TAX*talk*

STRESS AND TAXES

by Evelyn Jacks

Taxpayers are often called upon to make significant long-term decisions about large amounts of money during the most stressful times in their lives. It is not unusual, for example, for people to acquire or deal with significant sums upon:

- The death of a loved one, which can result in life insurance payments and other asset transfers;
- Prolonged disability, which can result in the receipt of lump-sum disability payments;
- Early retirement or job termination, which can generate significant severance packages;
- Emigration, which can trigger asset liquidation and departure taxes;
- Separation or divorce, which can prompt the sale of personal residences and other assets;
- Moves to a new city, which may prompt the sale of a family cottage as well as the principal residence;
- The landing of a new job, which may bring with it a signing bonus.

Other one-time windfalls, such as unexpected market gains, inheritances or the sizable recovery of tax overpayments from prior years, can deliver joy – or family discord or stress-related indecision. Many people may be overwhelmed or paralyzed at these times. Financial advisors can help by providing both perspective and experience to guide the "financially terrorized" back to the road to personal and financial success.

It is important to think about the tax consequences and to revisit key tax-planning strategies in making these decisions. Here are some things to remember to get the most from the tax department at times of significant change:

1. Review eligibility for refundable tax credits. The tax system is the first place to turn for relief when incomes fluctuate or personal circumstances change. It is possible, for example, to enhance the monthly income of families with children through the Canada Child Tax Benefit. This is not something a high-income earner would think of, as he or she may not have qualified for the credits in the past.

2. Invest a severance wisely. Those changing jobs should prepare "what if" scenarios for the investment of severance packages. How much can be transferred on a tax-free basis to RRSPs, how much should be taken as taxable income in a particular taxation year, and can any of the money be deferred to the next? Taxpayers will want to maximize RRSP contribution room and plan taxable withdrawals carefully, all the while managing non-deductible debt and preserving capital.

3. Use your losses. When a taxpayer dies, or assets are otherwise transferred or disposed of, it is important to properly utilize capital loss balances from prior years. Be sure the taxpayer has reported all capital losses of prior years (an adjustment request can be made for the previous 10-year period if this was missed). Remember, capital losses can be used to offset capital gains of the current year, the previous three years or indefinitely into the future.

4. Maximize new tax preferences. Identify new tax deductions, refundable and non-refundable tax credits you may be entitled to after a life-cycle change. This year, consider tax changes surrounding the claiming of medical expenses for your adult dependants, for example, as well as the latest RRSP contribution maximums and educational savings plan contribution limits for children or grandchildren. Caregiver credits may also be available when disabled parents move in to live with their adult children.

5. Manage your RRSP. Do you really need to withdraw taxable money to get through the current financial hurdle? Can you avoid generating a taxable withdrawal? If there are no other options, consider withdrawing in the hands of the lowest-income earner in the family first. If you have received a lump-sum payment, concentrate on topping up unused RRSP contribution room first, then plan orderly and systematic taxable withdrawals to take you through the temporary period of difficulty. Rebalance your portfolio according to your new risk tolerance level and objectives. Also, consider why you need the money. With the Lifelong Learning Plan or Home Buyers Plan, it may be possible to make a *tax-free* withdrawal from your RRSP.

6. RRSP withdrawals may be the right option. Those who are elderly or confronted with a terminal illness or other life-shortening event may need to consider their asset

continued on next page

accumulations in a completely different way. If income in the future or upon death will be taxed in a higher bracket and at higher rates than today, consider making taxable withdrawals now. Then reinvest the money in tax-efficient, non-registered investment vehicles.

7. Use your business start-up to generate cash flow. If you recently started a new business, consider claiming your start-up losses within a proprietorship rather than a corporation. Non-capital losses can be used to offset all other income of the year. Should there be excess losses, these can be applied back to all other income of the prior three years or for up to 10 years in the future. This can be particularly lucrative if you earned a high income in those previous years (or will again in the future).

8. Take advantage of reduced fair market values. Are the market values of your assets lower than they will be in the future? This may be a good time for intergenerational transfers or emigration – events that are usually based on the deemed disposition of taxable assets. Consider whether this is the time to transfer the family cottage or other assets to adult family members for the most advantageous tax result. Low fair market values, coupled with the ability to offset gains on the transfer with capital losses otherwise incurred this year or in prior years, can make tax sense.

9. Claim interest costs and losses stemming from business failure. Capital losses can be claimed when guarantees are called for investments in now insolvent public or private corporations, when funds loaned are not repaid, and when debts cannot be collected, provided these investments were made with an intent to earn income. Losses on small business corporations qualify for special tax treatment, which can result in a portion of the losses being used to offset other income of the current year, the three prior years or 10 years into the future. Furthermore, costs of borrowing money to invest in companies that have now lost significant value will continue to be possible; as CRA deems the original value to be the base of that deduction.

10. Review quarterly tax instalment payment requirements. If your income has declined, be sure to reduce quarterly tax instalments to accurately reflect your true income picture for the current tax year. It is not necessary to follow CRA's billing methodology; use Form T1033 to estimate your correct tax liability.

11. Audit problems? Seek fairness. If a tax audit results in an expensive tax balance due, you may be able to tap into CRA's "Fairness Provisions" to recover errors on prior-filed returns. This can offset your tax bill or bring significant tax windfalls your way. Your tax advisor should scour prior filed returns for such errors or omissions. Remember also that when financial hardship strikes, CRA has some power of leniency. It can accept tax remittances over a period of time, instead of in a lump sum, and even waive penalties and interest if you can show personal hardship like death, illness, disability or other factors beyond your control, as a reason for your tardiness in late filing, for example.

12. Comply voluntarily. There can be significant penalty and interest charges for late tax filings and payments. Don't miss filing your tax return even if you are short of cash. And, if you feel guilty about "aggressive deductions" or under-reporting of income, you can avoid tax evasion or gross negligence with voluntary compliance. Correct your returns before CRA does.

13. Going forward. Remember that it is your legal right and duty to arrange your affairs within the framework of the law so as to pay the least amount of taxes possible.

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