The Institute™
for Advanced Financial Education

COMMENT

Compliments of: Raymond Matt, CFP, CLU, TEP, CHS
Tel: 705-526-2807 Cell: 416-452-2334
www.csiplan.ca

Number 270 – NOVEMBER / DECEMBER 2011

Kiddie Tax Expands Its Reach

Kiddie tax was introduced in 2000 in order to neutralize an increasing trend towards splitting dividend income with minor children. The March 2011 Federal Budget expanded these rules to include certain capital gains realized by minor children with respect to the disposition of shares of private companies to non-arm's-length persons.

Kiddie tax was designed to curb the use of "dividend sprinkling" and management services structures. The tax applies to dividends and shareholder benefits received by a minor from a related private corporation, and income from a trust or partnership if it is derived from the provision of property or services by a person related to the minor. The targeted income is subject to income tax at the highest rate in the province of residence. By taxing this split income at the top marginal tax rate, the tax savings are neutralized.

The extension of the kiddie tax rule will convert certain capital gains realized by minors after March 21, 2011, into taxable dividends, which will then be subject to taxation under the kiddie tax rules. The capital gains affected are those from dispositions to non-arm's length parties (i.e., parents, family trusts, companies controlled by parents, etc). Since the capital gain is converted into a taxable dividend, the capital gains exemption will no longer apply and will not be available to reduce the resulting income tax liability. It is important to note that commonly used estate planning strategies designed to crystallize the capital gains exemption, which involve a disposition to non-arm's-length parties, may be impacted if there are minor children involved who would be subject to the current kiddie tax rules.

These new rules will catch some of the new income splitting techniques that arose after the introduction of the original kiddie tax rules. One such strategy was to pay a stock dividend on the shares held by the minor child. A stock dividend is taxed as a regular dividend based on the amount of the paid-up capital allocated to the shares. The shares issued as the stock dividend would have a high fair market value, a low adjusted cost base and a low paid-up capital, with little or no income tax implications. The minor would then sell the shares issued as the stock dividend. The income tax implications would have been a capital gain with a 50% inclusion rate, which might have been eligible for the enhanced capital gains exemption.

A child who inherits shares from a parent's estate will not be subject to kiddie tax. As well, kiddie tax will not apply where both parents of a child are not resident in Canada.

The extension of the kiddie tax rules to cover certain capital gains has created a need to re-think commonly used planning strategies. In all likelihood, income splitting will continue to thrive because of the savings that are possible, and the government will continue to monitor the resulting new strategies, eager to introduce new legislation designed to maintain the integrity of the Canadian tax system.

I/R 7401.00

Business Investment Losses

Business investment losses are a subset of capital losses, but with special income tax treatment that allows for a faster recovery of the resulting tax savings. Both individual taxpayers and corporations may realize a business investment loss, which can arise from the actual or deemed disposition of certain capital properties.

A business investment loss can arise from a disposition to an arm's-length person of the shares of a small business corporation or debt owed by the small business corporation. There are circumstances where a business investment loss may arise upon the payment of a guarantee provided on behalf of a small business corporation. As well, owning shares or debt in a

small business corporation that becomes bankrupt may result in a business investment loss. Any time a loss arises in respect of shares or debt related to a small business corporation, it is important to assess the circumstances to evaluate whether the actual or deemed disposition may fall within the parameters of special tax treatment for this unique type of loss.

A small business corporation is defined as a Canadian-controlled private corporation, where all or substantially all of the fair market value of the assets were, at that time, used principally in an active business carried on primarily in Canada. The assets of a company would include all those listed on the balance sheet and others that might not be listed such as goodwill. For the purpose of the business investment loss rules, the company must meet the definition of a small business corporation at the time of disposition or at any time within the preceding 12-month period.

Similar to capital losses, a business investment loss is multiplied by the capital gains inclusion rate to calculate the allowable business investment loss. However, while allowable capital losses are deductible only against taxable capital gains, an allowable business investment loss can be deducted against any type of income. This means that the tax shield resulting from an allowable business investment loss can be realized immediately provided that the taxpayer has sufficient other income.

A portion of the business investment loss may be disallowed to the extent the taxpayer has already benefited from the capital gains exemption at any time. The portion disallowed would be considered a capital loss and would still be available as a deduction against capital gains.

An allowable business investment loss is deductible in the current year against any type of income, or it can be carried back and claimed in any of the prior three taxation years, or carried forward and claimed in any of the next 10 taxation years. To the extent the business investment loss cannot be claimed in any of these years, the character of the loss changes to a net capital loss which can be carried forward indefinitely and can be claimed only against capital gains in future years. The rules for carrying an amount forward or backward have changed over the years, depending on when the loss arose. When an amount is claimed as an allowable business investment loss, it will impact the amount of capital gains deduction that can be claimed in the current or future years.

While no one makes an investment with the intention of losing value, sometimes it happens. To the extent an investment is in a small business corporation, the Income Tax Act may allow some leniency in claiming a loss, ultimately resulting in more favourable tax treatment than a regular capital loss

I/R 7401.00

Before The Tax Man Comes Calling

The Canadian income tax system relies on self-reporting, which means the system relies on taxpayers to disclose accurate complete information and comply with the rules. While the Canada Revenue Agency (CRA) has programs in place to catch non-reporters and it reserves the right to audit what a taxpayer reports, it simply cannot audit everyone.

When the CRA discovers an individual has failed to report income, it will reassess and calculate the taxes owing, and add penalties for non-compliance and interest from the date the income tax liability arose. The CRA can also bring criminal charges and subsequent prosecution.

Where a taxpayer has failed to report income in a previous taxation year, he or she may decide that it would be better to come clean rather than continue to take the risk of the failure to report. For these individuals, the Canadian government has established a formal process referred to as the Voluntary Disclosure Program (VDP). The VDP provides taxpayers with a process through which disclosures may be made to correct inaccurate or incomplete information. For example, a taxpayer may disclose unreported income, a claim for ineligible expenses, or unremitted source deductions, Goods and Services Tax (GST) or Harmonized Sales Tax (HST).

If the individual completes the voluntary disclosure, he or she will be liable for the income tax liability plus interest due since the liability arose. The advantage of disclosure is that the individual is able to avoid the application of penalties for non-disclosure, which amount to 50% of the income tax liability not disclosed.

Under the rules of the VDP, a valid disclosure must meet four conditions. In general terms, the disclosure must:

- be voluntary,
- be complete,
- involve a situation where there is the potential application of a penalty, and
- relate to something more than one year overdue (unless it relates to correcting something filed in the past year).

The concept that the disclosure is "voluntary" means that that the individual must be under no undue influence to come forward, such as having knowledge of a pending audit or enforcement action by the CRA. In terms of being "complete", this means that everything must be disclosed with appropriate documentation. The individual cannot pick and choose which items are disclosed. In addition to complete disclosure, the individual must provide additional information as requested by the CRA. The "potential of a penalty" ensures that only those situations that risk a penalty are disclosed under the program. This is reasonable given that the benefit of the program is the waiving of the associated income tax penalty. The last criterion relates to information being "more than one year overdue". By requiring that the information relate to something at least one year old, it ensures that the issue does not generally fall within the current filing period.

If the individual does not meet all four of the criteria in the disclosure process, the CRA will inform the individual of its decision and probably proceed to assess. If the CRA does not accept the disclosure as filed, the individual may request a second review of the file by contacting the Director of the Tax Services Office. Finally, the individual may seek relief through the judicial review process. It is advisable that individuals seek legal counsel when first considering this type of disclosure to better understand what is involved, to assess the risks and to benefit from the legal guidance.

Disclosures under the VDP can go beyond simply an income tax liability related to an individual; they can include disclosures by a corporation, partnership or trust and relate to not only income tax but also to GST or HST.

The voluntary disclosure program can be of tremendous value as it can allow a taxpayer to reveal a past indiscretion related to a tax filing (or lack thereof) without the fear of prosecution. Sometimes information was hidden due to lack of knowledge and sometimes because of lack of cash flow to pay the taxes: either way, the disclosure program can be helpful.

I/R 7401.00

The Health Of Canadians

Statistics Canada is constantly gathering and disseminating a wide variety of information about the Canadian population. This information can be very useful to businesses as they attempt to identify current market trends or predict new market segments.

A recently issued survey from Statistics Canada deals with the current state of health of Canadians and how these health measurements have changed over time. In general, the survey shows an increase in certain negative health factors; however, this needs to be weighed against the increase in the average age of Canadians.

High Blood Pressure

The incidence of high blood pressure is on the rise, with males catching up to females. In 2001, about 14% of females and 11% of males aged 12 or older reported having been diagnosed with high blood pressure. In 2010, these incidences rose to about 16% for both females and males. Some of the convergence of data is due to the fact that, prior to 2010, females were more likely than males to report that they were diagnosed with high blood pressure.

Obese individuals are more likely to have high blood pressure than individuals who are not obese. In 2010, one third of obese Canadians reported that they had high blood pressure, compared to only 15% of non-obese Canadians.

Smoking and Second-Hand Smoke

In 2010, 21% of the population, or 6 million people, aged 12 or older reported that they smoked either daily or occasionally. Males reported a smoking rate of 24%, which is up from 23% in 2008.

Teenage smoking has been holding steady at 20% since 2005. The good news is that this is down significantly from 29% in 2001.

Teenage smoking is an indicator of long-term smoking and the drop in teenage smoking is slowly impacting the overall rate of decline for Canadians as whole. In 2010, 57% of women aged 20 to 24 indicated that they have never smoked, which is up significantly from 2003 when only 41% reported they have never smoked. Corresponding figures show that, in 2010, 45% of males in this same age bracket have never smoked, compared with 37% in 2003.

It is well documented that smoking impacts the general health of individuals. For those who have never smoked, 65% reported very good or excellent health compared with 60% of former smokers and 51% of smokers.

Second-hand smoke is also on the decline, with 15% of young people reporting being exposed to smoke at home, down from 23% in 2003.

Access to a Doctor

In 2010, 15% of the population over age 11, or 4.4 million people, reported that they did not have a regular medical doctor. This number declines with age: 27% of young people aged 20 to 34 reported not having access to a regular medical doctor, compared with only 5% of seniors.

Men were generally more likely than women to report that they did not have access to a regular medical doctor.

Of those who reported having no medical doctor, over 50% had tried unsuccessfully to find one. They reported that doctors in their area were not taking on new patients, the local doctor had retired or that no doctors were available in their area. This same group reported that more than 80% had a usual place to go for medical attention, care or advice. These included a walk-in clinic or hospital emergency room.

Obesity

In 2010, 18% of the population over age 17, or 4.5 million people, reported heights and weights that classified them as being obese. This figure is on the increase: men increased from 16% in 2003 to 20% in 2010, and women increased from 15% to 18% during the same period.

Being overweight is also on the increase, with 52% of Canadians reporting that they are overweight, which is up from 49% in 2003.

Stress

Stress seems to be a way of life in the modern world, with 24% of Canadians reporting that they have suffered days that were extremely or quite stressful, up from 22% in 2008. Females were more likely to report stress than males, and stress was highest for the working ages of 35 to 54.

The collective health of Canadians is very important to Canadian society. It affects our economic and social well-being. Understanding Canadian health helps with the planning for simple things like the number of sick days that employers must anticipate through to more complex matters related to the amount and type of health care Canadians will need in the future.

Subscribe to Comment today at
www.advocis.ca.

Contributors to this issue of Comment:
James W. Kraft, CA, MTax, TEP, CFP, CLU, CH.F.C.
Deborah Kraft, MTax, TEP, CFP, CLU, CH.F.C.

Published by:
The Institute
390 Queens Quay West, Suite 209,
Toronto, Ontario M5V 3A2
T: 416.444.5251 or 1.800.563.5822
F: 416.444.8031
www.iafe.ca • info@iafe.ca

This commentary is published by The Institute in consultation with an editorial board comprised of recognized authorities in the fields of law, life insurance and estate administration.

The Institute is the professional organization that administers and promotes the Chartered Life Underwriter of Canada designation.

The articles in Comment are not intended to provide legal, accounting or other advice in individual circumstances. Seek professional assistance before acting upon information included in this publication.

Publication Agreement # 40069004

The Institute™, The Institute for Advanced Financial Education™ and the CLU® are trademarks of The Institute for Advanced Financial Education. Advocis® is a trademark of The Financial Advisors Association of Canada. Copyright © 2010 The Institute for Advanced Financial Education. All rights reserved. Unauthorized reproduction of any images or content without permission is prohibited.

Copyright 2010 ISSN 0382-7038 *All Rights Reserved*

corporate solutions