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TAX LETTER

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THE CRA ON OVER-CONTRIBUTIONS TO TFSAs
INCOME SPLITTING AND THE INCOME ATTRIBUTION RULES
THE "KIDDIE TAX"
EDUCATION TAX CREDITS
CHILD CARE EXPENSES
PRESCRIBED INTEREST RATES
AROUND THE COURTS

THE CRA ON OVER-CONTRIBUTIONS TO TFSAs

The tax-free savings account (TFSA) has been in place since 2009. It is an account that allows you to save and invest amounts tax-free - income earned is not taxed while in the account or upon withdrawal. The annual contribution limit since 2009 has been $5,000 (and carries over to later years if you do not use it). Furthermore, withdrawals made in one year add to the contribution limit for the **following** year, above and beyond the regular $5,000 annual limit.

Last year, the Canada Revenue Agency (CRA) sent out letters to thousands of individuals regarding over-contributions made to their TFSAs during 2009. Apparently, many individuals thought that withdrawn amounts could be recontributed in the year of withdrawal, rather than in the following year, so they withdrew and re-contributed in 2009 and went over the annual limit. Over-contributions carry a 1% per month penalty.

Owing to the apparent confusion over the rules, the CRA indicated that it would allow individuals a chance to explain their situation and that it would try to be flexible and waive penalties where appropriate.

Evidently, some of the confusion regarding the TFSA contribution limits continued into 2010. Therefore the CRA has been following up with individuals who may have overcontributed.

INCOME SPLITTING AND THE INCOME ATTRIBUTION RULES

Due to the progressive nature of our income tax system, it can be beneficial to split income with family members who are in a

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lower tax bracket. However, the Income Tax Act contains income attribution rules that, if applicable, effectively prevent the splitting of investment income (e.g. dividends, rent, and interest). Fortunately, there are some exceptions to those attribution rules. The following is a summary of the main rules and exceptions.

Transfers and loans to spouses – if you transfer or loan property to your spouse (or common-law partner), any subsequent income from the property is attributed back to you and included in your income. As a result, income splitting is effectively denied. Similarly, any taxable capital gains from the subsequent disposition of the property by your spouse are attributed to you. However, the attribution rules work in both directions, so any loss from the property or allowable capital loss from the disposition of property is also attributed back to you. If the rules apply, they also apply to income and losses from "substituted property" – for example, where the original property is disposed of by your spouse and the proceeds are used to purchase another property.

The attribution stops if you cease to be resident in Canada, you die, or you and your spouse get divorced (or you and your common-law partner cease to be common-law partners).

Transfers and loans to minors – if you transfer or loan property to a minor non-arm's length person (e.g. child, grandchild, sibling or niece or nephew), any subsequent income or loss from the property is attributed back to you. The substituted property rule discussed above also applies. The attribution ceases as of the year in which the minor turns 18 years of age. As above, the attribution stops if you cease to be a resident in Canada or die.

Interestingly, the attribution rules do not apply to capital gains realized by minors. Therefore, for example, you could buy stocks or equity mutual funds for your minor children and any resulting taxable capital gains would be taxed in their hands, and not be attributed to you.

Fortunately, as noted, there are other exceptions to the attribution rules. Some of the major exceptions are as follows.

Exception: fair market value consideration – if your spouse or minor child pays you consideration for the transfer of property equal to at least its fair market value, the attribution rules will not apply to subsequent income or capital gains from the property. If the consideration is debt (i.e. unpaid purchase price for the property), this exception applies only if they pay you at least the prescribed rate of interest on the debt in each year in which the debt remains outstanding or by January 30 of the following year. If they miss making even one interest payment by the deadline, this exception no longer applies. In the case of a transfer of property to your spouse, you must elect out of the spousal rollover that otherwise applies on such transfers, meaning that any accrued gain on the transfer will be recognized (as a result, it makes most sense to transfer property with little or no accrued gain).

Exception: fair market value loan – if you lend money to your spouse or minor child at the prescribed rate of interest at the time of the loan, the attribution rules will not apply. As above, this exception applies only if they pay you the prescribed rate of interest on the loan in each year in which the debt remains outstanding or by January 30 of the following year.

Currently, the prescribed rate of interest for these purposes is at a historic low of 1% (see “Prescribed Interest Rates”, later in the letter). Therefore, it is an ideal time to use this exception to split income with your family members. For instance, if you lend your spouse money at 1% interest and she uses the money to earn a return of 5%, you have effectively shifted 4% of income to your spouse. That is, she would include the 5% return, and deduct the 1% interest paid to you. You would include the 1% interest received from your spouse.

Exception: business income – the attribution rules do not apply to business income. Therefore, you could give or lend money to your spouse or minor and they could use it in a business to earn business income, without attribution.

Exception: transfers to adult children – you can transfer money or other property to your children who are 18 or over, and any subsequent income will not be attributed to you. (There is a different rule that attribute income if you lend money to an adult child for purposes of income-splitting.)

Exception: transfers for personal use – since the attribution rules apply only to investment income, you can transfer or lend money or other property to your family members for personal use – e.g. to buy a home, cottage, car, furniture, groceries and so on, or even to pay their income tax bill. The attribution rules have no application if there is no resulting income.

Exception: reinvested income – the attribution rules do not apply to income that arises from reinvesting any income that was subject to attribution. For example, if you give property to your spouse and she earns income from it, and uses the income to purchase another property, the income or gains from that other property will not be subject to attribution.

Exception: TFSAs – funds invested in a tax-free savings account (TFSA) are not subject to tax while in the account or when withdrawn from the account. Therefore, if you give funds to your spouse to invest in a TFSA, the attribution rules have no application as long as the funds stay in the TFSA.

Exception: income from certain child benefits – There is no attribution to income that is earned by investing the Canada Child Tax Benefit (which is paid to certain low-income families) or the Universal Child Care Benefit (which is available for all families with children under 6).

Lastly, the attribution rules do not normally apply to dividends and shareholder benefits received by minors from most private corporations. Unfortunately, however, the so-called "kiddie tax" applies to such amounts (see below), meaning that the child is taxed on the amounts at the highest marginal rate of tax. The child is, however, eligible for the dividend tax credit in respect of dividends received from Canadian resident corporations.

THE “KIDDIE TAX”

The kiddie tax applies to the “split income” of a child for any year in which the child is under 17 years of age. As noted above, the tax is a flat tax at the highest marginal rate of tax otherwise applicable to individuals; the federal rate is 29%, while the provincial rate depends on the province of residence.

Split income includes, among other things, taxable dividends and shareholder benefits received from corporations whose shares are not listed on a designated stock exchange.

The parents of the minor child are jointly and severally liable to pay the kiddie tax on such dividends if the parent was a "specified shareholder" of the corporation or, in the case of a professional corporation, simply a shareholder. A "specified shareholder" of a corporation generally means a person who owns, together with any non-arm's length person, 10% or more of the class of any shares in the corporation. As such, a parent will be liable for the kiddie tax on dividends received by the child if the child owns 10% or more of a class of shares in the corporation even if the parent owns no shares in the corporation.

There are a couple of exceptions where the kiddie tax does not apply. It does not apply where the shares were inherited upon the death of the child's parent, or inherited from anyone else if the child is enrolled full-time in a qualifying post-secondary institution or qualifies for the disability tax credit.

Recent amendment to kiddie tax

As a result of certain abuses, the kiddie tax will now apply to capital gains realized by a minor child from a disposition of shares of a corporation to a person who does not deal at arm's length with the minor, if taxable dividends on the shares would have been subject to the kiddie tax. The capital gains will be treated like dividends and therefore will not be eligible for the one-half inclusion rule for taxable capital gains or the lifetime capital gains exemption. This new measure applies to capital gains realized on or after March 22, 2011; draft legislation to implement this change was released on August 16, 2011. Other capital gains remain exempt from the kiddie tax.

EDUCATION TAX CREDITS

Readers are likely aware that various education tax credits are available for students pursuing post-secondary education.

There is a federal credit for tuition fees, including certain ancillary fees and charges. The credit is 15% (equal to a deduction against the lowest bracket of income) of the tuition fees paid in respect of the year. The fees must be a minimum of $100. Tuition at a foreign university can also qualify. As noted in our July 2011 Tax Letter, there used to be a requirement for study at a foreign university that the courses be at least 13 weeks in duration. The 2011 federal budget reduced this foreign study requirement to 3 weeks, starting in 2011.

There is a general education credit, which is 15% of a flat amount per month of attendance. For full-time students, the amount is $400 per month. For part-time students, the amount is $120 per month. However, part-time students who are eligible for the disability tax credit or who are certified as having an impairment that prevents them from attending school on a full-time basis qualify for the $400 full-time amount.

The textbook credit is 15% of $65 per month for full-time students, and 15% of $20 per month for part-time students. As above, part-time disabled students qualify for the full-time amount. (No record needs to be kept of the actual purchase of textbooks.)

If the above credits cannot be used in a given year, the student can carry them forward and use them to offset tax in a later year.

Alternately, instead of carrying forward the unused credits, the student can transfer the credits to his spouse or common-law partner, or parent or grandparent. The maximum amount that can be so transferred in a year is $5,000, so that up to $750 of credits (15% of $5,000) can be transferred. Unused credits that the student carries forward to future years cannot be transferred.

> **Example**
>
> John is a student with no tax payable for the year, so he cannot use his tuition, education and textbook credits. His total credit amounts for the year are $9,000 (i.e. 15% of $9,000, or $1,350, is his federal credit).
>
> He transfers $5,000 of the $9,000 to his mother, who uses the resulting $750 credit against her federal tax for the year. The remaining $4,000 is carried forward to the next year, and John must use it if he has tax payable (if not, it carries forward until it is eventually utilized). The $4,000 amount cannot be transferred to anyone else.

There is also a credit for student loan interest, which is 15% of the interest paid in a year on a student loan. The loan must be one that was made under the Canada Student Loans Act or similar provincial act. The credit does not apply to private loans that are not made under such legislation. Any unused credit can be carried forward for up to 5 years. It cannot be transferred to a spouse, parent, grandparent or anyone else.

CHILD CARE EXPENSES

Child care expenses are deductible for income tax purposes if they are incurred to enable you to carry on your employment or business, and generally also to enable you to attend school. The types of deductible expenses include those paid in the year for baby-sitting, day care, nanny services and similar services.

You cannot deduct child care expenses if they are paid to the other parent of the child (i.e. you can't pay your spouse to babysit your children and take a deduction) or to a related minor under the age of 18. You can normally deduct child care expenses paid to adult relatives (e.g. grandparents, aunts and uncles) to take care of your children. (The recipient is required to include the payments in their income.)

If you send your child to a boarding school or camp, you can also claim child care expenses. However, in such case you are limited to a maximum amount for each week during which the child attended the school or camp. For children under the age of 7 at the end of the year, the maximum is $175 per week; for children 7 through 16, $100 per week; and for disabled children eligible for the disability tax credit, $250 per week.

Basic limits to deduction

There are two basic limits on the amount of child care expenses you may deduct in a year. Generally, your deduction is limited to the lower of two.

First limit: 2/3^{rds} of your "earned income" for the year. This concept is somewhat narrower than your total income; earned income includes gross employment income and your net business income, and certain other amounts.

Second limit: A set amount per child, based on their age. For children under the age of 7 at the end of the year, it is $7,000; for children 7 through 16, it is $4,000; and for disabled children eligible for the disability

tax credit, it is $10,000. Note however that the child-care expenses need not be paid for that child; if you have one 5-year-old and one 10-year-old your limit is $11,000, even if you spent it all on child care for the 5-year-old.

For married couples (or common-law partners) with children, only the lower-income spouse can deduct the child-care expenses, except in the limited circumstances outlined below. If that spouse has no income (typically because he or she is busy at home taking care of the children), no deduction can be claimed by either spouse.

When the higher income spouse can claim a deduction

For married persons with children, the higher-income spouse may deduct child care expenses in the following circumstances:

- the other spouse attended school in the year;
- generally, if the other spouse was certified by a medical doctor of being incapable of looking after the children owing to a mental or physical infirmity; or
- the other spouse was in prison.

In these circumstances, the higher-income spouse's deduction is restricted to the two basic limits described earlier, and is further limited to a maximum for week in which the other spouse attended school, was incapable owing to infirmity, or was in prison. Under this third limit, the maximum per week is $175 per child under the age of 7 at the end of the year, $100 per child age 7 through 16, and $250 per disabled child eligible for the disability tax credit. (If the other spouse attended school on a part-time basis, the maximum dollar amounts apply per month, rather than per week.)

Example

John and Paula have two healthy children, aged 5 and 11. Throughout the year, they incurred $10,000 of eligible child care expenses. John's income is higher than Paula's income for the year. Paula was in law school on a full-time basis for 26 weeks during the year. John's earned income for the year was $60,000; Paula's earned income was $20,000.

Since Paula was attending school, John can claim some of the expenses. His claim is limited to the lowest of the following three amounts:

- 2/3 of his earned income = $40,000
- Set amounts per child = $7,000 + $4,000 = $11,000
- 26 weeks x ($100 + $175) = $7,150

Therefore, he can claim $7,150 of the $10,000 child care expenses on his return for the year. Paula can claim the remainder, subject to the two general limits described above as applied to her net of John's claim (in this case, she can claim the remaining $2,850 of expenses).

Finally, you must obtain a receipt from the person providing the child care services. If that person is an individual, you will also need their Social Insurance Number.

PRESCRIBED INTEREST RATES

The following rates are in effect from October 1, 2011 through December 31, 2011.

- The interest rate charged on overdue taxes, Canada Pension Plan contributions, and Employment Insurance premiums is 5%, compounded daily.
- The interest rate to be paid by the CRA on late refunds to corporations is 1%, compounded daily.
- The interest rate to be paid on late refunds to other taxpayers is 3%, compounded daily.
- As noted above, the interest rate used to calculate taxable benefits from interest-free and low-interest loans is 1%.

The same rates have applied since the beginning of 2010 (with the exception of interest paid on late refunds to corporations, which was 3% from January to June 2010).

AROUND THE COURTS

Favourable interpretation of 10-year interest waiver rule

Under the so-called Taxpayer Relief Provisions, the CRA may, at its discretion, waive interest that you owe because of the late payment of taxes and other amounts. However, there is a time limitation that applies to the waiver. The applicable section of the Income Tax Act provides that the CRA may waive the interest payable ***in respect of*** a taxation year only up to ten years after that taxation year, or if you make an application within ten years after that taxation year.

In the recent *Bozzer* case, the issue was whether the ten-year period began after the year in which the tax debt arose, or after the year in which the resulting interest accrued. The taxpayer incurred tax debts in 1989 and 1990. He did not pay the tax, so interest continued to accrue on the debt. On December 6, 2005, the taxpayer made an application to the CRA to waive the interest accruing for the last 10 years, that is, from 1995 onwards. The CRA denied the application on the grounds that the tax debts arose in 1989 and 1990, which were more than 10 years before his application. The CRA was of the view that the applicable section refers to the taxation year in which the tax debt arises, not a subsequent year in which interest accrues.

However, upon appeal, the Federal Court of Appeal sided with the taxpayer. The Federal Court of Appeal examined the purpose and context of the application provision, and held that the interest payable "in respect of a taxation year" refers to interest that accrues in that year, and not the year in which in the initial tax debt arose.

* * *

This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.