will be more beneficial because it saves you tax at your marginal rate of tax (e.g. 29% federal rate if you are in the highest tax bracket), whereas the credit is computed using the lowest rate of tax (15% federal

rate). (The provincial savings vary by province.)

However, to the extent that your premiums are not deductible by virtue of the above monetary limits, they do qualify for the medical expense credit. Therefore, in the above example, you could claim the credit in respect of the \$700 amount that was not deductible.

**TAX-FREE TRANSFERS
TO YOUR CORPORATION**

Under the Income Tax Act, you are allowed to transfer property to a taxable Canadian corporation in exchange for shares in the corporation on a tax-free "rollover" basis. (This is called a "section 85 rollover".) Therefore, for example, you could set up a corporation and transfer your unincorporated business property to the corporation on a tax-free basis (effectively incorporating your business). You can also transfer property on a partial rollover basis, that is, where you trigger part of the accrued gain or income in respect of the property (see below).

In order to use the tax-free rollover, you and the corporation need to file with the CRA a joint election in prescribed form (form T2057). The form must be filed by the earlier of your tax filing date and the corporation's tax filing date for the taxation year in which the transfer takes place. Late filings up to three years after that date are allowed, with a monetary penalty. Filings after the three-year period may be allowed by the CRA in its discretion.

The "elected amount" in respect of the property becomes your proceeds of disposition of the property that was transferred to the



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corporation. The elected amount also becomes the cost of the property to the corporation.

Furthermore, the elected amount becomes your cost of the shares issued to you by the corporation in consideration for the transfer of the property. However, if you receive any non-share consideration (such as cash or a promissory note) from the corporation as part of the transfer, the cost of your shares is reduced by the value of that consideration.

In order to claim a full tax-free rollover, the elected amount must equal your cost of the property transferred to the corporation.

EXAMPLE – Full Rollover

You transfer land which is capital property to your corporation in exchange for 100 common shares in the corporation. Your cost of the land was \$100,000 and its fair market value at the time of the transfer is \$180,000.

If you choose an elected amount of \$100,000, the transaction will take place on a full rollover basis. Your proceeds of disposition will equal \$100,000, and no gain will be triggered on the transfer. The corporation's cost of the land and your cost of the shares will both be \$100,000.

As noted, you can instead elect to have a partial rollover (or no rollover at all). For example, assume you had a \$10,000 net capital loss from last year that was not yet used.

EXAMPLE - Partial Rollover

Assume the same facts as above, but you elect \$120,000. In such case, your proceeds of disposition will equal \$120,000, which will trigger a \$20,000 capital gain, and one-half of that amount or \$10,000 will be included in your income as a taxable capital gain. However, you can carry forward the \$10,000 net capital loss of the previous year and deduct it in computing your taxable income, so the transfer will not generate any tax.

Furthermore, your corporation's cost of the land and your cost of the shares will both be bumped up to \$120,000.

There are certain limits on the elected amount. For example, the elected amount cannot exceed the fair market value of the property transferred to the corporation, and it cannot be less than the lesser of the fair market value of the property and your cost of the property.

Additionally, the elected amount cannot normally be less than the fair market value of any non-share consideration you receive back from the corporation. Therefore, in the first example above, if you received \$110,000 in cash from the corporation in addition to the 100 shares, you could not elect an amount less than \$110,000.

Most types of property qualify for the rollover. One notable exception is land inventory, which does not qualify.

The rules surrounding tax-free transfers are complex. You should consult you Buchanan Barry tax professional before undertaking such a transaction.



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TAX INSTALMENTS

If you earn income from which tax is not withheld (for example, business income, and interest and other investment income), you may be required to pay quarterly income tax instalments. Generally speaking, if your “net tax owing” for the year and one of the two immediately preceding taxation years exceeds \$3,000, you will be required to pay instalments in the year. Your “net tax owing” for a year is essentially your federal and provincial income tax and CPP pension owing, net of any tax withheld in respect of your income (e.g. from your employment income).

The instalments are due quarterly, on March 15, June 15, September 15, and December 15. There are three acceptable methods for computing instalments.

The first method is sometimes referred to as the CRA method because it is the method used by the CRA on its instalment reminders that it mails to you. This method requires payment on each of March 15 and June 15 of $\frac{1}{4}$ of your “instalment base” for the second preceding taxation year, and payment on each of September 15 and December 15 of $\frac{1}{2}$ of the amount by which your instalment base for the preceding year exceeds $\frac{1}{2}$ of the instalment base for the second preceding year (i.e., the amounts necessary to get your instalments up to the instalment base for the preceding year).

Your instalment base for a year is essentially your tax payable for the year, net of any tax withheld from your income.

The second method requires payment on each of the four dates of $\frac{1}{4}$ of your instalment base for the preceding taxation year.

The third method requires payment on each of the four dates of $\frac{1}{4}$ of your estimated tax payable for the current year.

You can rely on the CRA instalment reminders and pay those amounts as your instalments as per the first method outlined above. However, you are not obliged to follow that method, and can use one of the other two methods if it results in lower instalment payments.

Any balance of taxes owing for the year (i.e. after your instalments and any tax that was withheld from your income) is due by April 30 of the following year.

OBLIGATION FOR PROVINCIAL INCOME TAXES

As most readers are aware, Canadian residents pay both federal and provincial income taxes. We all pay federal income taxes (assuming we have sufficient income). The provincial income taxes vary by province, and tend to average somewhere around half of the amount of the federal tax.

Typically your provincial income tax will be paid to the province in which you are resident on December 31. In particular, you will pay tax to that province on your employment income and investment income including taxable capital gains regardless of the source of that income. You will also pay tax to that province on business income earned in the province.

However, if you carry on business in another province through a “permanent establishment” in that other province, you will pay provincial income tax to that province in respect of that business income. A permanent establishment includes the following:



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- A fixed place of business, including an office, a branch, a mine, an oil well, a farm, a timberland, a factory, a workshop or a warehouse;
- Any place in which you have established an employee or agent in your business, if that person has general authority to contract for you or has a stock of merchandise owned by you from which the person regularly fills orders from customers; and
- Any place in which you use substantial machinery or equipment in the business.

If you carry on business outside Canada, or in another province but not through a permanent establishment in that other province, you do not pay provincial income tax on that business income (except for Quebec residents in respect of their business income earned outside of Canada, to which the Quebec provincial tax applies). However, on top of the regular federal tax, you will pay an additional federal tax equal to 48% of the regular federal tax on that business income. In these circumstances, the additional federal income tax effectively replaces the provincial income tax.

PRESCRIBED INTEREST RATES

The Canada Revenue Agency (CRA) recently announced the prescribed annual interest rates that it will apply to any amounts owed to the CRA and to any amounts the CRA owes to individuals and corporations. These rates are calculated quarterly and the following rates will be in effect from January 1 to March 31, 2009.

- The interest rate charged on overdue taxes, Canada Pension Plan contributions,

and Employment Insurance premiums will be 6%.

- The interest rate paid on refunds of overpayments will be 4%.
- The interest rate used to calculate taxable benefits for employees and shareholders from interest-free and low-interest loans will be 2%.

These rates are 1% lower than the rates for the previous quarter of October 1 to December 31, 2008.

AROUND THE COURTS

Retroactive lump sum support payment deductible

Spousal support payments (including those made to a former common-law partner) are generally deductible for income tax purposes. However, certain conditions must be met in order for the deduction to be claimed. For example, the payments must normally be payable “as an allowance on a periodic basis” for the maintenance of the recipient spouse or common-law partner.

In the recent *Salzmann* case, the taxpayer’s marriage broke down in 2001. By a court order issued in December 2003, the taxpayer was ordered to pay interim spousal support to his former spouse in the sum of \$3,600 per month retroactive to November 2001. The taxpayer made a retroactive lump sum payment for these amounts, equal to \$90,000, in 2004. The CRA denied the deduction for the payment on the grounds that the payment was not payable as an allowance on a periodic basis.



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The taxpayer appealed to the Tax Court of Canada and his appeal was allowed. The Tax Court reviewed similar past cases where courts held that a payment on account of previous support arrears that were payable on a periodic basis effectively meant that the payment was in respect of support on a periodic basis. Applying the reasoning to the facts of the case, the Tax Court allowed the deduction of the \$90,000 lump sum payment.

Cost of new hardwood floors did not qualify for medical tax credit

The medical tax credit is allowed in respect of certain qualifying medical expenses as specified in the Income Tax Act. They include, among other things, reasonable expenses relating to renovations or alterations to a home of a taxpayer who lacks normal physical development or has a severe and prolonged mobility impairment, to enable the patient to be mobile or functional within the home. However, such expenses do not qualify if they “would typically be expected to increase the value” of the home.

In the recent *Hendricks* case, the taxpayer suffered from severe asthma. On the recommendation of his doctor, the taxpayer had the carpeting removed from his home and replaced with hardwood floors. The replacement of the carpeting with the new floors resulted in a dramatic improvement in the taxpayer’s condition. He attempted to claim the medical tax credit in respect of the cost of the new floors.

The CRA denied the deduction and the taxpayer appealed to the Tax Court. The Court disallowed the appeal. Although sympathetic with the taxpayer’s plight, the Court found that the taxpayer could not

disprove that the new hardwood floors increased the value of the home, particularly since they replaced carpeting that was 23 years old. Therefore, the cost of the new floors did not qualify for the credit.

Buchanan Barry LLP has served the Calgary business and non-profit community since 1960. We are a full-service chartered accounting firm providing accounting, audit, assurance, advisory, tax and valuation services to clients in the oil and gas sector, the service industry, real estate, the retail and wholesale trade, the manufacturing industry, agriculture, the non-profit sector and professionals.

Should you have any questions regarding the foregoing or other tax matters, please do not hesitate to contact members of our tax group at (403) 262-2116.

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This letter summarizes recent tax developments and tax planning opportunities. We recommend that you consult with an expert before embarking on any of the opportunities in this letter, which may not be appropriate to your own specific circumstances.