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COMMENT

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Tax-Zone Planning

When developing a financial plan, the associated income tax liability faced on an annual basis should be taken into account. Often, income tax is the one of largest annual expenditures an investor makes. Therefore, it can be valuable to devote attention to managing this expense.

"Tax-efficient investing" has been the topic of many articles. The strategy is to recognize that various types of investment income are taxed differently, and that the after-tax rate of return can be improved significantly by paying attention to the type of income.

Income Type	Income Inclusion	Top Effective Marginal Tax Rate for 2011
Interest income	100% included as income in the year as earned	39% to 50%
Dividend income	Subject to dividend gross up and dividend tax credit as dividends paid	17.72% to 31.85% for eligible dividends) 27.71% to 41.17% for ineligible dividends
Capital gains	50% included in income, but only as realized	19.5% to 25%

Another equally important factor in managing an investor's tax liability is to watch the tax brackets. By rearranging the type of income received, overall taxable income can be lowered. This may be somewhat difficult during an individual's working years, but it may be more easily achieved during retirement.

The first set of tax brackets to be aware of are the basic federal tax brackets (2011 taxation year):

Bottom of the bracket		Top ofthe bracket	Tax Rate
	Up to	$41,544	15.00%
$41,544	To	$83,088	22.00%
$83,088	To	$128,800	26.00%
$128,800	And over		29.00%

The province of residence will have its own set of tax brackets, which are generally very close to the federal tax brackets.

For retirees, there are other tax bracket impacts to observe:

- Individuals aged 65 or over in the year are entitled to the "age amount" personal tax credit of $6,537, which will reduce the individual's federal tax liability by $980.55 (i.e., 15% of $6,537). However, this personal tax credit is reduced by 15% of the amount of net income in excess of $32,961. The entire age amount tax credit will be completely eroded at a net income level of $76,541. Net income refers to the amount reported on line 236 of the T1 income tax return.

- Old age security is a benefit paid to all Canadians aged 65 or older based on residency requirements. However, the benefit is "clawed back" if net income exceeds $67,668. The clawback is 15% of income in excess of $67,688. Assuming an Old Age Security monthly amount of $533.70, the benefit is fully clawed back at an income level of $110,038.

These two examples (one of benefit reduction and one of benefit clawback) can increase the effective tax rate by as much as 30% for retirees when their income crosses critical thresholds.

Investors can somewhat control their tax brackets through several strategies:

- **Controlling the type of investments** can determine the how the related investment income is taxed. Interest income is taxed 100% as ordinary income. By contrast, only 50% of a return based on capital gains is subject to tax.

- **Systematic withdrawal programs** tend to maximize the cost base allocated to early withdrawals such that cash flow is high and

taxable income is low in the early years of such investments – at the cost of having higher taxable income in later years, without a corresponding increase in cash flow. Care needs to be exercised to project these consequences into the future in order to see the long-term impact.

- **Using prescribed treatment on non-registered annuities** keeps cash flow high and taxable income low, since the taxable portion of the payments is levelized over the expected life of the annuity.
- **Pension splitting** is available for eligible pension income. The strategy is to move taxable pension income from one spouse to the other, with the objective of lowering the overall tax liability of the couple. This is critical if one spouse has crossed one of the bracket thresholds and the other has not, or is far in excess of the thresholds.

Financial planning is an enormously important exercise. It helps couples determine if they have enough to live on, and to make these limited resources go as far as possible. Arranging investments so as maximize the after-tax return is one important aspect of this planning.

I/R 7401.00, 4000.14

Principal Residence

The family home is one of the very few potentially tax-free investments available to Canadians. This is achieved through the "principal residence exemption" (PRE), a valuable provision in the Canadian income tax system that ensures that the sale of the family home, plus a reasonable amount of the land on which it stands, does not generally create a tax liability.

While the concept of the principal residence exemption is simple, there are many rules in the Income Tax Act designed to ensure that the basic concept is not abused.

There can only be one principal residence per family unit at any given time, at least since 1981. A family is generally defined as the spouses (or common-law partners) plus their minor children. Each spouse can claim his or her own PRE in respect of separate properties, for periods of ownership prior to 1982.

Almost any type of housing unit can qualify as a principal residence. The general definition is any property that is ordinarily inhabited by the taxpayer, such as a house, cottage, condominium unit, trailer, house boat or mobile home. The period of occupancy can be quite short, such as a summer vacation home that the family visits for a few weeks each summer. The PRE shelters a capital gain from taxation but only on one property in any year. As such, it often makes sense to claim the exemption against the "home" with the biggest gain.

Contrary to popular belief, the disposition of the family home is a reportable transaction and could generate a capital gain. Fifty percent of the capital gain is reportable as a taxable capital gain on the individual's tax return. However, claiming the PRE can offset part or all of the capital gain, to reduce or eliminate any income tax on the sale. As taxpayers are sometimes under the impression that the gain on the sale of their home is simply a non-taxable item, many do not file the appropriate forms with their tax returns.

The appropriate form should be filed with the tax return in the year the family home is sold. The Canada Revenue Agency (CRA) takes the administrative position that if the forms are not filed, the taxpayer is considered to have designated the property as the principal residence and to have elected to claim the principal residence exemption for that property for the years it was owned. This may create issues when the family has more than one home that potentially qualifies as the principal residence during any taxation year. A presumed election on the sale of one home precludes the ability to elect, for those same years, on the other home, which could create a larger tax liability if that second home had a larger capital gain accrued over the years in question. Any time a family owns more than one property that could be classified as a principal residence, such as a home and cottage, the tax implications should be examined when the first property is disposed of.

The capital gain that is reportable on the sale of a principal residence is determined by the following formula:

A - (A x B/C) - D
where:

A is the amount of capital gain otherwise determined

B is the number of years the property is declared as the principal residence, plus 1

C is the number of years of ownership (after 1971)

D is a factor to pick up any 1994 capital gains exemption election claimed in respect of the property

Consider the example where Emily and John Summer

have recently retired and decided to sell their family home in the city and move to the cottage for their retirement years. The Summer family has vacationed at the cottage every summer without exception. This means that both properties could quality for the principal residence exemption for the years that they have been owned; however, only one of those properties can be claimed in respect of any given year.

	Home	**Cottage**
Purchased	1985 for $125,000	1995 for $75,000
Today – 2011 – fair market value	$233,000	$245,000
Accrued capital gain	$108,000	$170,000
Years of ownership	27 yrs	17 yrs
Gain per year	4,000	10,000

Since the city home is being sold in 2011, the Summers should make a conscious decision as to whether to claim the PRE on the city home or preserve the election for when they sell the cottage. If they each contributed equally to the purchase of the home, the $108,000 capital gain on the city home could be split between them; each would have to report a taxable capital gain of $27,000, which could attract income tax of about $12,160 each, or $24,320 in total (assuming a 45% tax rate).

An alternative would be to avoid the tax currently by electing 26 years (1985 to 2010 inclusive) under "B" in the formula. When they eventually sell the cottage, they can claim PRE under the formula for the years from 2011 to the year they sell.

Another alternative would be claiming the PRE for the years 1985 to 1994, and paying tax on the gain for the years 1995 to 2011. That would preserve the higher exemption for the full years of cottage ownership.

Emily and John may decide that it is better to claim the exemption on the city home and preserve capital today for their retirement. They or their estates can settle the income tax liability associated with the cottage at the time of its disposition.

One of the contentious issues in the definition of principal residence is the amount of land eligible to be counted as part of the principal residence. The definition in the Income Tax Act includes "immediately contiguous land as can reasonably be regarded as contributing to the use and enjoyment" of the home, except where "that portion exceeds ½ hectare, the excess shall be deemed not to have contributed to the use and enjoyment". This means that if the land exceeds ½ hectare, the taxpayer will have to prove that all of the land is required for his or her use and enjoyment, in order to claim the PRE on the disposition of that "excess" land. A half hectare is 5,000 square meters or about 1.24 acres.

The CRA sets out its administrative position with respect to principal residences in an Interpretation Bulletin IT120R6 – Principal Residence. This Bulletin deals with issues such as how the area in excess of ½ hectare could qualify as a principal residence. As well, it addresses homes outside of Canada that may qualify as the taxpayer's principal residence. However, the foreign tax exposure and the foreign tax credits would have to be carefully reviewed in order to determine whether the principal residence exemption would be of value to the taxpayer.

Lastly, it should be noted that any losses realized on the sale of the family home are never tax-deductible because it is considered personal-use property.

The tax-free accumulation of value within the family home is an important financial component of many wealth accumulation and wealth transfer plans. However, it is important to keep the detailed rules in mind in order to ensure that tax is minimized wherever possible. And considering the long time frame involved, the importance of keeping records of all capital costs cannot be overemphasized.

I/R 7401.011

Testamentary Trusts

There are many reasons why individuals might choose to establish testamentary trusts in their wills.

Sometimes an intended beneficiary cannot manage money or is a spendthrift. In such cases, it would be better for the inheritance to be held by a trustee who can distribute a periodic allowance to the beneficiary, or perhaps manage the investments. In such a situation, the trustee could be instructed to pay living expenses on behalf of the beneficiary, and maybe pay out an income amount to the beneficiary for other needs or invest the funds based on the instructions of the testator.

Sometimes the testator wishes to provide for the varying needs of different beneficiaries, such as a surviving spouse who requires income and children who will eventually receive capital. In such a situation, the trust could be designed to pay income to the surviving spouse for his or her lifetime and to distribute the capital to the children after the survivor passes away. This type of arrangement may be important if the individual is in a second marriage and wants to protect the inheritance of the children

from the first marriage. Second (and possibly third) marriage situations create divergent needs and the issues become more acute.

Meeting the needs and wishes of the testator is always an over-arching priority. In addition to being a creative tool to satisfy the unique objectives of the testator, a testamentary trust can often provide tax planning opportunities for the surviving beneficiaries.

Since a testamentary trust is a taxpayer separate from the beneficiaries, it can file its own tax return. A testamentary trust has the same graduated marginal tax rates as an individual (but no personal exemptions). This is significantly different from an inter vivos trust (i.e., a trust created by a living settlor), where the trust pays tax on all its taxable income at the top marginal tax rate in effect for its province of residence. For income tax purposes, the after-tax income accumulating in a trust is effectively capitalized. This prevents double taxation of such income at the time of its eventual distribution.

The potential tax savings between an inter vivos and a testamentary trust could be as much as $14,000 per year depending on the province of residence and the amount of the beneficiary's other income. This means that by using a testamentary trust, a testator can create the opportunity for income splitting for the surviving family.

The testator could establish a testamentary trust for the surviving spouse and one for each of the children. To the extent the surviving family leaves the capital in the testamentary trusts and earns investment income, they will be able to income split and reduce their overall income tax liability. The strategy would be to have the testamentary trust declare the income in the trust and distribute the after-tax income to the beneficiary. Note too that if the beneficiaries aren't in the top marginal tax bracket, it may be beneficial to allocate before-tax income to them, so that they can use their own exemptions and lower marginal tax rates.

Another strategy is to leave the adult child's inheritance in a testamentary trust naming the adult child, the child's spouse and the child's children as discretionary income beneficiaries. In this fashion, the surviving adult child could leave some income in the trust and "sprinkle" the income amongst his or her family based on their needs. The overall tax savings could be as much as $14,000 per beneficiary.

Sometimes individuals as well as beneficiaries do not like the idea of leaving an inheritance in a trust because it feels like the testator is controlling from the grave. If this is a concern, the testamentary trust could be designed with encroachment powers such that the beneficiary would have access to capital (subject to the trustee's discretion).

Tax planning with testamentary trusts can be complex. Because of the potential for tax savings, in theory it makes sense to set up the greatest number of trusts for the surviving family. It is important to recognize, though, that trusts can be very costly to set up and administer, and the tax savings must be weighed against those costs. Additionally there are numerous tax rules that must be monitored over long periods of time – for example, the "21-year deemed disposition rules" must be kept in mind and planned for by the trustees for over two decades.

Additionally, because of the potential for tax leakage, the Income Tax Act contains a special rule that gives the CRA a discretionary right to group trusts together and tax them as one. In order to exercise such discretion, generally the CRA must prove that substantially all of the property of the various trusts came from the same person and the income of the trusts accrues to the same beneficiary or class of beneficiaries.

Trusts can play an important part in estate planning. As a strategic tool that can accomplish the testator's objectives, care must be exercised to ensure that the tax tail does not wag the dog. While there is a significant opportunity to create a situation where the beneficiaries can save a tremendous amount of tax, the testator's objectives must come first.

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