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TAX LETTER

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CRA VOLUNTARY DISCLOSURE PROGRAM EMPLOYMENT EXPENSES DIVIDEND TAX CREDIT SPOUSAL AND CHILD SUPPORT SALE OF BUILDING AND LAND TAX CONSEQUENCES OF CEASING TO RESIDE IN CANADA PRESCRIBED INTEREST RATES AROUND THE COURTS

CRA VOLUNTARY DISCLOSURE PROGRAM

The stated purpose of the Voluntary Disclosure Program (VDP) is to encourage taxpayers to voluntarily come forward and correct previous omissions or false statements in their dealings with the CRA. The benefit of coming forward in this manner is that if you make a valid disclosure, you will be required to pay the taxes owing plus applicable interest only, but will **not** be subject to penalties or prosecution that could otherwise occur if the CRA discovered the problem on its own.

Under the CRA's administrative policy, a disclosure can be made if a taxpayer:

- failed to fulfill their obligations under the Income Tax Act,
- failed to report taxable income they received,
- claimed ineligible expenses on a tax return,
- failed to remit source deductions withheld from their employees,
- failed to report an amount of GST/HST,
- failed to file an information return, or
- failed to report foreign sourced-income that is taxable in Canada.

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Furthermore, the CRA requires that a valid disclosure meet four conditions: (1) the disclosure must be voluntary; (2) it must be complete; (3) it must involve the potential application of a penalty; and (4) generally it must include information that is more than one year overdue. Thus, for example, you cannot make a valid “disclosure” in respect of an issue that the CRA has already started investigating or inquiring about.

You can make an initial disclosure on a “name-basis” or a “no-name basis”. Under the former, you would of course disclose your name on the initial application.

The no-name disclosure allows your representative to informally discuss your situation with the CRA to see if it will qualify under the VDP. Based on the advice given by the CRA, you can then choose to continue under the VDP with your identity provided to the CRA (this *must* happen within 90 days of initiating the no-name disclosure, or it will be rejected). If you do not continue, your representative is not legally required to provide your identity to the CRA. However, if the CRA otherwise discovers your omission, you will not have VDP protection, so you will be subject to penalties and, in serious cases, criminal prosecution.

EMPLOYMENT EXPENSES

Employees are quite limited in their deduction of expenses for income tax purposes. They are allowed to claim only those expenses that are specifically allowed under the Income Tax Act. Such expenses must be incurred for the purpose of earning employment income, and in most cases the employee must be required to incur the expenses under the contract of employment

and supply Form T2200 signed by the employer certifying that the requirements under the Income Tax Act have been met.

The expenses that can be deducted include the following:

Employees can deduct their car and travel expenses if they are regularly required to carry on their employment duties away from the employer’s regular place of business. The car expenses include depreciation on a car the employee owns (called capital cost allowance (CCA)); interest payments on a loan used to purchase the car; lease payments for leased cars; and gas, oil, license fees and minor repairs and maintenance.

The annual CCA is generally limited to 30% (15% for the year of acquisition) of up to \$30,000 of the cost of the car plus GST and PST or HST. The monthly interest costs are generally limited to \$300 per month. The monthly leasing costs are generally limited to \$800 per month plus the applicable sales taxes. In each case, the deductible amount is the pro-rata portion of the costs, based on the extent to which the car is used for employment purposes (not including driving from home to work).

The travel expenses include expenses for accommodation, travel, and meals in the course of employment duties. For meals, the travel must be for at least 12 hours outside of the city in which the employee normally works, and the deduction is limited to 50% of the cost of the meals.

Employees can also deduct a portion of home office expenses, provided the home office is either the main place in which they carry on their employment duties, or an office that is used exclusively for work

purposes and regularly to meet customers or clients of the employment. The home office expenses include rent, heat and utilities, cleaning and supplies, and minor repairs and maintenance. The expenses that relate to the entire home (rent, heat and utilities) are pro-rated, based on a reasonable method such as the size of the home office relative to the entire house.

Employees can deduct their union dues and professional membership fees, as well as salaries paid to an assistant in most cases.

Commissioned salespersons are allowed to deduct additional expenses. For example, they can deduct their entertainment expenses (but only 50% of the costs) and promotional and advertising expenses. For home office expenses, they can also deduct property tax and house insurance (pro-rated as discussed above). In addition, they can deduct expenses such as lease payments for computers and user fees for a cell phone or Blackberry (again, pro-rated based on work use). These expenses are generally limited to the employee's commission or bonus income based on sales. Certain car expenses are subject to the commission/bonus limitation except for CCA on a car or interest on a car loan.

DIVIDEND TAX CREDIT

Readers are likely aware that Canadian resident individuals can claim the dividend tax credit for taxable dividends received from Canadian resident corporations. The credit mechanism requires the individual to "gross-up" the dividend, and then claim a credit based on the gross-up. The amount of the gross-up and credit depends on whether the dividend is an "eligible dividend" (which provides a higher credit) or a non-eligible dividend.

Eligible dividends include most dividends received from public corporations and dividends received from a Canadian-controlled private corporation (CCPC) from its earnings in excess of the small business amount, which is currently \$500,000 of active business income. It is the responsibility of the corporation paying the dividend to designate it as an eligible dividend and notify the recipient shareholders of the designation. Other dividends, for example, those received out of a CCPC's small business amount, are not eligible dividends.

The current federal gross-up for an eligible dividend is 45% of the amount of the dividend, and the dividend tax credit equals 11/18 of the gross up (there is an additional provincial credit as well which adds approximately half as much again, depending on the province). Thus, for example, a shareholder receiving a \$1,000 eligible dividend in 2009 would include \$1,450 in income, but would claim a federal dividend tax credit equal to 11/18 of \$450, or \$275.

The overall effect is that dividends are taxed at a lower rate than regular income. For example, in Ontario, the highest marginal tax rate (federal plus provincial) is 46.6%, while the highest effective marginal tax rate on eligible dividends is 23.06% (2009 figures). This reflects the fact that the corporation has already paid a high rate of tax on the income from which it pays the dividend.

Starting in 2010, the federal amounts of the gross-up and dividend tax credit for eligible dividends will change. For 2010, the gross-up will be 44% of the dividend, and the credit will be 10/17 of the gross-up. For 2011, the gross-up will be 41% of the dividend and the credit will be 13/23 of the

gross-up. For 2012 and later years, the gross-up will be 38% and the credit will be 6/11 of the gross-up.

For dividends that are not eligible dividends, the federal gross-up is 25% and the dividend tax credit is 2/3 of the gross-up. The federal gross-up and credit for these dividends is **not** changing next year.

SPOUSAL AND CHILD SUPPORT

When married couples or common-law partners separate or divorce, one person is often obligated to make support payments to the other. The income tax treatment of the support payments depends on whether they are for spousal (or common-law partner) support or child support.

Spousal support

Payments for spousal support are normally deductible for the payer and included in the income of the recipient. The spousal support payments can be made pursuant to a court order or an out-of-court written agreement. However, in order for the payments to be deductible for the payer and included in the recipient's income, they must be identified in the court order or written agreement as being solely for the support of the recipient spouse or common-law partner. If the payments are not identified as such, they will be considered child support and, as discussed below, will normally be tax-free for the recipient and not deductible for the payer.

Furthermore, in order for the spousal support payments to be deductible to the payer and taxable to the recipient, they must be payable on a periodic basis and the recipient must have discretion as to the use of the amounts paid. One exception, where the periodic

basis / discretion requirements are waived, is where the court order or written agreement specifies that the payment is to be paid to the recipient or a third party for a specific purpose, and the order or agreement indicates that the relevant provisions of the Income Tax Act apply. The types of payments that can qualify for this treatment in a year include payments for the recipient's rent, property taxes, utilities, insurance, medical expenses, and the recipient's mortgage payments for the year (not exceeding 20% of the original principal amount of the mortgage).

Normally, the spousal support must be made pursuant to a court order or written agreement that is already in place unless the court order or agreement specifically provides that previous payments are to qualify as spousal support.

Child support

For court orders or written agreements made after April 1997, payments for child support are tax-free to the recipient and are not deductible for the payer. Furthermore, for court orders or agreements made before May 1997, the parties can elect, in prescribed form filed with the CRA, that the current rules apply so that the child support is tax-free to the recipient and not deductible for the payer. Similarly, if a pre-May 1997 order or agreement is varied after April 1997 to change the amount of support, the child support becomes tax-free and non-deductible for the payer.

For other child support payments made under a court order or agreement made before May 1997, the payments are deductible for the payer and included in the recipient spouse's income. In other words, the rules for these

payments are generally the same as the existing spousal support rules.

SALE OF BUILDING AND LAND

Special rules apply to deny a terminal loss if a building used for income-earning purposes is sold. The effect is if we would otherwise have a capital gain on the sale of the accompanying land and a terminal loss on the sale of the building. A terminal loss arises when you sell the building for proceeds less than its “undepreciated capital cost” (UCC), which is basically the amount of the original cost that has not yet been depreciated for income tax purposes. A terminal loss is normally fully deductible against other sources of income. One-half of a capital gain is included in your income as a taxable capital gain.

The result is that sales proceeds equal to the lesser of the terminal loss on the building and the capital gain on the land otherwise determined will normally be re-allocated from the land to the building. Effectively, the terminal loss will be reduced or eliminated entirely.

EXAMPLE

You own a warehouse used in your business and the accompanying land. Your cost of the land was \$200,000. Your original cost of the building was \$150,000, but you have claimed \$20,000 in CCA over the years, so the UCC of the building is \$130,000.

You sell the warehouse and land for a total of \$360,000, allocated in the Agreement of Purchase and Sale as \$240,000 for the land and \$120,000 for the building. Thus, your capital gain on the land would normally be \$40,000 (\$240,000 minus \$200,000), and

your terminal loss on the building would be \$10,000 (\$130,000 minus \$120,000).

However, under the special rule, \$10,000 of your proceeds will be re-allocated from the land to the building, meaning that the terminal loss will be reduced to zero (\$130,000 minus \$130,000). Your capital gain will be \$30,000 (\$230,000 minus \$200,000), and one-half of that, or \$15,000, will be included in your income.

TAX CONSEQUENCES OF CEASING TO RESIDE IN CANADA

If you become non-resident, you are deemed to have disposed of each of your properties at its fair market value and to have reacquired it at a cost equal to the same fair market value, with certain exceptions listed below. This deemed disposition can give rise to taxable capital gains or allowable capital losses, or ordinary gains or losses, depending on the type of the property and its fair market value relative to your cost of the property. The purpose of the deemed disposition is to ensure that Canada can tax your gains (net of losses) that accrued while you were resident in Canada, since once you become non-resident Canada will lose the ability to tax you.

Some properties are excluded from the deemed disposition rule, generally because Canada will tax your gains on them even when you become non-resident. These include: real property located in Canada; property used in a business carried on through a permanent establishment in Canada; and your interests in RRSPs, registered pension plans, tax-free savings accounts, and similar deferred income plans.

However, you can elect to have the deemed disposition rule apply to real property

located in Canada or property used in a business carried on in Canada. The election would be useful if the property had an accrued loss, since the loss could be used to offset gains arising from the deemed disposition of other properties, if any. It may also be useful if you have other losses in the year you cease being resident in Canada, if those losses can absorb the gain while "bumping up" your cost base in the property for purposes of later disposition once you are non-resident.

If you were resident in Canada for 60 months or less in the 120-month period preceding the date of your emigration from Canada, then also excluded from the deemed disposition rule are any properties you owned when you became resident in Canada and any properties that you inherited after you became resident.

You can elect for the payment of any income tax payable as a result of the deemed disposition to be deferred until the year in which you actually dispose of the property, without interest. However, you must post security with the CRA to obtain the deferral, generally if the deemed disposition generates tax payable that is greater than the amount of tax applicable to \$50,000 of taxable income using the highest marginal rate of tax. Security is not required if the tax payable is less than this amount.

Once you are non-resident, the gain on the property that was subject to the deemed disposition rule may be taxed again in your new country of residence (or another country) when you eventually sell it. In order to avoid double taxation in such cases, you are normally allowed a Canadian tax credit, to be applied against the Canadian tax arising in the year in which you ceased to be resident, in respect of the tax paid to the

other country on the gain. The Canadian credit is generally allowed to the extent of the tax in the other country that relates to your pre-emigration portion of the gain (i.e. the gain that accrued while you were in Canada and which was taxed by Canada). The credit is available if it is paid to your new country of residence and the country has an income tax treaty with Canada, or, in the case of real property, if the tax is paid to the country in which the real property is located.

PRESCRIBED INTEREST RATES

The CRA recently announced the prescribed interest rates that are adjusted quarterly and will be in effect from October 1 to December 31, 2009. The rates are unchanged from the quarter that ended on September 30, 2009.

- The annual interest rate charged on overdue income taxes, GST/HST, Canada Pension Plan contributions, and Employment Insurance premiums will be 5%, compounded daily.
- The interest rate paid on late refunds paid by the CRA will be 3%, compounded daily.
- The interest rate used to calculate taxable benefits for employees and shareholders from interest-free and low-interest loans will be 1%.

AROUND THE COURTS

Interest on mortgage on rental property not deductible

In general terms, interest expense is deductible if the loan or borrowed money is used for the purpose of earning income from a business or property. In the recent *Sherle* case, the taxpayer took out a mortgage on a

rental property, but the interest was not deductible because the loan proceeds were used for non-income earning purposes.

Briefly, in 1994, the taxpayer owned two properties and switched uses of them – “property 1” changed from a rental property to the taxpayer’s residence, while “property 2” changed from the taxpayer’s residence to a rental property. In 1994, the taxpayer took out a loan on a new mortgage on property 2 and used the loan proceeds to pay off an existing mortgage on property 1. The taxpayer attempted to deduct the interest on the loan, but the deduction was denied by the CRA.

Upon appeal, the Tax Court of Canada agreed with the CRA that the loan was not used for income-earning purposes, since the loan funds were used directly to pay down the existing mortgage on the taxpayer's residence.

Deduction of moving expenses denied

You are normally allowed to deduct certain moving expenses if you move to a new residence to carry on work or business and your new residence is at least 40 kilometres closer to the new work location than your old residence.

In the recent *Sears* case, the taxpayer lived in New Brunswick with his wife and children. In 2006, he accepted a job in Alberta and moved there to work, but without his wife and children. While in Alberta, he lived either in the employer’s “camp” or with his relatives rent-free. After a few months, he returned to New Brunswick on a leave of absence, and worked there with another employer for another few months and lived with his wife and children during that stay. In late 2007 he returned to Alberta

to work and lived in his employer’s camp until early 2008, at which point he rented out an apartment. In early 2009 he moved back to New Brunswick to the same house that he had always shared with his wife and children. He and his wife remained married and on good terms throughout the period in question.

The taxpayer attempted to deduct his moving expenses for 2006. The deduction was denied by the CRA on the grounds that the taxpayer never took up a new residence in Alberta – he was always legally resident in New Brunswick such that he did not move to a “new residence” for the purposes of the moving expense deduction.

On appeal, the Tax Court of Canada upheld the CRA decision and denied the deduction. The Court ruled that the taxpayer had not established new residency in Alberta since he continued to use his New Brunswick address as his mailing address; he filed his tax returns in New Brunswick and all of his T4 slips showed the New Brunswick address; he kept his New Brunswick health card, driver's license and vehicle registration. As such, the Court concluded that his stay in Alberta was a casual or occasional stay that did not meet the requirements of legal "residency" for the purposes of the moving expense deduction.

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.