TAX NEWSLETTER

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

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- *Personal tax instalments:*
  - *► September 15, 2014*
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  - *► June 15, 2015*
- *Beware of telephone and email scams claiming to be from CRA!*
- *6 of 13 tax provinces and territories have maximum tax rates over 46%.*

Education Savings–An Alternative to RESPs

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In recent years, Registered Education Savings Plans (RESP) have become increasingly popular with Canadians as a method of saving for the ever-increasing costs of post-secondary education. This is in large part due to the many benefits that RESPs offer.

For example, the Canada Education Savings Grant (CESG) is one very attractive feature of the RESP. The CESG is an incentive to encourage Canadians to save for a child's post-secondary education, whereby Employment and Social Development Canada will make a deposit directly to the child's RESP equal to 20% of annual contributions, to a maximum annual CESG of $500, and a lifetime limit of $7,200. This means that an annual contribution of $2,500 will qualify for a CESG of $500 – this is equivalent to an instant 20% return on your investment.

There are some drawbacks with RESPs, such as the maximum lifetime contribution limit of $50,000. Also, because contributions to RESPs are not tax deductible, the contributions are being made with after-tax dollars. This means that an individual in the top marginal tax bracket in New Brunswick would have to earn approximately $94,000 of income and pay approximately $44,000 in personal tax in order to make the maximum lifetime contribution to an RESP of $50,000.

Some individuals, such as small business owners or incorporated professionals (doctors, lawyers, etc.), can forego RESPs and instead choose to keep the $94,000 (or more) inside their corporation and invest it. When the child is ready to begin their post-secondary education, the corporation can be restructured to put a Family Trust in place. This Family Trust can then be used to flow dividends from the corporation to the student.

Depending on applicable income tax rates in your province, investing this $94,000 within a corporation over a 17 or 18-year time period can result in significantly more savings than investing $50,000 plus the $7,200 CESG in an RESP over the same time period.

While there are many benefits to RESPs, a saving and investing strategy involving a corporation and Family Trust is an alternative that may provide greater long-term financial benefit and flexibility for certain taxpayers. This strategy may not be right for everyone and there are costs associated with restructuring a corporation and administering a Family Trust. However, for many families, this strategy can allow you to set aside more money as a result of the reduced up-front tax costs and the lack of a maximum lifetime contribution. It can also give greater flexibility as you maintain control over the funds and there is no requirement that the funds be used solely for post-secondary education.

To discuss whether this strategy might be right for you and your family, you should contact your local DFK affiliate firm.

Real Estate Sale—Don't Pay the Taxes Until You Get Paid!

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You've sold some real estate and turned a profit. Now it's time to report the gain to the taxman. The problem is, you took back a mortgage on the sale, haven't been paid, and the taxes on the gain are going to come out of your pocket!

Fortunately, there is the capital gains reserve. The capital gains reserve permits taxpayers to defer a portion of the taxes payable based on the proceeds not yet received at the end of the taxation year. It allows taxpayers to pay the taxes on the gain with the actual proceeds from the gain, as opposed to having to cover the taxes with their own money.

The calculation is simple. For any property disposed of, with a few exceptions, the reserve that can be claimed is the lesser of either:

[(capital gain) times (amount payable at the end of the year)] / (total proceeds of disposition)

OR

capital gain x 80 percent (in the year of sale), 60 percent (in the second year), 40 percent (in year three), 20 percent (in year four), and 0 percent (in year five).

This calculation allows the gain to be spread over a maximum period of 5 years, with a minimum 20 percent of the gain taxed each year.

The benefits of the capital gains reserve are three-fold. It provides:

- Easier cash flow. By spreading the tax bill over a similar period to that of the payment of the sale proceeds, you get to use the proceeds to pay some or all of the taxes, instead of dipping into your own pocket.
- Tax deferral. Taxes that would otherwise be payable immediately are spread over a period of up to five years.
- Tax savings. Depending on your income level, the ability to spread the gain over time may result in taxing income in a lower tax bracket in subsequent years to the sale.

To better understand the potential tax savings, if the proceeds aren't needed immediately, structuring a sale such that proceeds are paid over a period of time, say five years, could save taxes if the taxpayers' income tax bracket allows them to pay less tax marginally than they would otherwise if the entire gain were reported in one year.

The following criteria must be met for the capital gains reserve to be used:

- the claimant must be a resident of Canada;
- the claimant must not be exempt from paying tax; and
- the sale cannot be to a corporation that is controlled by the taxpayer.

In order to claim the capital gains reserve, the taxpayer must fill out Form T2017 – Summary of Reserves of Dispositions of Capital Property. The calculation takes into income the prior year reserve, if any, and deducts the current year reserve.

The reserve claimed in a given year need not be the maximum reserve permitted. This allows some flexibility in reporting income, and, when beneficial to do so, allows for reporting more income in the current year than in the future. However, the reserve on a particular disposition in a subsequent year can never be greater than the reserve claimed in the previous year. Doing so would result in a loss in such a year and is not permitted.

When property is sold in the ordinary course of business, i.e., land inventory, the capital gains reserve does not apply. However, a reserve is still permitted where some or all of the proceeds are not yet due at the end of the taxation year. A reasonable reserve could be calculated as the gross profit on the sale, multiplied by the unpaid proceeds at the end of the year, then divided by the total proceeds. Income reserves can be claimed for up to three years on a particular sale.

It's hard enough knowing that a big chunk of the profit on a real estate sale will be lost to taxes, and worse still when the taxes are coming out of the seller's own pocket. The capital gains reserve allows taxpayers to ease the burden of paying capital gains taxes when they haven't received the sale proceeds. It can improve cash flows, defer taxes, and, in certain instances, reduce the portion of the gain that ends up in government hands. With a quick call to your accountant and a properly structured sale, it's a seller's market.

You Snooze, You Lose—Joint Venture Election

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It is quite common for joint ventures to arrange bare trusts or nominee corporations to hold title to real estate, and act as the operator of the joint venture by collecting, remitting, and filing the GST/HST returns for the joint venture. According to the GST legislation, bare trusts or nominee corporations may not qualify to be the operator to account for GST/HST for the joint venture.

Up until now, the Canada Revenue Agency (CRA) has allowed administrative tolerance and advised their auditors not to assess any GST/HST owing. This tolerance requires confirmation that all returns have been filed, all amounts have been remitted, and the joint venture participants are fully compliant.

This administrative tolerance has been extended until December 31, 2014, and is only granted if the joint venture arranges its affairs to ensure that a participant is the operator of the joint venture on a go-forward basis. This means, if the affairs are not arranged before January 1, 2015, administrative tolerance would not be available before or after December 31, 2014, reporting periods.

This could have major financial ramifications because CRA will not accept any prior filings, and ask that returns be filed under the correct business number. Interest and penalties would be imposed for late filings.

All parties involved in a joint venture or a co-tenancy are required to file individual GST/HST returns based on their proportionate share in the property. The other option is to sign a joint venture election (GST21), which will entitle the operator to file a single return reporting the GST/HST for all parties involved.

If you are part of a co-tenancy or a joint venture, you have to fill out a joint venture election before January 1, 2015, to qualify for the administrative tolerance.

The joint venture election must be filled out by all participants, but is not required to be filed with the CRA (though they may request it at some point).

A joint venture election can only be filed if all the following conditions are met:

- The joint venture is **not** a partnership, corporation, or trust;
- The operator is a participant of the joint venture;
- A written agreement governing the joint venture exists;
- The operator is a GST/HST registrant; and
- The joint venture is for prescribed activity, which includes construction of real property and activities related to the sale or lease of real property.

One of the following conditions must be met to be a joint venture "participant" and be eligible to qualify as the operator for the purpose of this election:

- The person makes an investment by contributing resources and takes a proportionate share of revenue/losses from the joint venture; or
- Where the person has no financial interest, but is responsible for the managerial or operational control of the joint venture.

Unfortunately, no such election exists for bare trusts or nominee corporations, which means they will have to stop acting as an operator of the joint venture and unequivocally be ineligible to collect, remit, and file GST/HST returns.

If the operator of the joint venture is involved in multiple joint ventures, it is recommended that separate books and records be maintained for each joint venture, and that they be opened under different RT000# accounts (GST10 form).

Your advisor can help review your joint venture structures and determine if you qualify for the GST/HST joint venture election.

Rethinking Corporate Capital Gains

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Some investment advisors whom I have dealt with in recent years have praised certain types of investments (corporate class mutual funds for example) for the ability to transfer between investments without triggering capital gains. That seems logical and desirable – why pay tax if you don't have to?

Interestingly, given current capital gains tax rates and dividend rates in many Canadian provinces, that conclusion may not always be the correct one.

For example, assume you wanted to take out $100,000 from your company to pay down your home mortgage. In British Columbia, if you are taxable in the top personal tax bracket (over $150,000), the tax rate payable on ineligible dividends may be as much as 38%, requiring you to pay $161,300 of dividends and pay $61,300 of tax to net $100,000 personally after tax.

If, on the other hand you had assets in your company with accrued capital gains, you might actually be able to distribute $100,000 after tax to yourself at a lower tax cost because of the tax-free capital dividend account created on the realization of a corporate capital gain. For example, if you were a BC resident who owned a company with assets having an accrued capital gain of about $133,000, realizing that capital gain in your company would generate a capital dividend account of $66,500 that could be distributed tax free to the shareholders. The taxable $66,500 of the gain would give rise to corporate tax payable of about $12,500 and personal tax payable (on taxable dividends) of $20,500 for a total tax burden of $33,000 on the taxable portion of the gain to net the same $100,000. So, triggering corporate taxes on capital gains actually makes sense in that scenario.

Your DFK advisor can provide further details on whether this planning opportunity may apply in your specific situation.