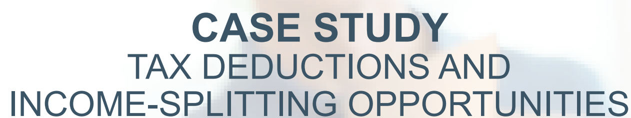

CASE STUDY
TAX DEDUCTIONS AND INCOME-SPLITTING OPPORTUNITIES

KNOWLEDGE EXPECTED OF: Both FPSC Level 1® Certificants and CFP® Professionals

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Peter and Diane bought their home in Atlantic Canada 10 years ago for $230,000. On July 1, they moved to Western Canada with their children, Ashleigh and Jason, so that Diane could take a new job that included a $50,000 increase to her existing $100,000 salary. Coincidentally, Diane's new job enabled the couple to be closer to Ashleigh, age 18, who will be attending university in Western Canada full-time in September.

The couple sold their home in Atlantic Canada for $315,000 on June 30, incurring realtor fees of $12,600 and legal expenses of $4,400. Diane's employer agreed to reimburse her $10,000 for moving expenses. The couple have also sold their cottage in Atlantic Canada. They purchased the cottage for $100,000 five years ago and they received net proceeds of $300,000 from the sale. The proceeds from both properties were used to purchase their new home in Western Canada and top up their emergency savings account. They now have $2,500 per month in surplus cash flow which they can apply toward their goals.

Upon leaving her previous employer, Diane sold shares held in her employee share plan. The shares were sold for $100,000 and had an adjusted cost base of $60,000. Diane would like advice on how she might use these funds to save for retirement. Diane and Peter have personal Registered Retirement Savings Plans (RRSPs) valued at $90,000 and $25,000, respectively. Diane also has $60,000 in unused RRSP contribution room. Both of them expect their incomes to be lower in retirement, although Diane expects to have a higher marginal tax rate than Peter. If the couple can contribute $20,000 per year to their RRSPs, they will be able to meet their retirement goals.

Prior to the move, Peter had been a stay-at-home father. He has recently established a painting business as a sole proprietor. This year, he expects gross revenues of $35,000 and operating expenses of $15,000. Peter is currently using one of the rooms in the house as an office, and a portion of the basement and garage for storage. As a new small business owner, Peter wants to know what he may be eligible to deduct from his business income. His average personal income tax rate is expected to be 12 percent.

The couple would like their children to have some responsibility for funding their education. Peter and Diane will fund $5,000 of Ashleigh's total tuition fees, in each of the next four years, from surplus cash flows. They would like to begin saving for the four-year, post-secondary education of their son Jason, who is nine. They will have to save $300 per month to achieve this goal.

Knowledge Expectations – Tax Deductions and Income Splitting

The FPSC Level 1 Certificant in Financial Planning and CFP Professional should be able to:

- Explain that, for tax purposes, Peter and Diane are considered residents of Western Canada. All income that the couple earns, or receives, during the calendar year will be subject to the tax rates and rules of the Western province, given that they will be residents there on December 31.

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- Explain that, as a sole proprietor, Peter will be responsible for remitting income taxes on his net business income. He will also be responsible for the employer and employee portions of contributions to the Canada Pension Plan (CPP). The employee portion may qualify for a non-refundable tax credit, while the employer portion may be deducted from his business income. Peter should confirm this with his tax specialist.

- Direct Peter to the Service Canada website to learn more about his contribution obligations, including the amounts required and the process for making contributions. Identify that, as a business owner, he may find other valuable information on the site, such as instructions for business planning and tips on applying for grants and financing.

- Explain that, as a sole proprietor, Peter may choose to make contributions toward Employment Insurance provided by the federal government. Doing so may enable him to claim benefits if Peter or a family member becomes ill, which would cause Peter to be away from work for a period of time. Direct Peter to the Service Canada website to learn more about his options.

- Explain that it would be prudent for Peter to set aside funds to cover his expected income tax, CPP and Employment Insurance obligations. Estimate that he should set aside $1,980 for CPP contributions,[1] $376 for Employment Insurance premiums[2] and $2,400 for taxes.

- Explain that Peter may be able to claim deductions related to his home office and storage space, as well as capital cost allowance, related to his use of the couple's principal residence for business purposes. Doing so may enable him to reduce his net income and save money by paying lower taxes. However, Peter should be aware that claiming capital cost allowance on his home may jeopardize his ability to claim the principal residence exemption in the future. He should seek the counsel of his tax specialist to make sure that future costs of claiming the capital cost allowance do not outweigh current benefits.

- Identify that, since Peter is now earning income, Diane's ability to claim tax credits for him may be affected. For example, her opportunity to claim the spouse amount is likely to be eliminated, given Peter's expected net income.

- Explain that Diane may consider making a lump-sum contribution to a spousal RRSP in Peter's name. Contributing to a spousal RRSP will enable the couple to split their income effectively since the higher earning spouse, Diane, will benefit from the tax deduction this year at her higher tax rate. The lower earning spouse, Peter, will not be required to pay the taxes owing until he withdraws the funds at his expected lower tax rate. The couple may expect to benefit from greater after-tax income in retirement using this strategy. Explain that should Peter withdraw funds from the spousal RRSP in the contribution year, or two years following the contribution year, the income will be attributed back to Diane and taxed at her higher marginal tax rate.

- Explain that Diane may consider contributing up to $60,000 to a spousal RRSP for Peter. In doing so, she will make full use of her unused RRSP contribution room, and help equalize their income streams in retirement.

- Explain that Diane should consult with her tax specialist to identify the optimal strategy for claiming RRSP tax deductions over time.

- Explain that Diane and Peter should use $20,000 of their annual surplus cash flow in future years to contribute to their RRSPs. This should enable them to meet their retirement goals. Peter should decide whether to continue his contributions to a spousal RRSP after assessing both plans' values, and the couple's current and estimated marginal tax rates in retirement.

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[1] 9.9 percent of net income estimated at $20,000.

[2] 1.88 percent of net income estimated at 20,000.

- Explain to Diane and Peter that they need to contribute only $300 per month over the next nine years to fund Jason's education costs. However, they may consider contributing $5,000 per year (via periodic payments) to a Registered Education Savings Plan (RESP) for each of the next seven years instead. This way, the couple will benefit from tax-deferred growth on the funds held in the RESP until Jason needs them. When funds are withdrawn from the RESP as an education assistance payment (EAP), the income portion of the EAP will be taxed at a lower rate under Jason's name, compared to the rates applicable to Peter and Diane. In addition, contributions made to an RESP will attract Canada Education Savings Grants (CESGs), which is additional income that may be withdrawn as part of an EAP. By contributing $5,000 per year for the next seven years and $1,000 in the eighth year, the couple may maximize the grant they receive from the Government of Canada. Doing so will result in fewer funds used toward Jason's educational costs.

- Explain that saving $5,000 per year for the next seven years will result in a surplus in the RESP. The surplus can be used by Jason if he decides to take additional qualifying education programs. Capital amounts contributed totaling $35,000 ($5,000 multiplied by seven years) can be withdrawn from the RESP at any time with no income tax implications. If Jason chooses not to pursue further education, up to $50,000 of the earnings on the contributions can be transferred, tax-deferred, to Diane or Peter's RRSP if they have RRSP contribution room available. CESG amounts would be clawed back. Alternatively, Diane and Peter may choose to withdraw from the RESP, and pay an additional 20 percent surtax on any of the earnings made on their contributions.

- Explain that Diane and Peter may consider contributing the remaining $35,000 from the sale of Diane's shares to a Tax-Free Savings Account (TFSA) to benefit from tax-free growth in the account. The couple may contribute up to $46,500 (as of January 1, 2016) to TFSAs in their individual names. They will also be permitted to make further contributions each year, as set by the Federal Government of Canada. They can save, invest and withdraw funds tax-free, compared to making a non-registered investment where growth and earnings from investments is taxable.

- Explain that in four years, when Ashleigh graduates, the couple may have an additional $5,000 in surplus cash flow. At that time, the couple may further increase their savings in their TFSAs (up to the maximums allowed).

- Explain that Diane will have a capital gain of $40,000[105] this year from the sale of her employee shares. According to the Income Tax Act, she will include one half of the amount of realized gain, in this case $20,000, as part of her income.

- Explain that the couple can claim a principal residence exemption on any property in which they lived during any part of the year; however, they can claim only one principal residence between them for each year. Since they had two properties, they can decide which property to claim under the principal exemption, and for how many years. They should seek guidance from their tax specialist to identify the optimal approach to reducing the tax impact from selling both properties this year, including taking advantage of the principal residence exemption. Encourage Peter and Diane to seek help from their tax specialist, sooner than later, since they must make the claim for the principal residence exemption on this year's tax returns.

- Explain that the moving expenses of $10,000 for which Diane's employer reimbursed her are not eligible for a tax deduction. However, the $17,000[4] realtor and legal expenses relating to the sale of their Atlantic Canada home may be eligible. While Diane should probably be the one claiming the expenses because of her higher income, the couple should meet with their tax specialist to evaluate the optimal strategy for claiming these expenses.

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[3] $100,000 - $60,000 = $40,000
[4] $12,600 + $4,400 = $17,000

- Explain that Ashleigh may be able to transfer up to $5,000 of her tuition, education and textbook costs to either of her parents this year, depending on her net income. She may transfer $5,000 minus the amount required to bring her federal taxes payable to $0. Doing so could earn Diane or Peter a tax credit of $750.[5]

- Identify that, although Ashleigh is not required to file a tax return, she should file it to benefit from tax credits, and the opportunity to carry forward any unused tuition, education and textbook credits not transferred to her parents.

[5] The 15 percent non-refundable federal tax credit rate on $5,000 equals $750.

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