The Institute™
for Advanced Financial Education

COMMENT

Edition 281 – 2013

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

OAS CHANGES WARRANT CAREFUL ATTENTION WHEN PLANNING

A cornerstone of Canada's retirement system, Old Age Security (OAS) has been regularly fine-tuned throughout its 60 years of existence. OAS has typically been paid at the beginning of each month following an individual's sixty-fifth birthday, with the benefit amount based on the number of years an individual is resident in Canada prior to reaching age 65. The most recent OAS updates were announced in the 2012 federal budget when the government introduced a series of changes that included increasing the age at which individuals will be eligible for benefits and a new option to defer receipt of the benefit.

OAS benefits are paid monthly, with the possibility of indexed adjustments on a quarterly basis to reflect cost-of-living changes as measured through Canada's Consumer Price Index (CPI). As of September 2013, the maximum monthly OAS benefit is $549.89. OAS payments are funded out of Canada's general revenue stream, and the federal government expects to spend $32.4 billion in OAS payments during the 2013-2014 fiscal year. In addition to the basic OAS benefit, approximately $10 billion will be spent on Guaranteed Income Supplement and Spousal Allowance benefits, which are additional amounts payable to lower-income seniors supported by the OAS.

Eligibility for OAS benefits is not dependent on any work requirements; instead, the basis for qualifying is residency in Canada. To qualify for OAS benefits — if receiving the benefit in Canada — an individual must have a minimum of 10 years of residence in Canada after reaching 18 years of age. The minimum increases to 20 years of residence in Canada (after age 18) if the benefit is to be paid outside Canada. In addition to the residence qualifying criteria, currently individuals must be at least age 65.

The amount of pension will depend on the years of residence in Canada. To receive the maximum benefit amount, an individual must have been resident in Canada for at least 40 years since turning 18. Alternatively, a full pension may also be paid to individuals who were resident in Canada on July 1, 1977, were at least 25 years of age on that date and had lived in Canada since turning 18.

Beginning in 2013, the government is phasing in proactive enrolment for OAS benefits. Shortly after individuals turn 64, they will receive a letter indicating they are eligible to proactively enrol for benefits or will receive an application form to apply for benefits. If an individual does not apply when first eligible, there is the opportunity to receive up to 11 months of back-payments.

OAS benefits are taxable income to the individual. In addition, because the program is part of Canada's social safety net, the program is designed to supplement income for those with a greater need. Qualifying individuals whose 2013 net income is below the threshold amount of $70,954 will receive the full benefit amount (OAS benefits received count in the threshold amount). Individuals whose net income is above the threshold amount will have their benefit amount clawed back (to repay benefits) at a rate of 15% of their income above $70,954. When individuals reach a net income of $114,640 (2013), they no longer qualify for OAS benefits and the full amount is clawed back (repaid). The threshold is indexed and could change annually. The "clawback" element is based on annual income so as an individual's income fluctuates from year to year so might the amount of net OAS benefit. Being clawed back does not mean the individual no longer qualifies for benefits.

The 2012 federal budget increased the age at which Old Age Security will become payable. This change will be introduced over several years and move the eligible age from 65 to 67. Individuals born before April 1958 will not be affected and individuals born after January 1962 will have to wait until their 67th birthday to be eligible for OAS.

Effective July 1, 2013, individuals can choose to defer receipt of their old age security pension. For every month delayed, the individual will receive an extra 0.6% entitlement. The Old Age Security pension can be delayed up to age 70 for a 36% (i.e., five years or 60 months times 0.6%, which is 36%) increase in entitlement. The individual must indicate the desired pension start date when he or she files an application for OAS benefits. The application can be filed no earlier than 11 months before the date the pension is to commence.

Consider the example of Martha, who just turned age

65 and is currently working at a job she truly enjoys. She expects to work for two more years, at which time she wants to retire from work. If she were to collect her OAS at age 65, she expects that about 50% of the OAS benefit amount would be clawed back under the clawback provisions of the Income Tax Act. With the recent changes to OAS that allow Martha to defer her pension, Martha has a new planning opportunity that could prove financially attractive depending on her situation. If Martha defers her OAS pension two years, her entitlement will increase by 14.4% (24 months at 0.6%). Not only does she avoid the current OAS clawback for the two years that she continues to work, but she is also building a larger long-term pension that may not be subject to clawback after her salary ceases.

There are a significant number of opportunities for planning, and it is important for individuals to ensure all opportunities are explored on their behalf. The Old Age Security benefit, along with other government pensions, is an important part of Canada's retirement landscape.

I/R 3201.03

CAPITAL DIVIDEND TRAPPED BY CIRCUMSTANCES

In a recent Technical Interpretation, the Canada Revenue Agency ("CRA") stated that a capital dividend could get "trapped" in a trust unless it was distributed to a beneficiary in the year of receipt.

A capital dividend can be received free of tax, and there are a series of mechanisms within the Income Tax Act to ensure this tax-free character is retained as the funds are passed through different types of entities and on to the ultimate taxpayer. In this scenario posed to the CRA, however, analysis showed that the tax-free nature can be lost if the timing of a distribution flowed through a trust is not properly aligned.

The situation presented by the taxpayer was as follows:

- *Inter vivos* family trust had been settled by the taxpayer
- Taxpayer's spouse, minor children, and any company controlled by the taxpayer were named as beneficiaries of the family trust
- Trust contained a provision such that the trust could not allocate income to "designated persons" (as explained below)
- Trust was the 100% owner of a private company
- Private company paid a capital dividend on the shares owned by the family trust in the first taxation year of the family trust

In simple terms, when individuals transfer or lend property to a corporation in order to provide a benefit to specific family members (i.e., designated persons, which include a spouse and minor children) while reducing the transferor's income tax liability, corporate tax attribution rules may deem an interest benefit to the transferor in order to dissuade income splitting. However, there is a "carve out" rule that provides that corporate attribution will not apply if those designated persons cannot access the income or capital of the trust. In the case presented for the CRA's technical interpretation, the trust contained a provision that disallowed income splitting with the taxpayer's spouse and minor children (designated persons) in order to meet the carve-out requirements. As a result, the taxpayer could escape the application of the corporate attribution rules. What does all this mean? Good planning was used to ensure corporate attribution would not apply, but as a result the taxpayer's spouse and minor children were not eligible to receive any payments out of the trust in the year the trust received the capital dividend.

The only other beneficiary of the trust was going to be a corporation controlled by the taxpayer. The wrinkle in the situation presented to the CRA was the fact that this beneficiary company was not set up until after the end of the trust's first taxation year. The inquiry to the CRA was whether the trust could allocate the capital dividend received in the first year of the trust to the new company in the second year of the trust and therefore create a capital dividend account (CDA) in the new company. (The ability of the trust to allocate a capital dividend to a specific beneficiary, and the ability of a corporation to receive such income in its CDA, are both parts of the mechanism to ensure such a dividend retains its tax-free character.)

The CRA responded that a capital dividend received by the trust could be allocated to a beneficiary of the trust and retain its character as a capital dividend, only if allocated in the year of receipt. However, if the capital dividend is not allocated to a beneficiary in the year of receipt, it would be reported by the trust as having been received and is added to the capital of the trust beginning in the subsequent year. At the beginning of year two there is no carry-forward of income from the first year, and the books from the prior year have been closed. Therefore, an unallocated capital dividend could be viewed as "trapped" in the trust under these circumstances. There was no beneficiary to whom it could be allocated in the year of receipt, and no ability to allocate it after that year.

When a tax plan is being developed, it is important to ensure all pieces are in order and ready to go. A step out of place in a tax plan can have unexpected results.

I/R 7401.00

CORPORATE CASH

Accumulating cash to ensure a financially secure future, whether for retirement or an unexpected expense, is something every individual should plan for. Business owners may also experience a buildup of cash accumulating within their operating or holding company that can be used to create an investment portfolio.

The primary reason for accumulating the investment portfolio in a corporation is because the earnings used to generate the funds, assuming they are from a business, are taxed at a lower rate than the shareholder. A lower rate of tax means more after-tax income accumulating for future needs. Business income up to the small business limit ($500,000) is taxed at a rate of between 11% and 19% depending on the province in which the business operates. Business income in excess of the small business limit is taxed at a rate of between 25% and 31%. With top personal rates of income tax between 39% and 50%, the business owner will be able to set aside more funds inside the company than outside the company.

It is important to note that investment income earned on accumulated funds will not generally be taxed at the lower rates applicable to business income; instead, investment income is taxed at higher rates within the corporation. This prevents an individual from using a corporate structure to indefinitely defer tax on passive investment income.

Even though the business owner can accumulate more capital inside his or her company, planning ahead is important because withdrawing funds may trigger personal tax that needs to be reflected in the long-term strategy. There are a number of strategies for removing capital from the company, and the business owner should explore each in order to determine which is the most efficient given his or her personal circumstances.

1. *Paid-up capital reduction*. When the shareholder originally set up the company he or she would have subscribed to shares, and this original subscription price can be returned to the shareholder tax-free as a reduction of paid-up capital.
2. *Shareholder loan repayment*. A shareholder loan may be built up in a private company for any number of reasons. If a shareholder loan exists, it can be repaid to the shareholder tax-free.
3. *Selling an asset to the company*. If the shareholder owns an asset that the company is using, consideration can be given to the possibility of selling the asset to the company. The sale may trigger income to the shareholder because the sale is treated as a disposition, so the tax impact would have to be included in the analysis. This strategy is most beneficial when the asset has a high cost basis. Note that there may be sales tax considerations that also should be taken into account in the analysis.
4. *Salary*. The business could pay the manager-shareholder and possibly other family members a salary for services provided to the company. Upward adjustments to salaries can often be a quick source of additional cash flow.
5. *Dividends*. The company can pay dividends to its shareholders. The dividends would be evidenced in the minutes of the shareholder meetings and the minutes of director meetings. Dividends would have to be paid proportionately to all shareholders of a class of shares, but could be paid differently on each class of shares.

   Note that if the corporation is a private company, when it pays dividends it will be eligible to reclaim a portion of the higher-rate income tax paid on the investment income at the time it was earned through the "refundable dividend tax on hand" (RDTOH) mechanism. This helps ensure the amount of tax paid in total by the corporation and the shareholder is approximately equal to the tax the shareholder would have paid had the investment income been earned directly.
6. *Income Splitting*. Income splitting strategies could use some or all of the above strategies, but with income being realized in a family member's hands rather than the business owner's. The objective of income splitting is to make use of everyone's lower marginal income tax rates and lower the family's overall income tax liability on the income required to maintain lifestyle. Note that income splitting in a corporate setting can be quite complex from a tax perspective, and professional tax guidance should be sought.
7. *Life Insurance*. Cash available within the corporation could be used to purchase a life insurance policy, which could create an addition to the corporation's capital dividend account at death, which would allow a tax-free distribution to the shareholder's estate.

One of the advantages of accumulating retirement capital in a company is that it defers the personal tax on those funds. Tax deferral is like getting an interest-free loan from the government — you owe them money in the future, but it does not incur any cost of capital. Deferral can be even more advantageous if the tax rate will be lower in the future when compared with what would have been levied on the income today.

One of the most significant drawbacks to accumulating capital inside a corporation is that it is exposed to the company's creditors and could be seized to settle debts or lawsuits. Using a holding company or separate corporation can alleviate some of this risk, but additional planning is required. Also note that the accumulation of "passive" investment assets within a corporation could jeopardize the shareholder's ability to claim a capital gains exemption upon disposition of his or her shares.

Planning is critical to many financial decisions. Accumulating capital inside a company can provide significant advantages to the business owner, but the strategy should be analyzed with the big picture in mind to ensure the advantages outweigh the disadvantages.

I/R 2101.00

CRA COMMUNICATING WITH TAXPAYERS

The Canada Revenue Agency's ("CRA's") role is to enforce the provisions of the Income Tax Act ("the Act"). The CRA does not set policy nor can it vary from the laws set out in the Act. However, it will interpret the Act and apply that interpretation to its assessments and actions.

Taxpayers can hire professionals to advise them on their income tax affairs. Tax advisors will read and interpret the Act, and will often look for guidance on how the CRA views the application of certain provisions. Rather than communicate with taxpayers and their tax advisors on a one-on-one basis only, the CRA utilizes several vehicles to enhance communications with Canadians and their tax advisors. These include:

- Guides and pamphlets
- Information circulars
- Interpretation bulletins (being replaced by folios)
- Technical interpretations letters
- Advance tax rulings

The CRA publishes many tax guides and pamphlets on a wide variety of subjects. These guides and pamphlets offer information about specialized broad-based topics or specific provisions of the Act. The guides are typically written with the taxpayer — individual or business — in mind and can be easily accessed through the CRA's website. Examples of the types of guides available include Information for Students, Seasonal Workers, and RRSPs.

Information Circulars are a communication resource used to publish the CRA's procedural matters related to the administration and enforcement of the Act. Available through the CRA's website, Information Circulars can be reviewed using a topical index. For example, one Information Circular sets out the CRA's administrative requirements and conditions for registration of Registered Education Savings Plans. The circular is intended for issuers of such plans.

Technical Interpretations are the CRA's responses to a specific taxpayer's inquiry about an income tax issue. The CRA responds directly to the taxpayer and later publishes its response, with the taxpayer's personal information removed. In this fashion, the entire community of tax advisors can access the CRA's technical interpretation on a tax matter with a specific set of facts. Technical interpretations are not available to the general public but rather are distributed to the tax community through firms that publish tax materials for research purposes. It is helpful to follow the CRA's interpretations by continuously reviewing technical interpretations because it allows tax professionals to monitor the CRA's opinion on particular topics which can, in some circumstances, change over time. It is important to note that the CRA's positions are not binding on the CRA for future similar cases.

Advance tax rulings are requested in respect of a proposed transaction that a taxpayer wants to complete, where the taxpayer is seeking certainty about the income tax outcome on a complex issue. The CRA will review the taxpayer's request and respond with a ruling in advance of the transaction. As with Technical Interpretations, the advance tax ruling is published by the CRA and available to the entire community of tax advisors. Once issued, the advance tax ruling is binding on the CRA, but only in respect of the particular taxpayer that requested the ruling, and only if the transaction in question was completed as described in the ruling request.

Folios are the CRA's newest publication designed to enhance the communication of information flowing between the CRA and the taxpayer. The intent of the Folios is to eventually completely replace the Interpretation Bulletins, which will take several years to complete. Interpretation Bulletins and Folios provide technical analysis and interpretation of specific tax provisions, and are generally intended as guidance for CRA staff and tax professionals.

It should be noted that none of the above CRA-published documents have the force of law. The CRA can assess a taxpayer based on its interpretation of the law as set out in the Act; however, if the matter goes before a judge at the Tax Court, he or she will be bound to follow the law, not necessarily the CRA's interpretation. For example, if the CRA takes a position that offers administrative leniency on a particular issue, the Tax Court of Canada cannot apply the CRA's administrative position but rather must apply the law as set out in the Income Tax Act.

Taxpayers and their tax advisors should take the time to carefully review the law and the CRA's communications. If the decision is made to rely on an interpretation of the Act that ignores or disagrees with the CRA's stated opinions, then the taxpayer should be prepared to prove his or her filing position.

I/R 7401.00

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

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.

Publication Agreement # 40069004