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Newsletter

Year End 2006

CONSIDERING PURCHASING PROPERTY THAT WILL BE USED PERSONALLY AND ALSO GO INTO A RENTAL POOL? - BE SURE YOU KNOW THE GST ISSUES

With the increase in rental-pool properties at resort areas all across Canada, the proper treatment of GST on these properties is an issue that the CRA is now looking at more closely. The Penticton GST office currently has an audit project on the go, where they are looking at the treatment of GST on the purchase and sale of all condominium units in all major resort areas in the southern interior of BC.

If you, as an individual, purchase a property that will be put into a rental pool and rented out on a short-term basis (any period under one month), you may be entitled to claim an Input Tax Credit ("ITC") for GST paid on the purchase of the property.

If the short-term rental of the property will account for 90% or more of the use of the property, you will be entitled to claim a full ITC. If the short-term rental of the property will be between 50% and 90%, you will be entitled to claim a prorated ITC. However, if your personal use of the property will account for more than 50% of the use of the property, you will not be entitled to claim any ITC.

The issue is how to determine your personal use of the property. A reasonable method would be to simply look at the total number of days in the year you, your family, or friends will personally use the property. If the number of days of personal use in the year will be 36 or less, your personal use of the property will be less than 10%. Assuming the property is in a rental pool and available for rental the remaining days of the year, you should be entitled to a full ITC.

However, if you are going to use this method to determine personal use, you may have to go to court to argue that it is a reasonable method. This is because, in the CRA's view, in order to claim a full ITC, personal use must be less than 10% of the actual rental use of the property, rather than less than 10% of the time the property was available for rent.

This could cost you thousands of dollars of up-front cash-flow costs, depending on the number of days of personal use and the number of days the property is actually rented.

It is debatable whether the CRA's interpretation of the method to determine personal use of the property is correct; but, you may not want to go to the expense of arguing with the CRA, because when you sell the property, assuming your personal use of the property is less than 50%, you can claim back the GST you were not able to claim as an ITC when you purchased the property.

Remember that, when the CRA is performing an audit, they have the benefit of hindsight. So, before you claim a full ITC for GST paid on a rental-pool property, ensure that you have carefully considered your intended use of the property.

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"Statistics are no substitute for judgment."
- Henry Clay

Special points of interest:

Personal tax instalments:

- ***December 15, 2006***
- ***March 15, 2007***
- ***June 15, 2007***
- ***Sept. 15, 2007***

PROTECTING YOUR ASSETS

Your tax minimization and business planning strategies should consider an asset protection plan to ensure that you protect the net worth you have created in your business. Two techniques you could implement to protect your assets are as follows:

Segregating real estate

Generally, real estate used in business should not be owned by an operating corporation.

If you are planning to purchase real estate for operating your business, it is preferable to have the real estate owned by a holding corporation. In this way, the real estate will not be exposed directly to the creditors of your operating corporation.

On the other hand, if the real estate is currently owned by your operating corporation, there are techniques to transfer the real estate to a sister corporation on a tax-deferred basis. Once the transfer is complete, the operating corporation should enter into a lease agreement with the sister corporation to pay fair market value rent for the use of the real estate.

Use of a holding corporation

An effective asset protection plan is to have a holding corporation own the shares of your operating corporation. If you currently own the shares of your operating corporation, it is possible to transfer the shares of your operating corporation to a holding corporation on a tax-deferred basis.

The advantage to this structure is the operating corporation's after-tax profits can be distributed annually by way of a tax-free intercorporate dividend to the holding corporation. This removes the surplus from the operating corporation and, thereby, limits the exposure to creditors. If the operating corporation requires working capital, the holding corporation can lend the funds to it and secure the loan by way of a general security agreement.

The above plan may make it difficult to utilize the $500,000 enhanced capital gains deduction in the future. However, it may be possible to crystallize the $500,000 deduction on the rollover to the holding corporation, and thereby increase the cost base of your shares of your corporation. A higher cost base of your shares should facilitate a reduction in the personal income tax on the ultimate sale of your shares of your corporation.

Other considerations

Asset protection planning is a valuable strategy you should consider. It can be combined with other strategies, such as an estate plan, as different family members may participate in the ownership of the real estate (holding corporation) as compared to the operating corporation. This can be quite effective where certain members of the family are involved in the business and some are not. In addition to a lease agreement, it is imperative to ensure that a proper shareholders' agreement is in place.

These plans can be combined with an income-splitting arrangement if low income adult family members subscribe for new common shares of the holding corporation.

A discretionary family trust can also be utilized. A trust can provide each beneficiary with the opportunity to use the $500,000 deduction, if the shares of the operating corporation are sold in the future.

Your tax minimization and business planning strategies
should consider an asset protection plan.

TAX IMPROVEMENTS FOR SENIORS

Over the last few years, the Canadian government has been recognizing the financial contributions our seniors have made to the economy by increasing certain tax credits and introducing new proposed legislation that will lower the amount of tax seniors pay.

As an example, assume Mr. and Mrs. Smith are both over 65. Mr. Smith has income from a Registered Pension Plan (RPP) in the amount of $50,000, Old Age Security of approximately $6,000, and Canada Pension Plan (CPP) income of $8,000. Mrs. Smith earns only OAS income of approximately $6,000.

Prior to the improvements described below, Mr. Smith paid annual tax of approximately $13,800 (in Alberta), and Mrs. Smith paid no tax.

Improvements to pension credit and age credit

Taxpayers earning pension income receive a personal tax credit of $1,000, which effectively exempts from tax the first $1,000 of pension income earned by the taxpayer. For purposes of the credit, pension income does not include CPP income. The 2006 Federal Budget announced an increase in the pension credit from $1,000 to $2,000.

Another personal tax credit available to seniors is the Age Credit. For 2006, this allows seniors to earn about $4,000 over and above the basic personal amount, and pay no tax. On October 31, 2006, the Finance Minister announced several tax policy changes. One of these changes proposes to increase the Age Credit for federal tax purposes from $4,066 to $5,066.

The increases to both the Pension Credit and the Age Credit are effective for the 2006 taxation year.

Income splitting between spouses

A further change announced on October 31st will allow pensioners to split their pension income with their spouse. Pension income for this purpose includes annuity payments from RPPs, RRIFs, and RRSPs (for taxpayers over 65). There was already a mechanism in place to split Canada Pension Plan benefits prior to this announcement.

Basically, for tax purposes, a taxpayer will have the ability to deduct up to 50% of his or her income from these sources and designate that it be included in the income of his or her spouse, providing the spouse is in agreement with the designation. This change will be effective for the 2007 taxation year.

Tax savings of this proposal for couples, such as the Smiths, will be substantial. Mr. Smith would choose to deduct $25,000 in pension income from his tax return and include it on Mrs. Smith's personal tax return. The tax savings for the Smiths of the changes to the Pension Credit, Age Credit, and the ability to split pension income are summarized in the table below.

Please note, in most cases, it is not known whether the provinces will enact the same changes to the tax credits. The above calculations use Alberta tax rates and provincial tax credit levels.

	Mr. Smith's Taxes	Mrs. Smith's Taxes	Total Family Taxes
Pre-changes	$13,800	0	$13,800
Post-changes	5,900	3,400	$9,300
Tax savings	7,900	(3,400)	$ 4,500

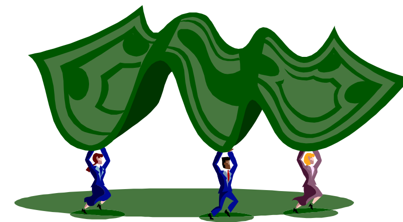
INCREASING THE SMALL BUSINESS DEDUCTION LIMIT

The 2006 Federal Budget, the first by Stephen Harper and his Conservative party, proposed to increase the $300,000 small business deduction limit to $400,000, effective January 1, 2007. Also suggested was a reduction to the applicable federal tax rate for this income.

The federal small business deduction is calculated as an annual tax credit, being 16% of the smallest of active business income for the year, taxable income subject to certain adjustments, and $300,000 ($400,000 in 2007) per corporation or group of associated corporations. This reduces a business's income taxes on the first $300,000 of active business income earned to rates in the range of 15% to 21%, depending on the province.

Your corporation must be a Canadian-controlled private corporation (CCPC) in order to be eligible for the small business deduction. Details about the characteristics of a CCPC can be found on the CRA website at http://www.cra-arc.gc.ca/tax/business/topics/corporations/types/ccpc-e.html.

While this deduction is intended to benefit only small corporations, a large corporation's access to the deduction is limited, based on its taxable capital employed in Canada. At $10 million of taxable capital, the amount of income eligible for the small business deduction begins to be reduced, and at $15 million of taxable capital, it is eliminated.



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