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The TAX factor

Tax planning strategies from BDO Dunwoody LLP

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2007 Personal Tax Returns —What's New?

Yet another year has passed and it is once again that time of year to turn your attention to your personal tax return. The following is a summary of the more significant federal changes to consider when preparing your 2007 tax return.

New pension income splitting

The election to split pension income will be available when filing returns this year. Eligible taxpayers will be able to allocate up to ½ of their eligible pension income for 2007 to their lower-earning spouse or common-law partner by making the election on new form T1032, Joint Election to Split Pension Income.

Lower tax rate

The 2007 Economic Statement, the federal mini-budget delivered in October, included a personal tax rate reduction for the lowest tax bracket (taxable income not exceeding \$37,178) from 15.5% to 15% for 2007.

Higher basic and spousal/partner personal tax credits

The 2007 Economic Statement also included an increase in the basic personal amount from \$8,929 to \$9,600 for 2007. There are corresponding increases to the spouse or common-law partner and wholly dependent relative credit amounts (as these credit amounts are equal to the basic personal amount). The actual federal tax credit for these items and the federal non-refundable tax credits discussed below are calculated by multiplying the applicable amount by 15% for 2007.



Eligible taxpayers will be able to allocate up to 1/2 of their eligible pension income for 2007 to their lower-earning spouse or common-law partner...

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... the new children's fitness tax credit is now available for eligible fees paid in 2007 that relate to the cost of registering your child (under 16 years of age at any time during the year) in an eligible fitness program

New children's fitness tax credit

The widely publicized non-refundable tax credit announced in the 2006 budget is now available for eligible fees paid in 2007 that relate to the cost of registering your child (who is under 16 years of age at any time during the year) in an eligible fitness program. The maximum amount of fees that can be claimed is \$500 per child.

There is an additional \$500 amount for children (under 18 at any time during the year) with disabilities.

New child tax credit

There is a new non-refundable tax credit for parents with children under the age of 18 (born in 1990 or later for 2007 returns), based on an amount of \$2,000 for each child. Either parent may claim the credit if the child resides together with the child's parents throughout the year. In other cases, the parent who is eligible to claim the wholly dependent person credit will make the claim. The full amount of the credit is available in the year of birth, death, or adoption of a child.

Expanded public transit credit

The expanded non-refundable public transit credit now includes payments for electronic payment cards and weekly passes provided certain conditions are satisfied in each case. Electronic payment cards are eligible if used for at least 32 one-way trips during 31 consecutive days. Weekly passes are eligible if the passes can be used for unlimited travel within at least a five day period and enough passes are purchased to allow the taxpayer to travel on at least 20 days in a 28-day period.

Canada employment credit

This credit was implemented effective July 1, 2006 to provide recognition of work-related expenses incurred by employees. Taxpayers will be provided relief based on the lesser of \$1,000 (increased from \$250 for 2006) and the taxpayer's employment income for the 2007.

New working income tax benefit (WITB)

The WITB is a new refundable tax credit for low-income earners over the age of 19 and is worth up to \$500 per year

for individuals and \$1,000 for families (couples and single parents) and is equal to 20% of each dollar of earned income in excess of \$3,000. When net family income exceeds certain thresholds (\$9,500 for individuals and \$14,500 for families), the credit is reduced by 15% of the net family income over the threshold. The WITB includes additional supplements for those with disabilities.

Extended mineral exploration tax credit for flow-through share investors

The 2007 budget extended this credit to apply to agreements entered into on or before March 31, 2008.

Donations to private foundations

Donations of publicly-listed securities to public charities have been eligible for a reduced inclusion rate on capital gains since 1997 and a complete exemption since May 2, 2006. The 2007 budget extended the zero inclusion rate for gains in respect of gifts of publicly-listed securities to eligible private foundations made on or after March 19, 2007.

Higher lifetime capital gains exemption (LCGE)

The LCGE on capital gains realized on the disposition of qualified small business corporation shares and qualified farm and fishing property was increased to \$750,000 from \$500,000 for dispositions of property that occur on or after March 19, 2007. Refer to "Have you taken advantage of the capital gains exemption?" from the 2007-02 edition of the *Tax Factor*.

Tax-exempt elementary and secondary school scholarships and bursaries

Scholarships and bursaries that are provided to attend elementary and secondary schools are no longer taxable.

Meal expenses of truck drivers

The deductible portion of the cost of food and beverages consumed by long-haul truck drivers during eligible periods of travel has increased to 60% from 50%. This rate will increase by 5% every year until 2011 when it reaches 80%.

RRSP changes

Previously, RRSPs, RPPs and DPSPs matured by the end of the year in which the taxpayer turns 69. This means that no further contributions or benefit accruals are permitted and that benefits under the plans must begin to be paid. The conversion age has been increased to 71 for individuals who turn 69 in 2007 or subsequent years. Individuals who turn 70 or 71 in 2007 can make RRSP contributions (subject to the usual rules) and waive RRIF withdrawals.

Instalment payments

The personal instalment threshold amount for the 2008 and subsequent taxation years increases to \$3,000 (\$1,800 for individuals resident in Québec). The CRA will continue to notify individuals who are required to remit instalments of the amount of each instalment, determined on the basis of tax information that is available to the CRA.

If you need more information on these changes or have any questions about how these changes may impact your 2007 tax return, contact your BDO advisor.

Tax Issues on Marital Breakdown

When a marriage or common-law relationship fails, there are a number of issues that need to be dealt with and the tax issues may not be at the top of the list for the former couple. However, there are numerous tax rules to consider, and some are beneficial which can make a difficult situation easier to deal with.

Who is considered to be married for tax purposes?

Although the issue will usually be obvious, we still need to review who is and isn't considered to be married for income tax purposes. In addition to individuals who have married each other in the traditional way, our income tax rules recognize "common-law" unions, which include same-sex couples. Two individuals (who aren't otherwise married) are generally considered to be spouses for tax purposes if they have been living together in a conjugal relationship and have been living in such a relationship for at least 12 consecutive months or have a child.

How does a marriage end for tax purposes?

The timing is somewhat different for legal marriages and common-law relationships. In a legal marriage, the couple typically separates for a time, and then the relationship ends when the couple obtains a divorce.

In a common-law relationship, the couple will no longer be spouses when they live separate and apart for at least 90 days due to a breakdown in their relationship (the relationship is deemed to end on the first day they separate).

For purposes of determining when a couple is separated for tax purposes, the 90 days rule is also applied to legal marriages, so once a legally married couple has been separated for 90 days, the effective day they separated is

the day they started living separate and apart.

In the rest of this article, references made to a spouse include a common-law partner and a marriage includes a common-law relationship.

What are the key tax rules to consider?

An end to a marriage can trigger two important events—a division of family assets, and the payment of support to a partner as spousal support (alimony) or child support.

Tax Rules for a Division of Assets

Under family law, a breakdown of a marriage may result in a requirement to divide assets. For income tax purposes, rollovers are available for these asset transfers, which allow an accrued gain or income inclusion to be deferred until the asset is disposed of or liquidated, as follows:

Capital Property – Property can be transferred between spouses at its tax cost. This means that no tax will arise on the transfer, and tax will not arise until the asset is sold. Income attribution may or may not apply, depending on the circumstances. The couple can also elect to divide property as a fair market value disposition, to utilize capital loss carryforwards or the capital gains exemption in the case of qualifying property.

RRSPs – Funds can be transferred on a tax-deferred basis from the RRSP of one spouse to an RRSP for the other spouse where the transfer is made in settlement of property rights. In addition, the transfer must be made pursuant to a court order or written separation agreement. Similar rules apply for RRIFs.



In the case of child support, the payment will generally not be deductible to the payer and won't be taxable to the recipient

Canada Pension Plan Credits – Although exceptions apply, CPP credits of both spouses will generally be combined and split on the end of their marriage.

Tax Treatment of Support Payments

Again under family law, one spouse may be obligated to pay spousal or child support to the other spouse on the breakdown of the marriage and we'll address how these payments will be taxed when an obligation does arise.

Spousal support payments (payments made solely for the support of the spouse) are generally deductible to the payer, and taxable to the recipient. However, there are conditions to be met—the most important being that the payments must be periodic (as opposed to a lump sum) and must be made pursuant to a court order or agreement. However, a lump sum which is a payment of periodic amounts in arrears will generally be treated as a periodic payment.

In the case of child support, the payment will generally not be deductible to the payer and won't be taxable to the recipient. An exception applies for orders or agreements made before May 1997 (where the tax treatment will generally be the same as for spousal support, unless the former spouses elect jointly to be subject to the current child support rules).

Where an agreement or court order calls for both spousal and child support payments, the payments will be allocated first to the child support obligation.

Are legal fees deductible?

For child or spousal support recipients, legal fees are deductible if paid to collect late support payments, to establish a support payment entitlement, to increase a support payment entitlement or to make child support payments non-taxable.

From the payer's perspective, legal fees paid are generally not deductible. Also, fees related to custody of a child or visitation issues are not deductible.

What other tax rules need to be considered?

Personal Tax Credits – Where a couple has dependants, they will have to determine which spouse can claim personal credits. In particular, if both spouses don't enter into a new marriage, this means each spouse has the ability to claim a dependant as an "eligible dependant", meaning that the credit amount will be the same as the basic personal credit (subject to a reduction based on the dependant's income).

The eligible dependant amount may be claimed as long as the following conditions are met:

- ◆ the taxpayer does not have a spouse or common-law partner, or if there was one, the taxpayer was not living with, supporting or being supported by that spouse or common-law partner,
- ◆ the taxpayer supported a dependant in the year who lived with the taxpayer in a home maintained by the taxpayer (this would include dependants living away from home while attending school as long as the dependant ordinarily lives with the taxpayer when not in school) and
- ◆ the dependant supported is the taxpayer's child who is either under 18 years of age or mentally or physically infirm (note that other individuals are eligible but in the context of this article, we are only referencing a child of the taxpayer).

A taxpayer can claim an eligible dependant if the above criteria are met, the taxpayer is not claiming a spouse or common-law partner amount and the taxpayer is not making support payments for the dependant. This claim can be made in the year of separation (a special rule also applies for support payments).

As only one spouse can claim this amount for a particular dependant, the former spouses will have to determine who will make the claim if both are eligible. A common planning idea where there is more than one dependant is to allow each spouse to claim one dependant each as an eligible dependant (if possible).

Child Care Expenses – Separation impacts the claim for childcare expenses. Separated or divorced parents may claim the deduction for childcare expenses based on the percentage of time the child(ren) resides with that parent. For example, in a 50-50 shared custody situation where each parent pays for 1/2 of the childcare costs, each parent can claim 50% of the child care expenses deduction.

Tuition and Education Credit – Where the parents of a student are separated or divorced, the student can transfer the unused portion of their tuition, textbook and education credits to either parent subject to the usual rules (but not a portion to both). As the transfer of the credit is not based on whether a parent actually supports the child or even pays the amounts for the child, the former spouses and the student will have to come to some agreement if there are credits to be transferred.

Principal Residence Rules – As a couple can only designate one residence, the couple will need to decide how the exemption will be used when more than one residence is held. The agreement/order should specifically address how the principal residence designations will be claimed on future sales.

Joint and Several Liability – The rules are complicated, and the key point to keep in mind is that a transfer of property could result in a joint and several liability for the associated tax in some situations.

This article has described, in general terms, just some of the important points that need to be considered on the breakdown of a marriage. It is crucial to get specific tax advice when agreements are prepared and tax returns are filed.

Your BDO advisor can guide you through the tax issues that arise on a marriage breakdown. Contact your advisor with any questions or concerns that you may have.

Do You Need a Shareholders' Agreement?

You're in business with other individuals. They may even be members of your family. The company is growing and all of you are working hard. You all agree with the direction in which the business is heading.

Does this sound like your company? But have you given any thought to how you and your fellow shareholders will resolve disputes should they arise? What will happen if one shareholder dies or becomes disabled?

A shareholders' agreement is a contract between shareholders of an incorporated business that puts mechanisms in place to deal with important issues before they become problems. For business owners who are carrying on business with others in an unincorporated partnership, the issues discussed in this article are dealt with through the use of a partnership agreement. Both agreements are an invaluable tool you can use to help ensure that your business grows and prospers.

Let's look at an example where a shareholders' agreement could have helped to prevent a major problem. Two sisters, Jane and Mary, started an incorporated catering business in the mid-1970s. They had always been close. In fact, their families live in the same town and they vacation together. As issues arose, Jane and Mary were able to discuss them and reach a mutually satisfactory agreement. Due to this, the sisters didn't think it was necessary to anticipate problems and therefore they didn't consider a shareholders' agreement.



You might also be thinking that the sisters don't need a shareholders' agreement. They have always been able to resolve differences, so what's the point of spending the money to document their business relationship in writing?

It turns out that there was one issue that they never could agree to deal with—who would take over the business when they couldn't run it anymore? Although they realized that a solution would eventually have to be found, they believed that they could deal with it later, once they were closer to retirement.

Then two events occurred which turned the lack of a shareholders' agreement (and a succession plan) into a major issue. First, children of each sister became actively involved in the business. However, no thought was given to how those children would interact with each other once the two sisters were no longer in the picture.

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Then Jane (now in her mid-sixties) suffered a heart attack. After a fairly lengthy recovery, she realized that working long hours in the business was not something she wanted anymore. So, she thought the time had come to pass on the business to the next generation. However, Mary was still in good health and didn't share her sister's desire to begin the succession process.

What follows in such a situation varies. In the case of the McCain family, the end result was a public conflict in which lawsuits were filed and the matter was eventually settled out of court by a New Brunswick judge who was hired as an arbitrator. For smaller businesses (as is the case for Jane and Mary), the business itself may not survive such an event.

How could a shareholders' agreement have helped?

A shareholders' agreement would have provided two benefits. First, an executed agreement would obviously set rules that would be followed to resolve business disputes and events such as Jane's illness. But more importantly, the process of working through an agreement would help the sisters identify possible business risks and let them discuss in advance how they would resolve each issue if it arose and perhaps even set aside resources in advance (such as life, disability or critical illness insurance).

This could have been accomplished when they were getting along, in good health and in a good position to be objective over who should take over the business. In particular, the agreement could have provided for a couple of options—a mandated succession plan where each sister would pass on their interests to the next generation or a buy-sell agreement which would allow one sister to buy the other's shares at a time when she became unable to carry on in the business due to poor health. Although the sisters could try to negotiate such an arrangement now, the point really is that their interests have already diverged and the issue is causing disharmony in their relationship. An

added problem is that Jane is potentially at a disadvantage in any negotiations as she is unable to continue in the business.

In addition to buy-sell rules on disability or death and rules for succession, a shareholders' agreement will usually include mechanisms to help shareholders deal with important issues such as:

- ◆ Major business decisions such as a merger;
- ◆ Rules for employing family members;
- ◆ Rules for disposing of major assets or a business line;
- ◆ Remuneration of shareholders and setting work expectations;
- ◆ Corporate financing decisions;
- ◆ Rules for determining a price of a shareholder's interest and the conditions under which the interest can be transferred (in addition to illness or death);
- ◆ Liquidation of a shareholder's interest in the event of disagreement, disability or death (this would include buy-sell agreements for shares); and
- ◆ Rules for resolving deadlocks (such as arbitration, mediation or appointing additional directors).

This list is not exhaustive—any issue of mutual concern to the shareholders of a company can and should be covered in the agreement.

The moral

You should put mechanisms in place now to help you deal with major issues at a time when you and your fellow shareholders are enjoying a good relationship, good health and can be objective. This is usually accomplished through the use of a shareholders' agreement for an incorporated business or a partnership agreement for unincorporated partners. Be sure to discuss these issues with your co-owners and your BDO advisor before business issues become business conflicts.

Shareholders' agreements are important tools to have in business—if you need additional information or assistance, contact your BDO advisor.



A shareholder's agreement is a contract between shareholders of an incorporated business that puts mechanisms in place to deal with important issues before they become problems

Are You Getting a Passing Grade on Education Savings?

The cost of a post-secondary education in Canada is high, and it isn't going to get any better. So how do you make sure you go to the front of the class when it comes to saving for your child's education? The answer—make sure you take advantage of all the tax breaks, including income splitting.

When saving for your child's education, there are two main strategies to consider—a Registered Education Savings Plan or RESP and what is generally referred to as an “in-trust” investment account.

RESPs have been around for a long time, and remain a powerful tool. Under an RESP, funds are invested in a tax deferred plan and the investment income is eventually paid out as taxable income to your child when he or she goes to college or university.

An in-trust account takes advantage of an exception to income attribution tax rules. Under these rules, if you gift money to your minor child in trust or loan money to a trust for the child, any income earned will be treated as your income. But, there's an exception—these rules don't apply to capital gains. So, if you pick investments that will produce capital gains, such as equity investments, then your child will be taxed on the income. With a 50% inclusion rate on gains and a personal credit available, often no tax arises.

For 2007, there are three important RESP changes to consider:

- ◆ The annual RESP contribution qualifying for the Canada Education Savings Grant (or CESG) was increased to \$2,500 from \$2,000,
- ◆ The annual RESP contribution limit of \$4,000 was eliminated, and
- ◆ The lifetime RESP contribution limit was increased to \$50,000.

These changes mean you have some homework to do—should you concentrate on making RESP contributions since the annual limit was removed or should you put just enough money into an RESP each year to get the CESG and put the rest into an in-trust account?

To see what gets a passing grade, let's work through the numbers with Mary and her newborn daughter Emily. With her husband, Mary thinks she'll be able to put away \$3,000 a year for Emily's education (over 18 years). Also, Mary's mother wants to contribute another \$10,000 now towards Emily's education.

As discussed, Mary has two choices—she can put all of her education savings into an RESP as it becomes available and then use an in-trust account (or a formal trust) later once the \$50,000 limit has been reached. Or, she can just put enough money in an RESP each year to get the maximum CESG, and put the rest into an in-trust account.

The chart below shows what will be available after contributions over 18 years under each option:

| | Maximize RESP contributions, use in-trust account later | | | Use RESP to get maximum CESG only, put rest in in-trust account | | |
|----------------------------------------|---------------------------------------------------------|------------------|-----------|-----------------------------------------------------------------|------------------|-----------|
| | RESP | In-Trust Account | Total | RESP | In-Trust Account | Total |
| Total cash available | \$50,000 | \$14,000 | \$64,000 | \$36,000 | \$28,000 | \$64,000 |
| Add: | | | | | | |
| CESG deposited in RESP | 6,700 | - | 6,700 | 7,200 | - | 7,200 |
| Accumulated investment income | 83,563 | 3,041 | 86,604 | 52,205 | 33,360 | 85,565 |
| | 140,263 | 17,041 | 157,304 | 95,405 | 61,360 | 156,765 |
| Less: Mary's tax on dividends | - | (183) | (183) | - | (2,002) | (2,002) |
| Amount available for Emily's education | \$140,263 | \$16,858 | \$157,121 | \$95,405 | \$59,358 | \$154,763 |

Main assumptions:

- Rate of return is 7%, 30% as eligible dividends and 70% as capital gains.
- Mary's RESP contributions are subject to a 20% CESG refund rate.
- Mary pays tax on eligible dividends at a rate of 20%.

Are You Getting a Passing Grade on Education Savings?, continued from page 7

Maximizing the RESP looks like the best choice. However, you'll get an A+ if you remember that an in-trust account represents after-tax money while the accumulated income and CESGs in an RESP is taxable when withdrawn. Therefore, if Mary chooses to maximize RESP contributions, there will be about \$31,000 more in accumulated income in the RESP when Emily goes to college or university. Although Emily may be able to avoid tax on this extra income with her combined tuition, education and textbook credits, remember that unused credits can also be transferred to Mary or her husband (within limits) or carried forward to the taxation year when Emily begins to work full time. Preserving \$31,000 of education-related credits is currently worth around \$7,500 (depending on where you live). An added benefit is that you have \$31,000 more that is not restricted by RESP rules in terms of how the plan income can be paid out (if Emily doesn't go to college or university).



Many advisors are suggesting that you take full advantage of the elimination of the annual RESP contribution limit, but you'll be on the honour roll if you remember you have other options.

If you are saving for your child's education and have further questions, contact your BDO advisor to discuss.

When saving for your child's education, there are two main strategies to consider —a Registered Education Savings Plan or RESP and what is generally referred to as an “in-trust” investment account

Update on Withholding Taxes on Cross-Border Interest Payments

As previously reported in *Fast Fact 07-02*, the 2007 federal budget announced that the government would eliminate withholding tax on certain interest payments made to arm's length non-residents, regardless of their country of residence once the withholding tax elimination is implemented in the Canada-U.S. Tax Treaty. Rather than waiting for treaty ratification, this change has now been implemented with Bill C-28 which received Royal Assent on December 14, 2007 and will apply after 2007.

The *Tax Factor* is published quarterly by BDO Dunwoody LLP. Our goal is to keep you up-to-date on recent tax developments and offer practical advice on tax and business issues. Comments and suggestions should be addressed to National Tax, by Fax: (416) 367-3912 or E-mail at info@bdo.ca. We invite you to visit our web site at www.bdo.ca to find out more about our firm and the offices near you. Or call us at 1-800-805-9544.

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