
COMMON-LAW PARTNERS

The federal Income Tax Act has been amended to provide common-law partners with all of the same tax benefits long enjoyed by married couples. A common-law partner is defined by the Income Tax Act as a person who cohabits with another individual in a conjugal relationship and who either (a) has so cohabited for a continuous period of one year or (b) has a child together with the other individual (naturally or adopted).

However, along with the many tax benefits enjoyed by a couple, there are a few tax disadvantages. For example, there are a number of income tax credits that use the combined net income of a couple in the determination of eligibility for the particular benefit, or the income of the other partner.

For many years, commentators wondered how the Canada Revenue Agency (CRA) would determine whether a couple was involved in a common-law relationship or simply cohabiting without meeting the common-law definition.

In a recent case, the CRA reassessed an individual and denied his claims for the Canada child tax benefit (CCTB) and the goods and services tax credit (GSTC). In making a claim for CCTB and GSTC,

the individual claimed that he was not married and not a party to a common-law relationship. (Eligibility for the CCTB and GSTC utilizes the combined net income of the taxpayer and the taxpayer's spouse or common-law partner.)

The taxpayer appealed the CRA's reassessment to the Tax Court of Canada. In denying the taxpayer's appeal, the court decided that the two individuals involved were a common-law couple and not co-tenants. In making his determination, the judge relied on several facts present in the situation. For ease of reference, the taxpayer is referred to as "A" and the other individual is referred to as "B."

- A deposited his pay cheques into B's bank account.
- B took charge of all of A's financial affairs.
- A contributed to the cost of maintaining B's home.
- B prepared A's meals.

While each case must be decided based on the facts of the situation, the Tax Court has now set out some of the facts that will be considered and the type of facts that lead to a conclusion of a common-law relationship versus one of co-tenancy.

It should also be noted that former common-law partners will fail to meet the definition of common-law partners if they are apart for 90 days as a result of a breakdown in their conjugal relationship. This is vastly different than the standard applied to married couples who have to complete a divorce before they are considered to be single again (although

some tax rules will specifically apply to spouses who are living apart and who have a written separation agreement).

This case highlights the fact that, while taxpayers have the right to structure their affairs to minimize their income tax liability, they cannot ignore their own specific facts and circumstances and simply file based on the best result.

I/R 7401.00, 2500.19

LIPSON AND GAAR

The Supreme Court of Canada recently handed down two rulings in respect of the general anti-avoidance rules (GAAR) and decisions by the lower courts are reflecting the precedent set by the Supreme Court. In the April 2006 decision in *Lipson et al. v. The Queen*, the Tax Court of Canada found in favour of the government and denied the taxpayer the tax results strategized by his planners.

Mr. Lipson owned all the shares of a private company. He and Mrs. Lipson agreed to purchase a home for \$750,000 in April 1994. The Lipsons structured the home purchase as follows:

1. Mrs. Lipson borrowed \$560,000 from a bank;
2. Mrs. Lipson bought \$560,000 worth of shares from Mr. Lipson;
3. Mr. Lipson forwarded the \$560,000 to his lawyer's trust account as payment towards the purchase of their home; and
4. upon taking possession of the home, the Lipsons mortgaged the property for \$560,000 and repaid Mrs. Lipson's bank loan.

This transaction is not very different from the well-known Singleton case that was decided in the taxpayer's favour by the Supreme Court. The facts in Singleton were that a lawyer drew capital from his firm to buy his home and later borrowed money to replace his firm's capital. It should be noted that the Crown did not use GAAR in its assessment of the taxpayer in Singleton.

However, the precedents established by recent decisions of the Supreme Court of Canada are now being applied by the tax courts and have resulted in differing outcomes.

To improve the tax results of this refinancing transaction, Mr. Lipson chose NOT to elect out of the spousal rollover rules on the sale of shares from Mr. Lipson to Mrs. Lipson. This means that the rollover rules applied and the transaction was deemed to take place at Mr. Lipson's tax cost. In addition, the spousal attribution rules would apply such that any income or loss realized by Mrs. Lipson would be attributed back to Mr. Lipson. Under this structure, the interest expense incurred by Mrs. Lipson on the "investment" loan would be attributed back to Mr. Lipson.

The CRA assessed Mr. Lipson and denied the interest expense deduction. Both the CRA and the Lipsons agreed that the transaction was a tax avoidance transaction. However, the CRA and Mr. Lipson did not agree as to whether the transaction was an abuse or misuse of the Income Tax Act.

For a GAAR assessment to be successful, the Crown must prove two criteria:

- that the transaction is an avoidance transaction; and
- the transaction is an abuse or misuse of the Act.

In determining the above two criteria, the Supreme Court used a two-step process. Firstly, one must determine the

object, spirit or purpose of the provision in question through textual, contextual and purposive analysis. Secondly, one must examine the factual context to determine whether the avoidance transaction defeated or frustrated the object, spirit or purpose of the provisions.

The taxpayer was unable to cite any evidence of a commercial purpose for the transactions, with the court concluding that the only incentive was tax avoidance. Therefore the transactions were considered an abuse of the tax system and fell within

the GAAR net. The result of this case is that the Tax Court of Canada has taken the position that GAAR applies to refinancing situations that are similar in circumstance to the Singleton case. Note that in May 2006, an appeal was filed.

One must always be mindful of GAAR when structuring a strategy that involves taxes. While GAAR cannot be used to deny all tax plans, it is important to consider these rules before finalizing any strategy.

I/R 2121.00

RETIREMENT PLANNING

Retirement planning can become a serious preoccupation for many individuals, especially as they pass age 50 and some of the family expenses begin to diminish (e.g., childcare, education expenses, etc.). Often at this time in life, individuals become aware that retirement is just around the corner. It should be noted that while many individuals start retirement planning early, those who seriously save early are in the minority.

The most important aspect of retirement planning, no matter when the planning actually starts, is to ensure adequate lifelong income. The fallacy of most retirement plans is to maximize contributions to registered retirement savings plans (RRSPs) without any consideration of the tax cost that could be created at retirement or the value of having a non-registered “cushion.” This issue was raised in a recent article published by Statistics Canada.

The Statistics Canada article pointed out that the income generated by the conversion of RRSPs into income can carry a high marginal tax cost. The issue is that the additional income withdrawn from an RRSP (up to age 69), a registered annuity or a registered retirement income fund (RRIF) can reduce some valuable tax preferences granted under the Income Tax Act. The following are important tax credits that are affected by net income and therefore

are directly impacted by a net income increase related to income derived from an individual’s registered savings plans.

- The age tax credit is reduced at the rate of 15 cents for every dollar of net income in excess of \$30,270 (2006 amount).
- The old age security benefit is “clawed back” at the rate of 15 cents for every dollar of net income in excess of \$62,144 (2006 amount).
- The GST credit is based on the net incomes of both spouses or common-law partners. The credit begins to phase out once family income exceeds \$30,270 and will be eliminated where that income exceeds \$39,550.
- Provincial credits may also be affected.

For some individuals, the reduction in these credits can produce a higher marginal tax rate during retirement than the tax rate in effect when the funds were contributed to the registered plan. While this is not always the case, it is a concern for some. (Note, however, that due to the deferral of taxation of investment income in registered plans, the after-tax income can be higher compared to unregistered investments even if the tax rate on the retirement income is higher than the tax rate applicable to the contributions.) Caution should be exercised when undertaking financial projections to ensure that the loss of potential tax credits/savings

is reflected when retirement income exceeds pre-determined thresholds and, for couples, it is important to maximize their combined after-tax income.

On the other hand, individuals do have the ability to adjust retirement income on an annual basis (subject, of course, to required minimum RRIF payments). The key is to carefully manage the annual withdrawal amount or any additional lump sum withdrawals to minimize the actual tax cost of the income. For example, if an additional \$5,000 is required in a particular year, it is important to understand the additional tax cost that may result from not only the additional income but also the loss of potential tax credits when income thresholds are exceeded.

Individuals with annual earnings above these clawback ranges (from employment, investments, company pensions and Canada/Quebec Pension Plans) will only be taxed at their marginal income tax rate on additional earnings from individual registered plans.

An individual can save towards retirement with RRSPPs, company pension plans or non-registered portfolios (owned personally or in a holding company). The two primary advantages of registered

savings are the tax deduction for the contribution and no annual taxation during the accumulation period. With the tax incentive of deductible contributions and tax-deferred accumulation, registered vehicles can often accumulate more capital than non-registered portfolios.

However, registered vehicles are not without some disadvantages. One of the primary advantages of a non-registered portfolio over registered savings is that the investment income retains its character for tax purposes and could be taxed more preferentially than ordinary income (for example, as a dividend or capital gain). Another advantage is that an individual is not forced to begin to liquidate a non-registered portfolio at age 69. Even though a non-registered portfolio could generate taxable income on an annual basis, some of the income can be timed to minimize the current tax liability.

Planning for retirement income should not simply be a linear event, but instead incorporate a series of strategies that allow for optimization of after-tax income over the longer term. The creation of multiple pools of capital, some registered and some not, allows for flexibility to maximize the after-tax income available at the point of retirement and beyond.

I/R 6401.00

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Contributors to this issue of Comment:

James W. Kraft, CA, MTax, TEP, CFP, CLU, CH.F.C.
Deborah Kraft, MTax, TEP, CFP, CLU, CH.F.C.

Published by:

CLU Institute
350 Bloor Street East, 2nd Floor,
Toronto, Ontario M4W 3W8
T: 416.444.5251 or 1.800.563.5822
F: 416.444.8031

www.cluinstitute.ca • info@cluinstitute.ca

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Publication Agreement # 40069004