TAX NEWSLETTER

Spring 2013

An Independent Member Firm of DFK Canada Inc. and DFK International

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Special points of interest:

- *Personal tax instalments:*
  - *June 15, 2013*
  - *September 15, 2013*
  - *December 15, 2013*
  - *March 15, 2014*
- *Personal tax filing deadline for self-employed individuals is June 15th.*
- *In July, the clawback of Old Age Security (OAS) benefits will be recalculated based on 2012 tax returns.*

It's Not All About Tax!

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Owner managed businesses, and their advisors, are continually trying to determine the best method to minimize tax through payment of salaries and dividends. The focus on tax savings often overshadows the non-tax factors that should have just as much or even more consideration.

The common tax related factors generally considered include the effect on RRSP contribution room, Old Age Security clawback, the cost of Canada Pension Plan (CPP) premiums and the future reduction in CPP benefits, refund of Refundable Dividend Tax on Hand, and provincial employer health tax.

Below are some non-tax factors that should be considered along with the tax calculations in deciding whether to pay salaries or dividends, or some combination thereof.

- For group insurance purposes, the plans will often refer to coverage for employees. The definition of employee may refer to "salaried individuals who work on a regular basis for the employer". If the decision is made to pay only dividends, the owner may no longer be considered an employee and, therefore, will not be eligible for group benefits. In this case, you may be able to adjust your group insurance policy to include owners that are compensated through dividends.
- Disability insurance and group life insurance will often calculate benefit coverage based on a percentage of "gross salary" or "employment income". If the decision is made to reduce or eliminate employment income in favour of dividend income, the owner may no longer be covered by the disability plan and may have reduced life insurance coverage.
- A deduction for child care expenses is limited to 2/3 of an individual's earned income for the year. Salary and wages will qualify as earned income, but dividends will not. Therefore, the decision to reduce or eliminate salary may reduce or eliminate the available deduction for child care expenses.
- Where owners have involvement with Scientific Research and Experimental Development (SR&ED), salaries and wages are a large component of the SR&ED tax credit calculation. If the company is using the proxy method for calculating SR&ED tax credits, the affect caused by reduced wages is even larger.

Other items to consider include the effect on Alternative Minimum Tax, personal tax installments, Individual Pension Plans, and Workers' Compensation.

With the recent change to dividend tax rates in the 2013 federal budget, the salary vs. dividend review will need to be revisited once again. Remember, when planning for compensation decisions, the focus should not be all about tax.

Optimizing Business Value Through Commercial Goodwill

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Many business owners who have been closely involved with their company's daily operations are surprised to discover their business is worth less than anticipated when selling due to the existence of personal goodwill. In order to understand what personal goodwill is, we must first understand how value is generated.

The fair market value of a company is directly related to the future cash flows the company is expected to generate and the risks associated with the company's ability to continue generating those cash flows subsequent to a sale.

In general terms, "goodwill" exists as a result of a company's ability to generate an above-average return on its operating assets. The more profitable a business is, the more likely the existence of goodwill. Goodwill is comprised of a number of so-called "intangible" assets, such as a business's reputation, customer relationships, brand, location, and workforce. The various components of goodwill fall into one of two categories - personal goodwill and commercial goodwill.

Commercial goodwill consists of components transferrable to a new owner, such as location and brand that are attached to the business. Since these items will remain with the business after a sale, there's little risk associated with new ownership obtaining the future returns generated by these intangible assets.

Personal goodwill attaches to the shareholder and relates to items such as the shareholder's reputation, skill or personal client relationships. Unlike commercial goodwill, personal goodwill walks out the door along with the old owner.

Consider two owner-operated sports therapy clinics with identical profits. Clinic A is known for its competent, friendly and knowledgeable staff, many of whom have developed long-term relationships with their patients. Although Shareholder A plays an active role in the clinic's daily operations, it is a behind-the-scenes role with limited patient interaction. Contrast this to Clinic B's clientele who specifically request the services of Shareholder B and who are indifferent to the services provided by Clinic B's staff.

In the above example, Clinic A's business will continue to be profitable subsequent to its sale and the departure of Shareholder A. This illustrates the existence of commercial goodwill rather than the personal goodwill that exists in Clinic B, whose profits will dramatically decline subsequent to the departure of Shareholder B.

With this knowledge in mind, owners should endeavour to convert their personal goodwill into commercial goodwill that will remain with the company – well in advance of the sale of the business. This is done through the transfer of the shareholder's knowledge, relationships and skills to the employees that will remain behind.

A holistic approach to succession planning involves proactively converting the shareholder's personal goodwill (i.e., business contacts and relationships) to commercial goodwill to the greatest extent possible, as well as developing an effective tax strategy, thus helping to ensure they obtain the greatest financial reward for the time and effort spent developing their successful business.

T1135—Foreign Reporting Issues

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For the last 15 years, Canadians have been required to identify and disclose if they own or hold foreign property as part of filing their annual income tax returns. Canadian taxpayer's are required to file a Form T1135 by the income tax return filing deadline if they own, or hold, foreign property with a cost of more than $100,000 CDN.

The question is: What constitutes foreign property and what should you report? While this may not seem like an overly complicated question, it inevitably raises a few interesting questions, usually in the dwindling days of April. Here are some examples of frequently asked questions.

Example 1
Jack holds his investments with a Canadian brokerage firm. Included in his non-registered investment account are shares of Apple Inc. that have a cost of $120,000. Every year Jack receives a T5 slip reporting the dividends he receives from these shares, which he includes in his income.

Is a T1135 required? Yes. Jack owns shares of a non-resident corporation and these shares constitute foreign property. It does not matter that all of the income is being reported annually on both a T5 slip and on Jack's personal tax return. Nor does it matter that the shares are held in a Canadian brokerage account. He still must file Form T1135.

Example 2
Jill owns a condo in Arizona which she purchased in 1991 for $95,000. She rents this condo 100% of the time to arm's length parties. She also holds shares of the TD Bank with a cost of $10,000. These TD shares are held in an account with a brokerage firm that is located in the Cayman Islands.

Is a T1135 required? Yes. Although the TD shares are not foreign property on their own, the fact they are held in a foreign brokerage account means that these shares are considered property held outside of Canada. Therefore, the total foreign property is $105,000. However, if the Arizona condo was not rented and was for personal use only, it would not be considered specified foreign property, and no T1135 would be required.

The above examples are fairly straightforward. However, with the increasingly more sophisticated planning that clients are undertaking; the issues surrounding T1135 reporting become problematic. Consider, for example, where one spouse transfers foreign shares to the other spouse for less than fair market value consideration to which the provisions of subsection 74.1(1) of the Income Tax Act apply. Who has the requirement to report the foreign property, and who reports the income earned from this investment on the T1135?

Failure to file Form T1135 on time may result in penalties that accumulate at the rate of $25 for each day you are late, up to a maximum of $2,500. If CRA determines that your failure to report constitutes "gross negligence", the penalties jump to $500 for each month, up to a maximum of $12,000. However, if you are able to file under the Voluntary Disclosure Program, you may be able to become compliant and avoid these harsh penalties.

The 2013 Federal Budget proposes a number of changes to Form T1135 which will require more detail to be provided. These will include the name of the specific foreign institution or other entity holding the funds outside of Canada; the specific country to which the property relates; and the income generated from the property.

Accordingly, clients should be considering this now and taking steps to compile this information so that they are ready by the filing deadline for next year.

New Rules for Old Age Security

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The federal government introduced major changes to Old Age Security (OAS) in its 2012 budget. The changes will affect your retirement planning; however, with proper planning, the changes can be beneficial.

The New Rules

Starting in July 2013, people turning 65 will have the opportunity to defer their OAS pension. For every month deferred, the monthly benefit will be increased by 0.6% (or a maximum increase of 36% if they defer until age 70), once they start collecting.

This voluntary election is not available to those who already collect OAS. Once you have begun collecting, you cannot elect to defer it under the new rules.

Who should defer their OAS benefits?

- People who had income in excess of $69,000 in 2012 are already losing their OAS benefits due to the OAS clawback. For every additional dollar of income, $0.15 is owing to CRA as a repayment of OAS. The OAS is fully repaid when a person's income is $112,000.
- People who are having OAS clawed back should defer in case their income is below the threshold in future years. Even if the OAS clawback applies when they collect at age 70, the OAS pension benefits will be 36% higher.
- People who are still working at age 65, but expect to retire shortly, will likely be in a lower tax bracket when they retire. By deferring the OAS, not only will they have the increased OAS benefit, but the income taxes payable on those benefits may be less.
- People who have a long life expectancy are generally better off to defer the collection of OAS.
- Several benefits (HST credits, age credit, Ontario Trillium Benefit) depend on a person's income for the year. Depending on a person's situation, it may be beneficial to defer OAS benefits to get the benefit of these other credits.

Who should apply at age 65?

- People who have large RRSPs will have to convert them into RRIFs and must start to withdraw a portion at age 72 (approximately 7.4% must be withdrawn in the first year). People with large RRSPs could receive OAS benefits for seven years by electing to collect starting at age 65.
- Lower-income Canadians who require the Guaranteed Income Supplement ("GIS") should apply for OAS at 65. In order to receive the GIS, taxpayers must be collecting OAS.

If you need more information, talk to your accountant or visit Service Canada's website at:
http://www.servicecanada.gc.ca/eng/isp/oas/changes/voluntary_deferral.shtml