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ELIGIBILITY FOR PENSION BENEFITS TAX CREDIT

The federal government and all provinces allow a tax credit based on pension income received. The federal tax credit is 15 per cent of the lesser of $2,000 and the eligible pension income of the individual, while provincial percentages and limits vary.

What qualifies as "pension income," however, is not as clear as one might think, and this question was the basis of a case heard at the Tax Court of Canada in 2014. Mrs. Taylor's husband passed away in 2008, and she was the beneficiary of his RRSP. Mrs. Taylor withdrew some of the RRSP funds in 2011, which was the year she turned 65, and claimed the pension credit on her tax return for that year. The Canada Revenue Agency denied her claim, and she appealed the tax assessment. The Tax Court dismissed the appeal, ruling that Mrs. Taylor's RRSP income was not pension income eligible for the credit — i.e., it did not qualify as an "annuity payment" under the RRSP because there was no obligation to make withdrawals on any recurring basis.

The definition of eligible pension income differs for those who have attained the age of 65 before the end of the tax year and those younger than 65.

For those 65 and older, pension income eligible for the pension credit is defined to include the following:

1) A life annuity payment from a registered pension plan

2) An annuity payment under a registered retirement savings plan

3) A payment under a registered retirement income fund

4) A payment from a pooled registered pension plan

5) An annuity or installment payment from a deferred profit sharing plan

6) The taxable portion of a non-registered annuity payment

7) Income reported from a non-exempt life insurance policy

For those who have not yet turned 65, pension income eligible for the pension credit is more limited and is defined to include the following:

1) A life annuity payment from a registered pension plan

2) Any of points two to seven above received as a consequence of the death of a spouse or common-law partner

An individual in receipt of split pension income can qualify for the pension credit if the situation fits one of the definitions outlined above. This can be a double advantage for seniors who opt to split pension income.

The pension credit means tax savings for retirees, and it is important that individuals understand the rules to maximize their financial resources.

I/R 5401.06; 2121.00

OPTIMIZING OAS TO THE CIRCUMSTANCES

The claw-back of Old Age Security (OAS) payments has been a part of the fabric of planning for many years. Many articles discuss planning strategies designed to avoid the claw-back. However, planning should not be limited to avoiding a single tax provision or minimizing exposure to a tax at the expense of broader planning objectives; instead, it should be more comprehensive in nature, and consider the impact on the retiree's overall situation.

One of the strategies often cited to avoid the OAS claw-back is to avoid dividends because the dividend gross-up increases net income, which in turn increases the taxpayer's exposure to the claw-back. However, as discussed below, dividends also produce a dividend tax credit that can improve the taxpayer's overall economic outcome. There are two types of dividends — eligible and ineligible dividends — and each attracts a different percentage for the grossed-up amount included in net income and for the resulting dividend tax credit.

For 2014 the federal dividend gross-up for eligible dividends is 38 per cent, and the dividend tax credit is 11/18ths of the gross-up amount, or 15.02 per cent of the taxable amount. For ineligible dividends the 2014 gross-up is 18 per cent while the dividend tax credit is 13/18ths of the gross-up amount, or 11.017 per cent of the taxable amount.

An issue worthy of careful analysis is whether the dividend tax credit can produce greater tax savings than the tax-cost of the OAS claw-back. Consider the following example that utilizes the combined federal and Ontario tax rates:

- Column A represents the individual's current situation where the taxpayer has $30,000 of interest income (investment income row). The individual's total income of $70,954 is exactly on the 2014 threshold for OAS claw-back

- Column B changes the $30,000 of interest income to $30,000 of eligible dividends received. Applying the gross-up and dividend tax create to this amount increases the amount of taxes payable and triggers $1,710 of OAS claw-back. However, the application of the dividend tax credit that reduces the taxes payable places the individual in a more advantageous economic position than column A.

• Column C assumes the $30,000 of investment income is generated through the receipt of $30,000 of ineligible dividends. After the integration of the applicable dividend gross-up and dividend tax credit, the taxpayer's net economic position is better than column A, even though the taxpayer was subject to OAS claw-back.

	A	B	C
Other Income	34,336	34,336	34,336
OAS Income	6,618	6,618	6,618
Dividend Income	30,000	30,000	30,000
Cash Income	70,954	70,954	70,954
Gross-Up	n/a	11,400	5,400
Total Taxable Income	70,954	82,354	76,354
Taxes Payable	15,315	19,061	16,992
OAS Claw-back	Zero	1,710	810
Dividend Tax Credit	Zero	9,218	5,493
Net Taxes Payable	15,315	11,553	12,309
Net Cash Position	55,639	59,401	58,645

The above example highlights the fact that the overall income tax liability could be less even though the individual was subject to OAS claw-back. Each client situation is unique with respect to the amount of income, the type of income, and the province of residence — all which should be taken into consideration in tax planning.

Another claw-back that has to be considered by retirees is the tax credit for individuals 65 or older. The federal government age amount of $6,916 is reduced by 15 per cent of net income in excess of $43,873, and is completely eliminated at a net income in excess of $80,890.

The OAS claw-back is an important tax that needs to be observed in planning for retired individuals. However, simply putting in place those strategies that avoid the tax may not be the most efficient strategy for the client. Planning should look at the individual's total profile in devising customized recommendations.

I/R 3201.03, 7401.00

BENEFITS OF AN ABIL

When a taxpayer suffers a capital loss on the disposition of a capital asset, tax relief is available in the form of an offset against capital gains. To utilize this offset, of course, the taxpayer needs a capital gain.

The capital gain may have been realized in the current year from the disposition of another capital asset. If insufficient current year gains are available, the taxpayer may use the loss to reduce a gain realized in the prior three years or may carry the amount forward to a future year. To benefit from the offset of a prior year capital gain the taxpayer will need to file a loss carryback request with the CRA. Any amount not carried back can be carried forward indefinitely and used to reduce a capital gain realized in a future year. In the year of the taxpayer's death, and the preceding year, any capital losses, including amounts carried forward, can be offset against any type of income.

There is, however, an exception to these rules in circumstances when a taxpayer suffers a capital loss on the disposition of shares of a Canadian-controlled private corporation (CCPC) carrying on an active business in Canada, or when a loan is made for the purpose of earning income from business or property in a CCPC that carries on an active business in Canada and the debt becomes uncollectible. In general terms these types of capital losses are defined as business investment losses (BILs), and are afforded special tax treatment. One-half of a BIL is defined as an allowable business investment loss (ABIL).

An ABIL can be deducted against any type of income, not just taxable capital gains. This means tax relief can be available much sooner than with a regular capital loss. A BIL can arise on an actual disposition of this type of asset or upon an elected deemed disposition.

A BIL can occur upon the disposition to an arm's-length party of a share or debt of a company that met the definition of a "small business corporation" at the time of disposition, at the time of bankruptcy, or at the time of windup. A BIL would occur if the proceeds of disposition are less than the taxpayer's adjusted cost base. In making the claim for an ABIL the taxpayer will want to ensure there is sufficient documentation to prove the disposition actually happened and the debt or shares were from a corporation that met the definition of a small business corporation.

A BIL could also occur if the taxpayer makes the appropriate election in his or her tax return for the year. In order to make the election the corporation must meet the definition of a small business corporation at that time, at the time of bankruptcy or at the time of windup, and the debt or share must have no value.

A small business corporation is defined in the Income Tax Act as being a Canadian-controlled private corporation where all or substantially all of the fair market value of the assets were used principally in an active business carried on primarily in Canada.

It is important to note that an ABIL and the capital gains exemption interact in that a claim for one can impact the other. An individual's claim for an ABIL will be reduced by a prior capital gains deduction claim. That portion of the ABIL reduced by a prior capital gains deduction claim will be converted into an allowable capital loss.

Summary

	Allowable Capital Loss	**Allowable Business Investment Loss**
Calculation of the amount	One-half of a capital loss	One-half of a capital loss realized on the disposition of debt or shares of a small business corporation
Offsetting amounts	Can only claim against taxable capital gains	Can be claimed against any type of income
Carry back to a prior year tax return	Back three years	Back three years
Carry forward to a future tax return	Forward indefinitely	The ABIL can be carried forward 10 years. At year 11 the ABIL reverts to an allowable capital loss, which can be carried forward indefinitely.

The ABIL rules provide an incentive for taxpayers to invest in Canadian private companies through tax relief designed to recognize the potential for investment risk. However, the rules are complex and the discussion here is of a general nature. Taxpayers would be wise to consult a professional when dealing with losses in this area.

No one lends or invests capital expecting a loss. To the extent a loss is realized in respect of a small business corporation, however, special tax relief may be available. I/R 7401.00

EVALUATING THE OPTION OF PROFESSIONAL INCORPORATION

Professionals in every province have been permitted to incorporate their practices for many years. This list of professionals generally includes physicians, architects, accountants, dentists, engineers, veterinarians and lawyers. The rules that govern incorporation are established by the professional bodies in each province. Such rules may include limitations associated with the selection of the corporation's name along with restrictions on share ownership, including who can and cannot own voting and non-voting shares.

Because each profession in each province is unique, it is extremely important to consult experienced lawyers and accountants, including tax professionals, when establishing a professional corporation. Some incorporation considerations are outlined below, but the rules can be very complex and must be analyzed carefully in any particular set of circumstances.

The decision to incorporate a professional's practice should involve a balanced analysis of the pros and cons. Some of the benefits may include:

- the ability to income split with family members;
- the ability to defer income taxes;
- funding corporate-owned life insurance; and
- accessing the capital gains exemption.

Some of the drawbacks may include:

- maintaining corporate records such as a minute book;
- additional record-keeping including financial statements and corporate filings; and
- adhering to shareholder benefit rules.

Income splitting can be achieved by issuing shares of the professional corporation to family members of the professional, but there are issues to consider. To the extent dividends can be flowed to the other family members who are in a lower tax bracket, the professional's family will pay less tax and retain more cash overall. Dividends paid to minors will be subject to the "kiddie tax" rules, which eliminate the benefit of income splitting with minors. In situations where the professional is supporting his or her parents financially, consideration could be given to including the individual's parents as shareholders, if the provincial professional body allows for it. (Note that additional factors need to be considered, such as age and capacity of the parents, now and in the future.) As well, careful attention should be paid to the issue of corporate attribution when structuring transactions. This may be a concern for investment-rich corporations, either currently or in the future, as this could cause the corporation to fall outside the definition of a "small business corporation" and result in unexpected consequences. Awareness of these rules will help ensure planning addresses potential concerns and minimizes unanticipated surprises.

Tax deferral can be achieved to the extent that income is retained in the corporation and the corporation pays income tax at a lower rate than the professional would pay had the income been received directly. Deferral of income tax provides more funds on which income can compound; however, deferred taxes will eventually be paid when the professional withdraws the accumulations from the company.

Consider the following example of a professional who is saving about $100,000 of pre-tax professional income.

	Unicorporated Professional	Incorporated Professional
Income not required for current lifestyle	$100,000	$100,000
Income tax rate	45%	16%
Income taxes paid	$45,000	$16,000
Cash for Accumulation	$55,000	$84,000
Potential Dividend (in the future to access funds)		$84,000
Income tax rate		34%
Income taxes paid		28,600
Cash for Spending	$55,000	$55,400

In this example the professional is deferring $29,000 of income tax during the accumulation phase by opting to retain $100,000 in the corporation because it is not required for current lifestyle needs. This means the deferred tax, which is the difference between the personal tax rate (approximately 45 per cent) and the corporate tax rate (approximately 16 per cent), is available for investment and can generate additional income. The deferred tax is eventually paid when taxable dividends are withdrawn from the professional corporation at a future point in time. Some of the tax deferral noted above could translate into actual tax savings to the extent the professional is not in the top tax bracket during retirement when dividends are paid out of the professional corporation.

A professional could use the corporation to pay for life insurance premiums. To the extent the corporation is the owner and beneficiary of the life insurance policy, no taxable shareholder benefit arises. Upon death the life insurance would be paid to the corporation, create a credit in the corporation's capital dividend account, and be available to fund capital dividends to the ongoing shareholders. It takes less income at lower tax rates to generate the after-tax cashflow required to pay the life insurance premiums through a corporation than personally, even though the corporatio n is not eligible to deduct the premium expense.

Access to the capital gains exemption is often cited as an advantage of professionals incorporating their practice. The capital gains exemption is currently $800,000, which is worth about $180,000 in income taxes (assuming a 45 per cent marginal tax rate) and will be indexed after 2014. However, the professional may not be able to avail him or herself of this exemption amount, depending on the situation.

For example, a purchaser may not want to purchase shares of the corporation because of liabilities that may arise, including potential litigation or tax re-assessments from the past. While indemnities and guarantees can help offset this concern, the individual offering the indemnity or guarantee may have limited resources and not be in a position to make a payment. For these reasons a purchaser may prefer to purchase the practice owned by the corporation rather than the shares of the corporation itself. No capital gains exemption would be available in that case.

It is also possible that the corporation may not qualify as a qualified small business corporation because of its accumulated investments. When non-active assets such as investments represent more than 10 per cent of the company's fair market value of its assets, the corporate shares do not qualify for the capital gains exemption.

A benefit of operating the professional practice through a corporation is the flexibility with regard to personal remuneration. The professional can plan whether income is paid in the form of salary, bonus or dividends. This allows the professional to minimize current income tax through payment of dividends, for example, or to create RRSP or IPP contribution room through the payment of salary.

Operating a professional practice from a corporation means the professional must observe the uniqueness of the corporation as a separate tax payer with its own set of accounting records. Funds taken from the corporation must be properly accounted for. This creates financial complexity to which the professional may not be accustomed. Planning involves looking at every option and projecting the circumstances into the future. A professional considering incorporating his or her practice should ensure the benefits outweigh the costs in their situation.

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