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Accountants
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Your Personal Tax Planning Guide 2008-09

Prepared by Ontario's
Certified General Accountants

2008-2009
Personal
Tax Planning

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The mission of the Certified General Accountants of Ontario is to ensure its members merit the confidence and trust of all who rely upon their professional knowledge, skills, judgment and integrity, by regulating qualification, performance and discipline standards for certified general accountants, while advocating the use of their professional expertise in the public interest.

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The objective of personal tax planning is to minimize or defer income taxes payable, as part of a long-recognized right for taxpayers to organize their financial/taxation affairs in the most beneficial way possible within legal confines. This requires a thorough understanding of Canada's Income Tax Act, plus bulletins, circulars and rulings put forth by the Canada Revenue Agency (CRA), along with other events such as tax rulings in the courts.

This booklet reflects federal legislation to approximately September 15, 2008, plus other draft legislation introduced but not yet passed into law, which are, therefore, subject to change before final passage.

General Inclusions/Exclusions

The Income Tax Act is a wide-ranging document, dealing with broad issues such as income from employment, a business or property, while at the same time outlining specific rules in many areas. There are, for instance, rules dealing with the inclusion in taxable income of items such as:

- employment-insurance (EI) benefits received
- annuity payments
- receipts from deferred-income plans

Some payments, such as workers' compensation (WC), federal supplements and social assistance payments are not included in taxable income, but are contained in the calculation of threshold income when determining entitlement to the:

- child tax benefit
- age credit
- goods and services tax credit (GST)
- old-age security (OAS)
- some provincial tax credits

Other amounts are specifically excluded from income for tax purposes. Examples, which are not discussed in this booklet, include, but are not limited to, the following:

- income earned by a member of a First Nations group on a specified reserve
- civilian and veterans' war pensions or allowances, from Canada or any ally of Her Majesty
- income earned by Canadian Forces personnel or police officers while serving in certain high-risk overseas destinations
- certain other benefits and awards to members of the Canadian Forces
- certain personal damage amounts awarded by the courts
- payments received by qualified individuals, their spouses or common-law partners and dependants under the multi-provincial assistance package for individuals infected with HIV through the blood-supply program
- payments received by a special trust for distribution to Canadians who were infected with the hepatitis C virus through the blood-distribution system over a specified period
- government-related compensation for disaster relief

- an RCMP pension or compensation received in respect of an injury, disability or death
- lottery winnings and other windfalls as defined by the CRA.

Amounts that are exempt from income tax by virtue of a stipulation in a tax convention or agreement with another country with the force of law in Canada are also excluded from income.

Key Terminology

One term that is often used in this booklet is “arm’s length.” This term refers to two parties who are free to act independently, neither of whom is considered to have undue influence or control over the other’s decisions. Any deal they make is assumed to be fair for income tax purposes. Conversely, certain related parties, which could include people and/or corporations controlled by them, are not considered to be dealing at arm’s length. “Non-arm’s-length” transactions are subject to special rules. A special provision of the Income Tax Act, for example, automatically reduces an excessive price to fair market value (FMV) in a transaction involving parties who are not dealing at arm’s length from each other. Furthermore, such adjustments might lead to a double-taxation situation; thus, take great care when not dealing at arm’s length.

Another term often used is “rollover,” such as a “spousal rollover,” where property is transferred from one spouse to another upon death on a tax-deferred basis. Various types of rollovers are available under the Income Tax Act, and such transactions are often complex, requiring professional assistance.

Readers should also note that social changes over the past few years have contributed toward a broader definition of what constitutes a “spouse.” Most references in the Income Tax Act now refer to a “spouse or common-law partner.” The term spouse means a party to a legal marriage to an opposite-sex partner or, as per legislation passed by the federal government in mid-2005, a same-sex partner. Common-law partner means a person of either the opposite or the same sex who has been cohabiting with the taxpayer in a conjugal relationship for at least one year, or is the natural or adoptive parent of the taxpayer’s child.

Personal tax planning includes a concerted effort to minimize or defer taxes payable, a practice that is generally accepted. However, the Income Tax Act includes a general anti-avoidance rule (GAAR), which allows the CRA and tax courts to reassess any transaction that is considered to have defeated the object, spirit and purpose of the Act. Under GAAR, for instance, if it appears that a transaction, or series of transactions, has taken place primarily for the purpose of obtaining a tax benefit, it could be subject to adjustment, particularly if it can be established that its application results in a misuse or abuse of the provisions contained within the Act.

As income tax rules are often complex and ever-developing, however, tax planning should be an ongoing process. Taxpayers should, for instance, revise their tax and financial plans as changes occur in government legislation and as personal circumstances dictate. Readers are advised to review specific tax plans with their certified general accountant.

Major 2008 Federal and Provincial Changes Affecting Individuals

Federal

CPI Adjustment to Income Tax Brackets and Non-Refundable Tax Credits

The taxable income thresholds in all four federal tax brackets were increased by 1.9 per cent in 2008 to mirror changes in the Consumer-Price Index (CPI). Furthermore, all indexed non-refundable tax credits also increased by 1.9 per cent in 2008 in order to reflect the CPI adjustment. Please see the chapter on federal and provincial/territorial non-refundable tax credits, as well as Appendices I & III, for further details.

Tax-Free Savings Account (TFSA)

The 2008 federal budget introduced a new Tax-Free Savings Account (TFSA) which, beginning in 2009, will allow Canadians who are 18 and older to save up to \$5,000 per year in the TFSA investment vehicle. Unlike a registered retirement savings plan (RRSP), investors will not be able to deduct contributions to a TFSA for tax purposes; however, investment income, including capital gains earned within the TFSA will not be subject to tax, even when the funds are ultimately withdrawn.

Increase in RRSP Annual Contribution Limit

The annual registered retirement savings plan (RRSP) contribution ceiling was raised to \$20,000 in 2008, from \$19,000 in 2007. It is scheduled to rise to at least \$21,000 in 2009, and \$22,000 in 2010, after which the annual maximum contribution rates will be indexed to reflect increases in average wage growth.

Increase in RPP Annual Contribution Limit

Money-purchase plan registered pension plan (RPP) contribution limits increased in 2008 to \$21,000, from \$20,000 in 2007; they will increase again to at least \$22,000 in 2009, after which they will be indexed annually to account for the average wage growth.

The maximum annual contribution limit for defined-benefit RPPs also increased in 2008 to \$2,333 per year of service, up from \$2,222 in 2007; they will increase again to at least \$2,444 in 2009, after which they will be indexed on an annual basis to reflect increases in average wage growth.

Pension/Work Option

The 2007 federal budget introduced legislation whereby beginning in 2008, certain defined-benefit pension plan holders who are at least 55 years of age may receive up to 60 per cent of their pension, while still being permitted to accrue further benefits.

Increase in RESP Time Limits

The 2008 federal budget increased by 10 years the time available for contributors, such as a parent or grandparent, to contribute to a registered education savings plans (RESP) for their child or grandchild. Contributors may

now deposit into an RESP plan for a maximum of 31 years–35 years for a taxpayer who is disabled, up from 21 and 25 years respectively.

The contribution age limit for beneficiaries of family plan RESPs has also increased. No contributions may be made on behalf of a beneficiary who is 31 years of age or older, up from 21 years of age previously.

The deadline for plan termination has also been extended. RESP plans may now stay open for 35 years, 10 years beyond the previous 25-year limit. The new deadline is 40 years for taxpayers who qualify for the disability tax credit (DTC), up from 30 years previously.

Registered Disability Savings Plan (RDSP)

The 2007 federal budget introduced a new registered disability savings plan (RDSP), which is designed to provide savings for the long-term financial security of a child or adult with a disability who is eligible for the disability tax credit (DTC). In December 2008, the federal government announced that RDSP contributions for the 2008 calendar year, and applications for a corresponding CDSG and CDSB, had been extended until March 2, 2009.

As with an RESP, earnings generated on contributions are tax exempt while they remain in the plan. Contributions are not tax deductible, nor are they included in income when paid out. All other amounts paid out of the plan are included in the beneficiary's income. Anyone can contribute to an RDSP with the permission of the holder, and contributions are permitted until the end of the year in which the beneficiary reaches 59. Contributions are limited to a lifetime maximum of \$200,000 with no annual limit. Payments from an RDSP must commence by the end of the year in which the beneficiary turns 60.

To augment funds in the RDSP the government will contribute, in the form of Canada Disability Savings Grants (CDSG), funds equivalent to between 100 per cent to 300 per cent of RDSP contributions, to a maximum of \$3,500 annually, and \$70,000 over the lifetime of the beneficiary, depending on the net income of the beneficiary's family. The federal government will also contribute up to \$1,000 annually in Canada Disability Savings Bonds (CDSB), to a maximum of \$20,000; depending on the beneficiary's family net income. Beneficiaries must be 49 years of age or younger at the end of the year to be eligible for a CDSG or CDSB.

Canada Child Tax Benefit Payments (CCTB)

Beginning July 2008, CCTB national child benefit supplement (NCB) payments to Canadians rose to \$2,025 for the first child (from \$1,988), \$1,792 for the second child (from \$1,758) and \$1,704 for each subsequent child (from \$1,673).

As a result, the maximum annual benefit under the combined CCTB and NCB supplement increased to \$3,332 (from \$3,271) for the first child; to \$3,099 (from \$3,041) for the second child; and \$3,102 (from \$3,046) for each subsequent child. The maximum indexed child-disability benefit (CDB) supplement for parents in low and modest-income families with children who have disabilities and a net family income of less than \$37,885 (from \$37,178), increased to \$2,395 (from \$2,351) in 2008.

Decrease in Goods and Services (GST) Tax Rate

The goods and services (GST) tax rate was reduced by one percentage point, from six per cent, down to five per cent, effective January 1, 2008.

Ontario Provincial

Increased Threshold for All Income Tax Brackets

The taxable income thresholds in all three Ontario provincial tax brackets were increased by 1.5 per cent in 2008, reflecting changes to Canada's consumer-price index (CPI) in Ontario. All indexed non-refundable tax credits also increased by 1.5 per cent.

Please see the chapter on federal and provincial/territorial non-refundable tax credits, as well as Appendices I, III and V, for further details.

Increase in Ontario Child Benefit

The 2007 provincial budget introduced an Ontario child benefit (OCB), effective July 1, 2007, for each child under 18. The OCB will ultimately replace the Ontario child-care supplement for working-families (OCCS) benefit as well as most child-related social-assistance benefits. This process began in 2008.

The initial OCB payment was \$250 (in addition to social assistance or OCCS payments), reduced by 3.4 per cent of adjusted family net income over \$20,000. That amount was increased to \$600 on July 1, 2008, reduced by 8 per cent of adjusted family net income in excess of \$20,000.

Land Transfer Tax Refund Program

The province's December 2007 Fall Economic Outlook and Fiscal Review, or mini-budget, expanded the provisions of Ontario's existing land transfer tax refund available to first-time purchasers of newly constructed homes to encompass first-time homebuyers of resale homes as well. Effective December 14, 2007, first-time purchasers of both types of homes are eligible for a provincial refund on up to \$2,000 of the land transfer tax paid for their new home.

Increase in Small Business Deduction Threshold

The 2007 mini-budget in December 2007 increased Ontario's small business deduction-threshold rate from \$400,000 to \$500,000, retroactive to January 1, 2007. This is the amount of active business income that Canadian-controlled private corporations (CCPC) are able to earn at a preferential tax rate.

Various Parallel Measures to Federal Initiatives

The Ontario provincial government has paralleled certain measures announced by the federal government, including enhancing the limits of the province's Ontario innovation tax credit (OITC) to follow improvements made to the federal scientific-research & experimental-development (SR&ED) tax credit; as well as having announced various capital cost allowance measures.

Employment Income, Expenses and Allowable Deductions

Taxable Benefits Derived from Employment Income

The value of most benefits derived from employment is included in personal income. Among the myriad benefits which generally must be included in income are the following:

- tips and gratuities must be reported as income, even though they may not necessarily be included by employers on the employee's T4 slip
- employees who are awarded near-cash merchandise, such as a gift certificate, must take the fair-market value of that award into account as taxable income
- subsidized long-term accommodation provided by an employer for the employee's benefit
- the value of a discount on university tuition fees offered by an employer to spouses and children of employees would normally be considered employment income and, therefore, represent a taxable benefit to employees (however, if the employer provided a scholarship award directly to the student, that might not be taxable).
- employees or ex-employees who receive periodic payments under a disability insurance plan, sickness or accident-insurance plan or income-maintenance-insurance plan to compensate for loss of income from an office or employment must include that amount in income if the plan's premiums were paid by the employer; however, they may deduct from income any amount they may have personally contributed toward such a plan
- employees who exercise an option to purchase an automobile from their employer at less than its fair-market value (FMV) are considered to have received a taxable benefit for the difference between the price paid and FMV

Non-Taxable Benefits Derived from Employment Income

Although most benefits derived from employment must be included in personal income, there are some exceptions. These include: employers' contributions to private health-service plans; group sickness or accident plans; registered pension plans (RPP); and deferred profit-sharing plans (DPSP).

Tax Tip

Flexible employee benefit programs, which allow employees to custom-design their own package of health and other benefits, are now very popular in the workplace. Take care when structuring such plans, however, because taxable benefits can result. If, for example, an employee accumulates flex credits and those benefits are received in cash, that amount is generally considered taxable income.

Tax Tip

If you receive more than two non-cash gifts or awards from your employer, select the two with an aggregate cost closest to \$500 as your entitlement. For example, if you received four awards that cost \$300, \$200, \$150 and \$100 respectively, select the first two awards (costing \$500) as being non-taxable and declare the \$250 cost of the remaining two as a taxable benefit.

Other examples of non-taxable benefits include, but are not limited to:

- ordinary discounts on the employer's merchandise, available to all employees on a non-discriminatory basis
- subsidized meals available to all employees, provided a reasonable charge is made to cover direct costs
- the cost for distinctive uniforms, protective clothing or footwear required to be worn during employment, including related laundry expenses
- reimbursement of moving expenses upon relocation
- receipt of up to two non-cash gifts (e.g., for Christmas, wedding, birthday) in one year, for certain items and under certain conditions, with a total cost to the employer not exceeding \$500, including all applicable taxes
- receipt of up to two non-cash awards, (e.g., for meeting or exceeding targets, reaching a milestone in years of service) in one year, for certain items and under certain conditions, with a total cost to the employer not exceeding \$500, including all applicable taxes
- use of the employer's recreational facilities, or employer-sponsored membership in a social or athletic club, where such membership is considered all or primarily beneficial to the employer (despite the employer not being able to deduct the cost of such fees)
- an employer-mandated medical examination required as a condition of employment
- employer-sponsored personal counselling services in respect of the mental or physical health of an employee or a person related to an employee, re-employment or retirement
- employer-sponsored travel where the trip was undertaken predominantly for business reasons
- employer-sponsored training costs that are work-related
- tuition and related fees, if the course is required for employment and is primarily for the employer's benefit
- reasonable per-kilometre automobile allowance
- employer-paid cellular phones and other such hand-held devices as long as they were used primarily for business purposes
- board, lodging and transportation to special worksites involving duties of a temporary nature, or to remote worksite venues away from the general community where employees are required to be a reasonable distance from their principal residence for at least 36 hours
- a reasonable employer-provided allowance for an employee's child to live at and attend the nearest suitable school, if one is not close to where the parents must reside for employment purposes
- employer-paid expenses for moving employees and their family, along with

Tax Tip

If you use air miles earned from an incentive program for personal use, you will be deemed to have received a taxable benefit if those points were earned as a result of expenditures paid for by your employer. To avoid that situation, be careful to use such air miles strictly for business purposes on behalf of your employer.

Tax Tip

Non-taxable expenses for a temporary work site might apply for varying lengths of time, such as a week, a month or a year. The key is that they apply for a reasonable and determinate period of time—generally with about a two-year maximum (although this could vary), with a scheduled date of return to the employee's regular place of employment.

Tax Tip

The CRA has ruled that there is no taxable benefit to employees when their employers arrange for them to purchase discounted fitness-pass memberships from a third party.

household effects, out of a remote location upon the termination of employment

- exclusive on-site child care services provided by employers to all employees for minimal or no cost.

Tax Tip

If you are an emergency-services volunteer, the first \$1,000 in payment you receive from a government, municipality, or other public authority may be tax free.

Special Considerations Related to Taxable and Non-Taxable Employment Income

Other current issues with respect to the taxability and non-taxability of employee benefits include, but are certainly not limited to, the following points:

- an employer-provided computer and Internet service might not represent a taxable benefit under certain circumstances if employees require such a service to carry out their business obligations; however, the costs associated with purchasing an employer-funded computer that is also used for personal reasons would likely result in a taxable benefit
- taxpayers who receive an arbitration award from their employer for reasons such as a collective agreement breach to compensate for lost wages, or receive retroactive payments as a result of a decision such as pay equity—a component of which might constitute damages—should consult a certified general accountant to determine the appropriate tax treatment for that payment.
- in some cases, the courts may be more lenient toward an employee than a shareholder in terms of any benefit amount deemed to be non-taxable. For instance, employees might be able to exclude 100 per cent of membership fees in a golf club if their membership is primarily for the benefit of their employer. On the other hand, corporate shareholders might have to apportion the tax-exempt and taxable portion of their fees between business and personal use, respectively. Taxpayers—especially those with dual employee/shareholder roles—should clarify the proper tax treatment with their certified general accountant
- although child-care expenses that have been paid for by an employer are generally considered a taxable benefit, if an employee is required to travel out of town on employment-related business and, as a result, incurs additional child-care expenses that are reimbursed by the employer, that amount will not be a taxable benefit
- if spouses accompany employees on a business trip, and the employer reimburses their travel expenses, that payment is a taxable benefit to the employees unless the spouses were engaged primarily in business activities on behalf of the employer during that trip.
- any accumulated credit used under frequent-flyer programs during business trips are taxable to the employees and included in their income.
- certain members of the clergy or religious organizations are entitled to exclude from income reasonable allowances with respect to transportation expenses in the discharge of their duties.

Employee Stock Options

Employees who acquire certain publicly listed shares under employee stock-option plans are entitled to defer the associated stock-option benefit, subject to an annual \$100,000 vesting limit, until such shares have been disposed. This

deferral is available for shares acquired after February 27, 2000, but is also subject to certain conditions.

If all conditions have been met and the employees elect to defer the tax, they must file a letter by January 15 of the year after the share is acquired (e.g., January 15, 2009, for shares acquired in 2008), complete with the following information:

- a request to have the deferral provisions apply
- the stock option benefit amount related to the deferred shares
- confirmation that the employees were a resident in Canada when the shares were acquired
- confirmation that the \$100,000 annual vesting limit has not been exceeded.

The tax consequences with respect to stock-option plan shares exercised after February 27, 2000, can be quite complicated. For example, special rules might apply that create a deemed dividend and a capital loss.

Holders of employee stock options exercised prior to February 28, 2000, were subject to the long-standing rule that during the year they exercised such an option, the excess of the stock's fair-market value (FMV) at the date acquired, over the option's exercise price, was taxable as employment income and must be added to the cost-base of shares. Any subsequent gain or loss on disposal—measured from the cost base—was a capital gain or loss.

There were, however, also a series of complex exceptions to that rule and holders of stock-option shares exercised on or after February 28, 2000, which do not qualify for the deduction, are still subject to those rules and exceptions.

Consult your certified general accountant for more details about the correct treatment for stock options or other arrangements, such as exercising warrants to buy or sell shares from an employer.

Deferred Compensation

A deferred compensation agreement is an agreement to pay wages at a later date for services rendered now. However, the Income Tax Act does not allow employees to defer income recognition until it is received. Remuneration that would have been paid had the employee not opted to defer it must be included in the employee's income and also deducted by the employer.

This eliminates the potential income tax advantages that could arise from funded and unfunded deferral plans that are based on unlikely contingencies. When receipt of funds is subject to contingencies, those conditions will be ignored and the employee taxed unless there is a substantial risk the contingency will not occur, with the amount therefore forfeited.

Deferred signing bonuses may also be considered part of a salary-deferral arrangement unless the employment contract stipulates that the employee must render additional services in exchange for earning that extra amount.

Specifically excluded from the definition of salary-deferral arrangements are:

- registered pension funds or plans
- disability or income-maintenance insurance plans under policies with insurance companies
- deferred profit-sharing plans (DPSP)
- employee profit-sharing plans
- employee trusts
- group-sickness or accident-insurance plans
- supplementary unemployment-benefit plans
- vacation-pay trusts
- plans or arrangements established for the sole purpose of providing education or training to employees to improve work-related skills
- plans or arrangements established to defer the salary or wages of a professional athlete
- employee bonus plans under which employees receive their annual bonuses within three years of the applicable year-end
- prescribed plans or arrangements, such as sabbatical plans or deferred-salary-leave plans (DSLPL).

Individuals who participate in a deferred-salary-leave plan must return to regular employment following a leave of absence for a period that is at least as long as the leave itself. Otherwise any deferred amounts, plus unpaid interest, immediately become taxable as employment income—whether paid out or not—during the taxation year the taxpayers realize they can't return to work for the specified period.

If employees have the opportunity to obtain additional vacation time via flex credits or payroll deductions, and that vacation time is carried forward until the next calendar year, the CRA has warned this might be considered a salary deferral arrangement for tax purposes.

Salary-deferral-arrangement taxation rules might also apply when employees take a funded leave of absence just prior to retirement due to unused credits provided under a flex plan. See your certified general accountant for details.

Deductions from Employment Income

Employment-income deductions are restricted to those items specifically provided for in the Income Tax Act. Besides automobile and legal expenses, which are discussed in the next chapter, other deductible expenses may include:

- employment-related travel expenses, including parking, taxis, bus fare, etc., if required by the terms of employment and not reimbursed
- office rent and expenses, if the employees and employers have agreed that the employees are to provide their own working environment. It must be their principal workplace or used exclusively, on a regular and continuous basis, for activities such as business-related meetings. If the qualified workspace is in the employees' homes, the employees may be allowed a pro-rata deduction for rent paid, maintenance, utilities and minor repairs. Expenses related to mortgage

interest, property taxes and insurance may not be deducted (unless, in the case of property taxes and home-insurance premiums, they are related to commission sales expenses). To the extent that a claim for workspace in the home exceeds employment income, that portion of the deduction is denied in the current year; however, it may be carried forward indefinitely against future income resulting from the same employment

- assistants' salaries and supplies, if required to be paid without reimbursement by the terms of employment
- musical instruments—capital-cost allowance (CCA) and related rental, insurance and maintenance costs—may be claimed only against income earned directly from using the musical instrument
- aircraft—CCA, interest expense and operating and maintenance costs related to business use
- union dues and professional fees if required to maintain membership
- expenses of up to two-thirds of earned income for attendant-care expenses necessary for a medically impaired person to earn business or employment income. Form T2201 is required when making this claim. (Note: this amount potentially reduces the availability of any medical-expense credit for full-time attendant care).

Apprentice mechanics of self-propelled motor vehicles can write off expenses for tools of the trade acquired after 2001. The amount eligible for write-off is that by which the annual cost of tools (plus the last three months of the previous year, if it represents the first year of employment) exceeds the greater of \$1,000 or five per cent of the apprentice's related income for that year. Amounts not used can be carried forward for deduction in a subsequent taxation year.

Additional provisions are available for various tradespeople to claim an additional credit of up to \$500. Apprentice vehicle mechanics can deduct this amount on top of existing write-off opportunities.

Employers must complete *Form T2200—Declaration of Conditions of Employment* to legitimize these deductions.

Employees and partners claiming expenses on their tax returns may be entitled to claim a refund for the business-use portion of the GST paid. The GST rebate must then be reported as income in the year it is received. To claim a refund, complete Form GST 370. For a copy of this form and more information, obtain the CRA's *Completion Guide and Form for Employee and Partner GST Rebate*.

Tax Tip

Union dues do not necessarily have to be paid to a Canadian organization. Therefore, employment-related annual dues paid to a trade union outside Canada might also be tax deductible.

Tax Tip

A computer used by a professor to teach and create music was ruled to be a musical instrument and thus eligible for employment deductions, by the tax courts.

Tax Tip

An assistant's salary might include amounts paid to a spouse or other family member if the salary is reasonable for the amount of work performed.

Tax Tip

If required by your employer to work at home after business hours, deductions might be available in certain instances if employment after hours is considered by an employer and/or union to constitute a separate working arrangement.

Certain members of the clergy or religious organizations may be entitled to deduct an amount paid for living accommodation. They must complete Form T1223 in order to determine that amount. Special rules for expense deductions might also apply to employees, such as artists and those who are required to move temporarily to a work camp for their jobs, like individuals involved in forestry operations.

Consult your certified general accountant for more details.

Commission Sales Expenses

Commissioned salespeople, if required by contract to pay their own expenses, may be able to deduct those expenses against commission income. To do so, both the employee and employer must complete portions of Form T2200.

Commissioned employees are allowed a broader range of deductions than other employees in areas such as advertising, promotion, meals and entertainment. Furthermore, commissioned salespeople, unlike other employees, are allowed to deduct a pro-rata share of property taxes and home-insurance premiums against commission income if their workspace is in their home. Such deductions are generally limited to offsetting the amount of commissions earned.

Although the restrictions for commissioned employees are mainly similar to those for salaried employees, there are notable exceptions. For instance, CCA (a full description of Capital-Cost Allowance is on page 34) on an automobile or aircraft used for business may be deducted against other income to the extent that it has already been used to fully reduce commission income, with any residue allowable as a non-capital loss. The interest paid on money borrowed to purchase such an automobile or aircraft may also be deducted.

Other Taxable Benefits

Use of Company Cars

An employee or shareholder using a company car for strictly business purposes does not incur a taxable benefit.

However, where the automobile involves a degree of personal use, a taxable benefit does occur. A standby charge consisting of two per cent of the automobile's original cost (one and one-half per cent for a car salesperson) or two-thirds of the lease cost, plus GST, applies for each month the automobile is available for the employee's personal use.

Tax Tip

If your expenses exceed commission-related income, there may be alternative methods of making claims available to you. Consult your certified general accountant for advice on how to maximize tax savings.

Tax Tip

If you are a commissioned employee, consider leasing rather than purchasing capital equipment (such as a computer) where CCA is not allowed.

Tax Tip

Commissioned life-insurance salespeople are allowed to deduct commissions earned with respect to the purchase of their own policies.

Tax Tip

Commissioned sales employees who work in their homes should ensure that a separate business telephone line exists in order for regular phone expenses, other than business long-distance charges, to be deductible.

If personal use of the automobile does not exceed 20,000 kilometres annually, and the automobile is used for business more than 50 per cent of the time, a proportional standby-charge reduction is permitted. If, for example, a vehicle was driven 40,000 kilometres, including 25,000 kilometres for business (more than half) and 15,000 for personal purposes, the actual standby charge would be calculated as 75 per cent (15,000 divided by 20,000) of the regular standby charge.

When both the employer and employee/shareholder have contributed toward purchasing an automobile, its cost for the purposes of calculating a standby charge would be reduced by the amount paid by the employee/shareholder.

Where an employer is primarily engaged in selling or leasing luxury automobiles, special considerations involving the value of multiple automobiles might have to be taken into account when calculating the standby charge calculation. Please consult your certified general accountant for further details if this affects you.

In addition to the standby charge, the employee must calculate an operating benefit, using one of two options.

In 2008, they may elect to make a general declaration of 24 cents per kilometre for personal use (up from 22 cents in 2007); 21 cents per kilometre if selling or leasing automobiles constitutes their principal source of employment (up from 19 cents in 2007). Alternatively, if the car is used more than 50 per cent for business, the deemed operating benefit may be one-half of the standby charge, provided the employee notifies the employer in writing before the end of the year. As with other taxable benefits, GST is deemed to be included in the operating benefit.

The operating benefit may also be reduced by any amount reimbursed to the employer within 45 days of the calendar year-end.

For capital cost allowance (CCA) purposes, employers are restricted to \$30,000 of the automobile cost on purchases made after 2000, not including federal and provincial sales tax. The annual CCA allowance is 30 per cent on a declining-balance basis, except for the year of acquisition when the allowance is limited to one-half or 15 per cent. Each car costing more than the allowable limit at the time of purchase is included in a separate CCA class with no

Tax Tip

Additional expense-deduction provisions might be available to certain employees who sell property or negotiate contracts on behalf of their employer, provided they normally work away from the employer's office; must pay their own expenses; and are remunerated in whole or in part by commissions. Contact your certified general accountant for details.

Tax Tip

The full operating benefit for personal use of an automobile applies if the employer pays any operating expenses. Therefore, it may benefit you to fully reimburse your employer for such coverage.

Tax Tip

A standby charge may not apply under certain, well-defined, circumstances. If, for instance, the employers' policy is to have employees return the automobile to company premises when they embark on a business trip, the standby charge should be prorated to exclude those days. But if employees voluntarily leave the automobile at the employers' premises over that period, those days will probably count toward the standby charge.

recapture or terminal loss available upon disposal.

(A more complete description of CCA and how it works is on page 33).

The deduction for interest on money borrowed is restricted to a maximum of \$300 per month if the automobile was purchased after 2000.

If the automobile is leased as per an agreement entered into after 2000, the maximum deduction is \$800 per month (excluding PST and GST). This limit helps to ensure that the deduction level is consistent for both leased and purchased vehicles. Another restriction prorates deductible lease costs in situations where the value of the vehicle exceeds the CCA limit.

The employee benefit is generally calculated on the vehicle's full cost, regardless of the fact the employer is limited in the amount of capital cost, finance charges or lease payments permitted as a write-off for a passenger vehicle.

Note that some vehicles, such as those used for emergency response purposes (i.e., medical, fire or police) are not defined as automobiles for income tax purposes.

Use of Employee-Owned Car

Employees who are required to travel on business or work away from their employer's office can use their own automobile. Employees required by terms of employment to provide their own vehicle and who want to deduct the employment-related costs of operating the car, or any other employment-related expense (see Deductions from Employment Income, page 14), must file form T2200. The employer must sign this form annually, certifying the required conditions were met during that year.

Employees who are required to pay their own automobile expenses are entitled to deduct business-related vehicle expenses that are not reimbursed by the employer. Deductions for the capital cost or lease cost of the vehicle are limited in their extent just as they are for employer-owned automobiles.

Deductions for expenses such as gasoline, insurance, maintenance, licence, auto-club membership, leasing costs and interest on money borrowed to purchase the car are normally allowable in the same proportion as business

Tax Tip

The standby charge is calculated on the vehicle's original cost regardless of its age. If it is an older vehicle, consider purchasing the car from your employer. Note, however, that if a leased automobile is purchased at less than its fair market value, the difference is considered a taxable benefit and must be included in your income.

Tax Tip

Special rules might apply for a van, pick-up truck or a similar vehicle (such as a sport-utility vehicle) used in the course of business, particularly where it is used to travel to a remote or special work site. If you drive one of these vehicles to earn income, check with your certified general accountant to see which rules apply to you.

Tax Tip

Keep a record log, in addition to relevant travel receipts, to support business mileage. Without a statistical record, taxpayers often have a tendency to overestimate the percentage of mileage incurred as a result of business activities.

to total kilometres driven during the year. Major accident repair costs, minus insurance proceeds or damage claims, are also fully deductible provided the vehicle was used for business, not personal, purposes at the time of the accident.

Travel between an employee's home and the employer's office is generally considered to constitute personal, rather than business, use of the automobile. In 2007, however, a taxpayer successfully appealed a CRA decision to disallow expense deductions incurred to and from the office on the grounds that their employer required them to have a car at work every day, thus preventing them from commuting using less expensive modes of transportation. Furthermore, if required to make a business stop between their home and office at the request of their employer, the entire distance travelled throughout the day may constitute business, rather than personal use.

Employer-subsidized parking must generally be included in income if the benefit is being provided primarily to the employee. However, if the parking spot is provided for the primary benefit of the employer, to allow the employee to use an automobile in the course of carrying out business-related duties during office hours or save on taxi fares when required to work late, all or a proportion of this amount might be reduced or waived.

Any proportion of an employer-paid automobile allowance that is deemed by the CRA to be unreasonably high is taxable to the employee. The maximum amount the employer may claim in 2008 has been established by the CRA at 52 cents per kilometre for the first 5,000 kilometres of business travel in a year (up from 50 cents in 2007) and 46 cents per kilometre thereafter (up from 44 cents in 2007).

Alternatively, an employee who receives an unreasonably low allowance may choose to include that amount in income and then deduct the actual business-use expenses. However, employees cannot refuse to accept a reasonable allowance without also jeopardizing their ability to claim a deduction for automobile expenses.

An allowance based on anything other than actual business travel on a per kilometre basis is not considered reasonable and must, therefore, be included in the employee's income. Similarly, should the actual expenses be reimbursed, any additional allowance would be considered unreasonable and need to be treated as income.

Tax Tip

If your employer allows you to keep an office in your home, but also requires that you travel to head office on business, related travel-expense allowances have been ruled by the courts as being exempt from taxation.

Tax Tip

Salespeople or other employees who live and travel in a motor home might be able to deduct expenses of that motor home relative to the proportion it is used for business (i.e., distance travelled).

Tax Tip

If you have an arrangement with your employer that involves a combination of both a flat rate and per-kilometre travel allowance for the same vehicle, the tax treatment might be complex, particularly if some automobile expenses were also reimbursed. Your certified general accountant can assist in this process.

It is acceptable for an employer and employee to agree on a periodic advance based on a reasonable estimate of business kilometres driven. At the calendar year-end or termination of employment, whichever comes first, the employee and employer must reconcile that advance against the actual distance travelled on behalf of the company. If the advance was inadequate, the employer must make up the shortfall, whereas the employee must return any excess should the reverse situation occur. Once an employee receives a reasonable allowance to cover all employment-related use of the automobile, no further expenses can be claimed for tax purposes.

Loans to Employees

A loan or any other debt owed by employees to their employers potentially creates an attributed taxable benefit based on the prescribed rate of interest set quarterly by the CRA. The employers must record any difference between the prescribed and actual interest rates as employment income on the employees' T4s.

When borrowed funds are used to acquire either income-producing property or an automobile or aircraft for employment use, the interest amount actually paid or imputed may be deductible as an offsetting expense against the resulting investment or employment income.

The imputed benefit of a loan used for a home purchase or refinancing is calculated using the lesser of the prescribed rate in effect at the time the loan was made (refer to Appendix VII, page 126), or the prescribed rate for each quarterly period the loan remains outstanding. Employees will remain liable for this taxation benefit even if they transfer the home to a relative. All employee home-purchase loans are deemed to have a five-year maximum term, after which they are deemed to have been re-established at the prescribed rate in effect at that time.

Employees who receive a home-relocation loan from an employer for a move designed to bring them at least 40 kilometres closer to their new place of business may be eligible to deduct attributed interest on up to \$25,000 of loan principal for five years.

When the full or partial proceeds of a loan from an employer are forgiven, that amount is considered to be a taxable benefit to the employee.

The tax treatment on loans to employees might be less favourable if the employees are also shareholders of the company making the loan.

Retiring Allowance and Termination Payments

A retiring allowance, including termination damages, paid to an employee upon or after retirement to recognize long service or to compensate for office or

Tax Tip

Borrowing funds from your employer may prove to be more efficient and less expensive than other sources, even though you may pay tax on the imputed interest benefit. Note, however, that careful evaluation of borrowing alternatives may require professional advice.

Tax Tip

If you expect interest rates to increase, consider renegotiating an employee home-purchase loan for an additional term. If you have predicted correctly, the taxable benefit might be minimized over the next five years of that term.

employment loss, must be included in income. Retirement refers to retirement from an employer, regardless of whether the employee is of normal retirement age. If the employee receives the allowance in instalments, they are taxable in the year received.

The employer is not required to withhold tax if the tax-eligible retiring allowance is contributed directly to the employee's registered retirement savings plan (RRSP). Otherwise, if the employee receives the payment directly, tax must be withheld. Employees may then contribute to their plan up to 60 days after the year of receipt, claim that amount as a deduction on their tax return, and recover the corresponding tax withheld.

In addition to an individual's normal RRSP contribution limits, retiring allowances transferred to an RRSP are allowable to a maximum of \$2,000 for each employment year prior to 1996, plus an additional \$1,500 for each employment year prior to 1989 in which the employee did not have vested rights in an employer-sponsored pension plan at retirement.

Years of past service need not have been continuous. Where there were gaps in employment and the employee has "bought back" years of service under a registered pension plan, special taxation rules may apply.

The fair market value of any benefit received by an employee in recognition of long service will also likely qualify as a retiring allowance under the Income Tax Act. If, for instance, an employer buys out an automobile lease on behalf of an employee at a discount from fair market value, any resulting taxable benefit could qualify as a retiring allowance.

The payment of accumulated sick-leave credits may also qualify as a retiring allowance if such payment is made in recognition of long service or in respect of the loss of an office or employment.

The fair-market value of other property, such as shares, jewellery or life-insurance policies, which are not paid for, but instead received in respect of a loss of office or employment, may also be considered part of an employee's retiring allowance and, therefore, included in income.

All or a portion of payments with respect to a loss of employment may still qualify as a retiring allowance, even if they are made before the employer/employee relationship has been formally severed. If, however, a retiring allowance initiates while an employee remains on the company's payroll there must be some

Tax Tip

Employees who retire but retain a seat on the board of directors of a private company at nominal compensation might still be eligible to collect a retiring allowance.

Tax Tip

In cases involving a loss of office or employment, you may receive an amount awarded as damages by a human-rights tribunal. If that amount is part of a retiring allowance, you might be able to exclude a reasonable amount of such an allowance from income for tax purposes.

Tax Tip

Legal fees incurred in a termination case do not necessarily have to be paid to a lawyer in order to be deductible. Fees paid to another professional, such as a labour-relations consultant retained to negotiate a severance package, may also be deductible.

evidence the cessation of that relationship, including the receipt of individual employee benefits, (i.e., they don't also extend to other former employees) is scheduled to occur at a fixed date.

The CRA stated in 2006 that if, following retirement, employees are rehired by the same employer or by an affiliated, non-arm's-length company pursuant to an arrangement made prior to retirement, they would generally not qualify for retiring allowances. However, it also identified certain exceptions where the retirement allowance might not be adversely affected, such as when retired civil servants subsequently obtain part-time employment in a different area of government, without any continuation of pension benefits, solely through their own efforts. Such cases will be examined on an individual basis.

Taxpayers who receive a retroactive lump-sum payment of at least \$3,000 as part of a lump-sum settlement related to dismissal from an office or employment (or other qualifying award) may qualify for federal tax relief. A mechanism exists to provide such taxpayers with the opportunity to deduct any excess tax liability that may result from declaring settlement proceeds all at once as they must do under the current system, rather than being able to apply it retroactively to the respective year(s) related to the settlement.

Tax Tip

A severance amount paid to a spouse or common-law partner as a result of working in a family business such as farming may qualify as a retiring allowance regardless of past remuneration, provided an employer/employee relationship existed over that period and the proposed retiring allowance is considered reasonable by the CRA.

Retirement Compensation Arrangement (RCA)

A retirement compensation arrangement (RCA) might be established under which the taxpayer's current or former employer or another non-arm's-length party has contributed funds. Such payments, made prior to retirement or the loss of an office, would be designed to fund future payments in case the taxpayer vacates that office. The RCA may provide for discretionary payments prior to the loss of such office if the taxpayer can prove there has been a "substantial change" in the services required.

Examples of a substantial change in duties may include situations such as where a former officer of a company is retained as a consultant, or a professional athlete resigns as a player but continues to provide services to the sporting franchise as a member of the coaching staff or scout.

RCA plans are very specific and do not overlap with other plans such as a deferred profit-sharing plan, employee profit-sharing plan or employee trust, among others. Consult your certified general accountant for more details.

Legal Expenses Incurred

Taxpayers can deduct legal expenses incurred and paid during the year to obtain a pension benefit or retiring allowance in respect of employment. In any single year this deduction is limited to the pension or retiring allowance received, less any related transfer to an RRSP or RPP. Expenses that are not deductible in a particular year may be carried forward seven years.

A separate provision of the Income Tax Act allows individuals to deduct legal costs paid to collect salary or wages. Even if they are never collected, a deduction is allowed provided the employee incurs costs to establish a right to wages or salary.

Legal expenses associated with establishing a right to collect salary or wages may be incurred from a variety of sources including, for example, a former or current employer or a professional association.

In a related matter, it used to be the long-standing administrative practice of the CRA not to tax prejudgment interest on awards with respect to wrongful dismissal. However that policy changed in 2004 and prejudgment interest relating to wrongful dismissal is now taxable. Check with your certified general accountant to determine the correct tax treatment if this situation applies to you.

Death Benefits

When an employee dies and an employer makes a payment to the surviving spouse or common-law partner or other beneficiary in recognition of the deceased's employment, the first \$10,000 of this amount is generally a tax-free death benefit.

This \$10,000 exemption first applies to the surviving spouse or common-law partner. If the surviving spouse or common-law partner receives less than \$10,000 and other beneficiaries are entitled to receive a benefit in respect of the employee, their exempt limit will be \$10,000 less any amount already claimed by the surviving spouse. The remaining exempt portion would then be shared on a pro-rata basis among the other beneficiaries.

From a tax point of view, it is possible to have more than one spouse or common-law partner (e.g., a legally married spouse and a common-law partner). If more than one spouse or common-law partner is entitled to receive a death benefit with respect to a deceased individual, the resulting benefit must be allocated on a pro-rata basis.

Income and Dividends from a Business and Self-Employment

Self-employed individuals, unlike those who are employed by others, have the right to control a number of factors in their work environment, such as the hiring and firing of staff, wages or salary to be paid and the place and manner in which work is done. They are also responsible for supplying the tools of their trade along with covering overhead and other expenses.

Tax Tip

Self-employment might also exist in circumstances where a worker is hired through an agency for various temporary assignments.

A measure of uncertainty arises with that control. Generally speaking, self-employed individuals, unlike employees, have no guarantee of a steady income because their remuneration depends on the continuing success of their business enterprise; thus, there is a greater degree of financial risk.

The CRA Guide RC4110, entitled *Employee or Self-Employed?*, outlines detailed criteria for determining whether a taxpayer is employed or self-employed. The major themes of this booklet include an analysis of who has control over the working environment and time spent on the job; who owns the tools and equipment necessary to do the job; as well as who bears the brunt of responsibility for a potential risk/reward scenario when it comes to a financial profit or loss.

Determining whether an individual should be classified as self-employed or as an employee for tax purposes is sometimes complicated. Your certified general accountant can assist you in making this determination.

Accounting for Business Income

With the exception of farmers and fishers, self-employed taxpayers generally must declare income in the period it is earned, even if the remuneration billed for is collected in a subsequent period. Expenses incurred to earn that revenue must be matched in the same period, even if they are paid in a subsequent time frame. This is known as the accrual method of accounting.

Under accrual accounting, for instance, construction contractors would normally declare any progress billings made, less amounts withheld pending satisfactory completion of a job, as earned income for that period. However, contractors may also elect to include such holdbacks in their income for that year, provided they administer the same accounting treatment to all contracts.

The correct tax treatment to apply in specific instances could differ. Your certified general accountant can assist you in this area.

Royalty Income

Royalty income, such as that received by an author or musician, is generally considered to be investment income, although it might also be classified under some circumstances as business or employment income.

Because the tax treatment for royalty income can be complicated, it is best to check with your certified general accountant to determine the correct tax treatment to apply toward it.

Salary versus Dividends

To maximize the availability of after-tax funds and minimize total corporate and personal tax, an owner/manager should consider the appropriate mix of salary and dividends to receive as compensation. Although the tax system is designed to extract approximately the same combined corporate and personal tax dollars regardless of any salary and dividend mix, perfect integration does not always occur.

Tax Tip

When determining the optimal mix of salary and dividends, ensure that personal tax credits are fully used. Maintain desired levels of salary for purposes of CPP and RRSP contributions.

No two situations are identical and the optimum combination of salary and dividends can only be determined on an individual basis. However, the following factors should be considered:

- whether tax credits or losses are available to reduce corporate tax otherwise payable, in which case dividends may be preferable to salary
- dividends can be received tax-free to the extent the company has a balance in its capital-dividend account
- dividends may trigger refundable taxes to the corporation, resulting in a reduction of taxes payable
- dividends may reduce the individual's cumulative net investment loss (CNIL) account
- dividends, when taken with other tax preference items, may result in alternative minimum tax (AMT). Sufficient salary or bonus may eliminate or reduce AMT
- salary or bonus in the current year creates earned income necessary for RRSP contributions in the subsequent year, whereas dividends do not
- share redemption or reduction of shareholder advances to a corporation as an alternative to paying either dividends and/or salary can result in a tax-free return of paid-up capital or debt
- the existence of payroll-related costs, such as employment insurance (if the shareholder owns 40 per cent or less of the company) and Canada pension-plan (CPP) premiums. However, dividends are not used for the calculation of CPP and employment insurance (EI)
- there is a federal small business deduction of 13.12 per cent on the active business income of Canadian-controlled private corporations (CCPC) for up to \$400,000. Ontario also has special provincial rates for small business corporations under its jurisdiction. The small business deduction threshold in Ontario is \$500,000.

Related Issues Affecting Business Income and Dividends

Establishing a Management Company or Professional Corporation

There may be certain tax advantages associated with establishing a management company to provide non-professional services or products to a professional at a reasonable mark-up (e.g., the CRA generally considers 15 per cent to be reasonable in many instances).

If incorporated by a professional's spouse or common-law partner, for example, a management company can be used to split income in addition to providing other incorporation benefits, such as a tax deferral. As earnings are taxed at the lower corporate tax rate, more cash may be available for working capital or the purchase of capital assets.

Those in charge of establishing management companies should ensure they are not deemed to be personal-services businesses. A personal-services business is defined by the Income Tax Act as a corporation through

Tax Tip

Because management fees paid by management companies are effectively subject to GST, professionals who are exempt from charging GST should consider directly employing administrative staff.

Tax Tip

A management corporation structure might allow for greater ownership control than a professional corporation in certain situations. Consult your certified general accountant.

which individuals deliver services to a recipient individual, partnership or organization, etc., of which they would otherwise be considered officers or employees. As a means of discouraging individuals from delivering such services through a corporation, personal-services businesses are denied the small business deduction as well as being limited in terms of eligible expense deductions.

This restriction could, for instance, apply to a business that does not have more than five full-time employees (although additional part-time employees might be enough to qualify it for a deduction, according to a 2008 court ruling).

The goods and services tax (GST) also reduces some of the potential advantages for exempt professionals to establish management companies. For instance, while management companies must charge GST on fees and mark-ups, the exempt practitioner is unable to recover the GST as an input credit.

Some provinces allow certain professionals to form professional corporations. Note, however, that there are legal differences between management companies and professional corporations. Furthermore, professional corporations face certain restrictions compared to other corporations.

Check with your certified general accountant and lawyer to make sure you understand all the taxation, legal and other important aspects that apply to your circumstances before taking any action with respect to incorporation.

Business Partnerships

Various business partnerships may exist between two or more people. The agreement between these business principals is likely to cover a multitude of issues, including the distribution of subsequent profits and losses, which could be equal or in some other proportion reflecting the degree of their involvement in the business; the initial financial investment; proportion of risk assumed; or other criteria.

In addition to an arm's-length partnership, it may also be possible for owners of unincorporated businesses to establish their spouses or common-law partners as partners who are eligible to share in the business's profits or losses. To qualify as partners, the spouses or common-law partners will be required to:

- contribute a significant amount of time, specified skill or training to the business or
- invest property in the business

The allocation of partnership income or losses should be reasonable under the circumstances. Partners should be aware that a provision of the Income Tax Act allows the CRA to reallocate income

Tax Tip

Make sure that any partnership agreements, including any intended taxation strategies or objectives, are in writing and can be accessed, particularly in the event a future dispute should arise that needs to be resolved in the courts.

Tax Tip

Consider introducing family members as officers or shareholders so that they may participate in dividend income, even if no direct involvement in operations was present to justify salaries.

or losses among the partners if it is determined that the primary motivation for selecting a particular allocation is to reduce or postpone tax that would otherwise be payable.

Special rules apply to limited partnerships. Consult your certified general accountant for details.

Share Structure

Owner-managers often hold corporate shares in a Canadian-controlled private corporation (CCPC). It is also possible for an individual to own shares of a holding company, which in turn owns all the shares of the operating company. Under this structure, dividends may be passed tax-free among CCPCs. By doing this, funds can be transferred away from future risks associated with the operating company without incurring additional income taxes. Provided excess funds are not personally required, this might be advantageous in certain situations.

Although investment capital accumulation in the holding company may cause complications with respect to claiming the small business-corporation (SBC) capital-gains deduction on a subsequent sale of shares, this potential problem can generally be remedied if appropriate steps are taken prior to disposition. You might want to discuss this with your certified general accountant.

In determining whether a corporation qualifies as a CCPC, it is important to ascertain not just the current share ownership, but also with whom the right of control resides. If, for instance, a foreign-based minority owner has the right to either acquire shares or dilute ownership such that the company is no longer majority owned by Canadian parties, it could be denied status as a CCPC.

The size of the business may also be a factor; for example, if it does not have more than five full-time employees it might be considered a specified investment business and, therefore, not qualify for the small business deduction.

Share restructuring can also be conducive toward establishing a potential estate freeze. A capital gain realized on the ultimate sale of qualifying small business shares might, for instance, be split among several family members holding shares, each with an available \$750,000 lifetime capital-gains deduction (see Capital-Gains Deduction on page 43 for a discussion of the conditions that qualify).

Decisions handed down in several recent court cases have reinforced that family members are eligible to receive dividends, regardless of the degree of their participation in helping to establish or run a family business.

Loans to Shareholders

Generally, a shareholder loan is required to be included in the taxpayer's income in the year the loan was made. However, there are certain exceptions. One is that the loan must be repaid by the end of the following fiscal year of the corporation making the loan, provided it is not part of a series of loans and repayments.

The imposition of taxable benefits on a shareholder loan is based on prescribed interest rates, as applied to the loan principal outstanding. Loan repayments are applied to outstanding balances on a first-in, first-out basis. The payment of dividends, salaries and bonuses may also qualify as legitimate repayments of a shareholder loan, provided that amount is included in the taxpayer's income.

If bona-fide arrangements were made when the loans originated that repayment would take place within a reasonable period of time, that loan might not be considered income if it occurred in the ordinary course of the lender's business or was made to enable a shareholder who is also an employee who deals at arm's length with the corporation to:

- acquire a dwelling for personal use
- purchase an automobile for use in the course of employment
- purchase fully paid shares from the corporation or a related corporation (provided such shares are held by the individual for personal benefit)

Preserving Business Losses

A business with non-capital-loss carry-overs that are due to expire may increase taxable income, in order to use as much of the loss as possible, by any of the following methods:

- reduce CCA claims and amortization of eligible capital expenditures (see section on page 33)
- compensate employee shareholders by declaring dividends rather than pay a salary (assuming there are sufficient retained earnings)
- sell redundant fixed assets or other capital property when this will result in a recapture of capital-cost allowance
- reduce tax reserves, including reserves for doubtful accounts
- elect to capitalize interest and related costs on money borrowed to acquire depreciable property
- transfer losses to another corporation within the corporate group as losses may be used within that group by means of an amalgamation or wind-up, subject to restrictions if a change of control results
- value the business inventory at full market value. Note, however, that a change in the method of valuing inventory must result in a more appropriate way of calculating income. The Minister of National Revenue must also approve this change
- realize capital gains on investments
- bring capital-gains reserves into income
- apply losses to a corporation's part IV tax account (referred to in the Income Tax Act as tax on taxable dividends received by private corporations), if no other alternative is viable.

Choice of Year-End

Proprietorship/Partnership

All sole proprietorships, professional corporations that are partnership members and partnerships (where at least one member is an individual, professional

corporation or other affected partnership) are generally required to have a December 31 fiscal year-end.

If an appropriate election is made, however, some businesses may qualify to establish an alternative fiscal year-end and estimate calendar-year business income using a specified formula. The alternative method is a one-time election that must be made by the taxpayer (or in the case of a partnership, by a representative on behalf of all members). This election must be made by the filing due date of the first tax return that includes the business's income.

The alternative method election remains in effect until it is revoked or the business no longer qualifies to apply it. Once a December 31 year-end is used for tax reporting, however, the business cannot subsequently elect to use the alternative method.

In the year an individual dies, goes bankrupt or otherwise ceases to carry on the business, there can be no additional income inclusion under the alternative method unless, in the case of business cessation, a similar business is started in the same calendar year.

Some taxpayers in a partnership arrangement are required to fill out *CRA Form T5013–Statement of Partnership Income*.

The rules governing this subject are complex. Taxpayers are advised to consult a certified general accountant for more details.

Corporation

A corporation can choose its first year-end, which must be within 53 weeks from the date of incorporation.

In establishing an incorporated business's fiscal period, the timing of income recognition is often a major consideration; other factors, such as the normal business cycle, should also be weighed into the decision.

Business and Self-Employment Expenses

Individuals may deduct all expenses incurred in the conduct of their business, provided they are undertaken to earn income, are reasonable under the circumstances, and not limited or prohibited by certain rules or regulations established with respect to specific expenses.

Examples of business expenses may include all or part of the following:

- accounting
- advertising
- amortization of capital assets
- bad debts
- business-related memberships and subscriptions
- business-related start-up costs

- business taxes, fees and dues
- certain group benefits
- collection (i.e., related to bad debt)
- convention expenses (up to two a year)
- consulting
- delivery and freight
- disability-related modification expenses
- equipment rental
- insurance (fire, theft, liability)
- interest and bank charges
- legal
- light, heat and water
- maintenance and repairs (other than for passenger motor vehicles)
- management and administration fees
- meals and entertainment expenses
- motor-vehicle expenses (such as fuel, insurance and repairs)
- home-office expenses (including postage, stationery, telephone and other supplies)
- property taxes or rent on business property
- purchases of materials and supplies
- representation costs to obtain a business-related licence, permit, franchise or trademark
- salaries and amounts paid “in kind”
- specific courses taken to improve business skills
- subcontractors’ costs
- travelling expenses (limitations apply to motor vehicles)
- workspace in the home (when appropriate).

Tax Tip

Self-employment expenses must be documented. There are instances where the tax courts have disallowed what might otherwise have been legitimate expenses because of poor or non-existent documentation. A lack of proof to support the taxpayer’s argument in the event of a dispute with the CRA could also lead to the imposition, or upholding of penalties.

Other Deductions

Individuals who are self-employed can deduct the employer’s share of Canada pension plan (CPP) and Quebec pension plan (QPP) earned-income contributions. They can also deduct premiums paid for coverage under Ontario’s Workplace Safety and Insurance Board (WSIB).

Self-employed individuals may also, within limits, deduct health and dental premiums paid on behalf of them or immediate family members sustained under a private health-services plan (PHSP), provided they are actively engaged in the business and derive more than 50 per cent of their income from it.

Legitimacy of Expense Deductions

When determining whether a self-employment enterprise, such as a sole proprietorship or partnership, constitutes a true business with allowable expense deductions, the tax courts generally place a great deal of emphasis on determining the commercial viability of the enterprise.

Hence, taxpayers must establish that their prominent intentions are to make a profit and, in so doing, they are employing objective standards in their conduct of

the business. The courts will also look at factors such as the amount of time and capital devoted to the business, the existence of a solid business plan, whether or not there is adequate capitalization, ties to professional associations, the training of its entrepreneur(s) and, depending on the nature of the enterprise, the existence of employees.

If there is a personal element associated with the business operation (e.g., if it has been established as a hobby), the expenses associated with that personal element are likely to be denied as taxable deductions. The tax courts might then turn their attention toward determining whether or not the activity was also being carried out in a sufficiently commercial manner as to constitute a source of income, in which case a proportion of its expenses might be related to commercial operations and, therefore, deductible. Somebody using artistic talents such as painting, writing or photography in a business endeavour should, for example, be especially diligent about being able to provide tangible proof the enterprise is predominantly commercial in nature.

One of the tests the courts are likely to employ in this situation is a determination regarding whether or not the business was established with, and maintains, a reasonable expectation of profit (REOP) within a reasonable period of time.

Deductions Related to Salary Paid to Spouse/ Common-Law Partner or Children

If a spouse, common-law partner or other family member is employed by a business, whether it be incorporated, a partnership or sole proprietorship, there are potential opportunities for income splitting and reduction of the family's overall tax burden.

The following criteria must be met if a business is to be allowed a deduction for salary paid to a family member:

- the salary must be paid periodically, preferably by cheque for bona-fide services performed
- an employer-employee relationship must exist
- any salary paid must be reasonable for the work performed.

Normal payroll deductions apply for non-arm's-length employees (such as a spouse or child), except for employment-insurance (EI) premiums, which may be exempt. Consult your certified general accountant with the particulars of your situation.

Deductions Related to Workspace in the Home

The Income Tax Act limits the circumstances under which a self-employed individual can deduct the costs related to a workspace in the home. They are confined to situations where the space is used exclusively to earn income from a business and on a regular and continuous basis for meeting clients, customers or patients, or if it is the individual's principal place of business.

Tax Tip

The salary paid to a family member may allow that individual to become eligible for CPP and RRSP contributions.

Tax Tip

You should be especially vigilant about documenting the work carried out by family members in order to help prove the compensation they received was equitable.

This claim may be based on the proportionate space within the home that is used as a workplace. Eligible expenses include rent, mortgage interest, realty taxes, insurance, utilities and maintenance. It is generally not advisable to claim capital-cost allowance (CCA), (see page 33), on a portion of the home because that portion would then not qualify for the principal-residence exemption when it is ultimately sold.

Tax Tip

A bed-and-breakfast enterprise may also qualify as workspace in the home, provided the guest rooms are located inside the owner's home and not in a separate dwelling.

Similarly, claiming 50 per cent or more business use of the home or making major structural alterations to adapt it to business use will trigger a "change in use," resulting in loss of the principal-residence exemption.

Tax Tip

Don't forget to include business-storage space in the basement and elsewhere, when determining the proportion of your home used for commercial purposes.

The amount a taxpayer can claim is limited to his or her business income before deductions for home workspace. Any unused amount may then be carried forward and claimed in the subsequent year against related business income. To the extent that unused amounts cannot be claimed in the following year, they can be carried forward indefinitely to be claimed at the first available opportunity.

Automobile Expenses

The Income Tax Act restricts certain expenses relating to "passenger vehicles." A passenger vehicle, which can include a van, pick-up truck or sport-utility vehicle, is defined as a motor vehicle designed to carry no more than nine people, including a driver and luggage. It does not fit this definition if:

- ninety per cent or more of its use is for the transportation of goods, equipment or passengers in the course of income-earning activities or
- more than 50 per cent of its use is for such activities and it seats not more than three people, including the driver.

The restrictions on deductible expenses and related business-use calculations are both discussed under Use of Company Cars, on page 16.

It is impossible to provide a simple rule of thumb with respect to an automobile lease versus purchase decision. Each situation must be carefully reviewed and many factors, including interest rates, mileage allowances and expected resale value, plus income tax implications, taken into consideration before a final decision is made. Certified general accountants are well equipped to help in this process.

Deduction for Business Meals and Entertainment

The Income Tax Act imposes a restriction on the deductibility of business-related meals, beverages and entertainment expenses, based on a general presumption that these normally combine elements of both a personal and business nature. Only 50 per cent of such expenses are deductible with certain exceptions, such as when employees are required to work at selected special work sites or in remote locations; are travelling aboard an airplane, train or bus on business; or

they are incurred at a fundraising event to benefit a registered charity, among others.

The 2007 federal budget increased this allowance to 80 per cent for long-haul truck drivers while they are working. This increase will be phased in over a five-year period. It was 60 per cent for expenses incurred on or after March 19, 2007; that allowance increased to 65 per cent on January 1, 2008.

The 50-per-cent rule also applies to meals and entertainment provided as part of a convention, seminar or similar event, where the organizer may specify a reasonable amount to cover the cost of food and entertainment. Otherwise, the fee for that event will be deemed to include \$50 a day for meals and/or entertainment. (Incidental refreshments, such as coffee and doughnuts, are exempt from this calculation.) Certain other expenses, such as transportation costs incurred to get people to attend an entertainment event, might also be subject to this 50-per-cent restriction.

Bottles of liquor or certain food items given as gifts at Christmas or on other special occasions may also fall within the auspices of this 50 per cent limitation. However, some food, beverage and entertainment-related expenses for up to six special events in a calendar year, such as Christmas parties and employee meetings, held at a particular place of business to which all of the firm's employees are invited, might be 100-per-cent deductible. Business owners with employees should, therefore, consult their certified general accountant for a clarification of these rules.

Capital Cost Allowance (CCA)

Capital assets such as land, buildings, automobiles, furniture, computers, etc., provide an enduring benefit to a business. This period is generally recognized by the accounting profession as being at least one year; in practice, most capital assets provide benefits that last for several years. Capital costs also include items such as leasehold improvements and legal, accounting and other professional fees paid to acquire a capital property.

Individuals who run their own business cannot, therefore, expense or write off the cost of such assets immediately upon purchase; rather, they must spread the cost over several years. For tax purposes, this write-off is referred to as capital cost allowance (CCA) and it is subject to strict rules and limitations. Assets are grouped into approximately 40 classes where items are provided with a discretionary allowance claimed annually at a fixed percentage, generally on a declining balance basis.

A small sampling of common CCA classes, a description of what is contained in those classes and their corresponding deduction rates include:

- automobile (class 10 or 10.1), 30 per cent on a declining-balance basis
- computer software (class 12), 100 per cent on a declining-balance basis
- furniture and fixtures (class 8), 20 per cent on a declining-balance basis
- manufacturing and processing machinery (class 43), 30 per cent on a declining-balance basis

- leasehold improvements, which may either be written off on a straight-line basis over the term of the lease (including the first renewal period), or five years, whichever is greater.

Special rules apply for Class 10.1 automobiles, the cost of which exceeds the threshold amount of \$30,000 prior to sales taxes.

Special rates also apply to computer equipment. The federal budget in 2004 increased the CCA rate on such items acquired after March 22, 2004, to 45 per cent from 30 per cent. The federal budget in 2007 further increased the CCA rate on such items acquired on or after March 19, 2007, to 55 per cent from 45 per cent. The rates for broadband, Internet and other data-network infrastructure equipment were increased to 30 per cent from 20 per cent in 2004.

The Ontario government has matched those changes, with the same effective dates.

New CCA classes have also been created to accommodate equipment qualifying for these accelerated rates.

In most cases, only one-half of the normal allowance is available on depreciable property acquired in an arm's-length transaction in the fiscal period it is acquired. Where the fiscal period is less than 365 days, the amount that would otherwise be claimed must be prorated, based on the number of days in that period.

The 2007 federal budget established a temporary two-year 50 per cent straight-line accelerated-CCA rate to cover investment in eligible machinery and equipment acquired on or after March 19, 2007 and before 2009 and used in manufacturing or processing activities as an economic incentive to Canada's manufacturing sector.

Budget 2008 extended this by three years until the end of 2011. However, the straight-line depreciation will only continue to apply to eligible assets purchased in 2009. Eligible assets purchased in 2010 will generally be subject to a 50 per cent declining-balance rate in the first taxation year ending after the assets are acquired, followed by a 40 per cent declining-balance write-off the following year, and 30 per cent thereafter. Eligible assets acquired in 2011 will be allowed a 40 per cent declining-balance write-off the first taxation year after the assets are acquired; then 30 per cent thereafter.

Certain types of equipment can become obsolete before being fully depreciated for income tax purposes. Taxpayers may elect to place eligible rapidly depreciating

Tax Tip

If you dispose of one of several identical eligible capital properties with a shared value, you may use an average cost to determine the value of the individual property sold.

Tax Tip

Specific costs incurred by employers to improve business premises' access for people who are disabled may be deducted in the year they are incurred and need not be capitalized.

Tax Tip

You do not have to claim all eligible CCA amounts in the year they are incurred if you believe it may be tax advantageous to carry all, or some, of that amount forward to a future year.

equipment in a separate class. Examples of eligible property include certain computers, photocopiers, fax machines or telephone equipment costing more than \$1,000. If such property has not been disposed of after five years, it must be transferred to the general class to which it would have originally been placed.

A terminal loss could result on the disposition of such elected property should the proceeds ultimately received be less than any remaining undepreciated-capital cost (UCC). Consult your certified general accountant for details on these and other specific rules, such as the correct tax treatment associated with any subsequent recapture of CCA, as well as a full clarification of CCA classes and the multitude of items contained within.

Eligible Capital Expenditures and Receipts

Certain expenditures are capital in nature, but not included in any CCA class that qualifies them to be written off on a declining-balance basis. These include, but are not limited to, expenditures related to acquiring certain government rights; trademarks; franchises; incorporation fees; certain farm-related quotas; and goodwill.

Seventy-five per cent of such expenditures may be amortized at a rate of seven per cent per year, on a declining-balance basis.

When this type of capital asset is sold, income is generated when applied to the recapture of depreciation amounts previously written off, with any remainder treated as a taxable capital gain from a capital-property disposition. Such a sale could also generate a loss, in which case special rules apply.

Consult your certified general accountant for more details.

GST Input Tax Credit

The GST input-tax credit is a credit, or refund, claimed by registrants on goods and services tax (GST) returns filed on a monthly, quarterly or annual basis. This credit covers GST paid or payable in the course of any business activity.

The following criteria must be met in order for taxpayers to be eligible to claim the input tax credit:

- the person making the claim must be registered
- the registrant must deal with taxable supplies
- goods or services must be acquired or imported for consumption, use or supply in the course of a commercial activity
- documentation pertaining to the tax paid or payable must be retained .

Consult your certified general accountant for details about the calculation methods available for you to claim this credit, the due dates for making this claim, and other related information.

Farming Income and Losses and Other Special Considerations

Farming is a very diverse and specialized industry in Canada. It encompasses a wide range of activities, including tilling the soil, livestock raising or showing, poultry raising, dairy farming, winery-related vineyard operations; tree farming, beekeeping and, in some instances, activities associated with raising fish, such as commercial shellfish, among others.

Determining Whether Farming Constitutes the Main Source of Income

Qualified farm property (QFP) is defined in the Income Tax Act as property that is owned by the taxpayer, his or her spouse or common-law partner or in a partnership, that was used “in the course of carrying on the business of farming in Canada,” under some very specific scenarios.

The CRA may take several factors into consideration when determining whether taxpayers engage in farming activities to the extent that it constitutes their chief source of income. Taxpayers for whom farming does not represent their main source of income will be limited in their ability to deduct farm-related expenses.

The criteria used by the CRA to examine this issue include:

- whether the farming operation has a reasonable expectation of profit (REOP)
- whether earned profits from farming are substantial compared to the taxpayer’s major source of income
- whether there is a family history of farming activities
- the extent of the taxpayer’s knowledge of farming
- whether the activity generating the taxpayer’s major source of income has, to some degree, been subordinated as a result of farming activities
- the professionalism of business activities, including the existence of a business plan, and the amount of time and capital committed.

Consult your certified general accountant for more details.

Method of Accounting

To accommodate such a myriad of farming-related operations, there are a number of accounting and income tax provisions available.

Farmers and fishers have the option of reporting income using the cash (rather than the accrual) method of accounting. The cash method can be advantageous to farmers because it allows them to decide when to report income by timing the sale of produce or livestock in the most appropriate year. Using the cash method, farmers can also time expenses by paying accounts in the year they wish to make the deduction.

This timing option, which is not available to members of any other industry, can

Tax Tip

If you are a farmer using the cash method of accounting, note that when an expense is paid using a credit card, the relevant date for tax purposes occurs when the expense is charged to the credit card, not when the credit card is paid.

greatly increase tax-planning alternatives for the farming community.

Several additional calculations in determining farming income may also differ from those of other businesses. For instance, under the cash method of accounting, expenses relating to a taxation year that falls two or more years after the actual payment are not allowed as deductions in the current taxation year. If, for example, in December 2008 a farmer pays insurance premiums covering 2008, 2009 and 2010, the amount deductible on their 2008 income tax return would be limited to the actual cost of insurance for 2008 and 2009 only. Costs related to 2010 will only be deductible during 2009. Also, a farmer who enters into a three-or-more-year equipment lease cannot deduct the portions that relate to lease payments beyond one year into the future (e.g., if the lease were signed in 2008 that would cover up until the end of 2009).

Tilling, clearing and levelling of farmland, as well as the building of an unpaved road, can be expensed in the year such payments are made or any portion carried forward to future years. However, land improvements on farmland rented out to another producer do not qualify for this deferral. In such cases, land improvements can be expensed in the current year or, alternatively, added to the cost of the land.

Tax Tip

Expenses for dogs and cats located on the farm are deductible if those expenses relate to their use for rodent or other wild-animal control.

If the farmer is actively involved in peripheral activities, such as the purchase and sale of seed, this business is not considered farming and must be reported using the accrual method of accounting, which will include the reflection of inventories on hand at year-end. The CRA will consider certain non-farming activities to be part of the farming operation if these activities are undertaken on a small scale and the income from them is incidental to other farming revenue.

Other differences that affect the farming industry include:

- assets purchased during the year are restricted by the CCA half-year rule, except assets such as quotas (which are eligible capital property), where the full amortization amount is allowed in the year of acquisition
- deceased farmers' Rights and Things include harvested crops, livestock on hand (less the basic herd), supplies on hand, inventory and receivables (if the deceased used the cash basis of accounting)
- no GST is charged on sales of most farm commodities. Registered farmers must, however, charge GST on items such as land and quota rentals and firewood sales that do not fall under the exception list provided by the CRA. Asset purchases and sales specifically exempt include tractors over 44.74 kW (60 PTO hp) and most harvesting, tillage, haying and grain-handling equipment. Consult the CRA list for further details.

Farmers and fishers should also be aware that:

- payments received out of the agricultural income disaster assistance (AIDA) and the Canadian agricultural income stabilization (CAIS) programs are

