A year-end tax "to do" list (December 2010)

For most Canadians, December means holiday celebrations and school vacations. In the tax world, however, December 31 marks the deadline by which most tax planning and saving strategies must be put in place in order to have an impact on one's tax liability for the 2010 tax year. What follows is a list of tax "to do's" that must be accomplished by the end of the calendar year—and a few more that can wait until sometime in the first quarter of 2011.

Things to be dealt with by December 31, 2010

- *Medical expense credit calculation*

When preparing their tax returns, many taxpayers find the computation of medical expenses eligible for the medical expense tax credit somewhat confusing, and that confusion is understandable. First of all, medical expenses, in order to be claimed, must total more than 3% of the taxpayer's net income for the year, or a specified threshold amount ($2,024 for 2010), whichever is less. As a rule of thumb therefore, for 2010, taxpayers who have an income from all sources of less than $67,465 can claim all qualifying medical expenses in excess of 3% of their net income for the year. For example, a taxpayer earning $45,000 could claim qualifying medical expenses over $1,350 (3% of $45,000). Where the taxpayer's income is over $67,465, only those medical expenses over the $2,024 threshold may be claimed for credit.

Adding to the confusion, it's possible to claim on the 2010 return medical expenses which were paid in 2009. The actual rule is that a taxpayer can claim medical expenses (in excess of the threshold percentage, as outlined above) incurred in any 12-month period ending during the taxation year, assuming, of course, that such expenses were not claimed on a previous tax return. Here there is no easy rule of thumb, except perhaps to say that for tax purposes the best result is obtained where significant medical expenses can be grouped together and paid within a 12-month period, rather than spreading them out, in order to maximize the claim. So, as December 31 approaches, it's a good idea to add up the medical expenses which have been incurred during 2010, as well as those paid during 2009 and not claimed on the 2009 return. Once those totals are known, it will be easier to determine whether to make a claim for 2010 or to wait and claim 2010 expenses on the 2011 return. And, if the decision is to make a claim for calendar year 2010, knowing what medical expenses were paid when will enable the taxpayer to determine the optimal 12-month period for the claim. Finally, it's a good idea to look into the timing of medical expenses which will have to be paid early in 2011. It may make sense to accelerate the payment of those expenses to December 2010, which would allow them to be included in 2010 totals and claimed on the 2010 return.

- *Make charitable donations for 2010*

The federal and all provincial governments provide a two-level tax credit for donations made to registered charities during the year. To earn a credit for the tax year, donations must be made by the end of the calendar year. There is, however, another reason to ensure donations are made by December 31. For federal purposes, the first $200 in donations is eligible for a non-refundable tax credit equal to 15% of the donation. The credit for donations made during the year which exceed the $200 threshold is, however, calculated as 29% of the excess.

As a result of the two-level credit structure, it makes sense to aggregate donations in a single calendar year where possible. A qualifying charitable donation of $400 made in December of 2010 will receive a federal credit of $88 ($200 x 15% + $200 x 29%). If the same amount is donated, but the donation is split equally between December 2010 and January 2011, the total credit claimed is only $60 ($200 x 15% + $200 x 15%), and the 2011 donation can't be claimed until the 2010 return is filed in April of 2012. And, of course, the larger the donation in any one calendar year, the greater the proportion of that donation which will receive credit at the 29% rather than the 15% level.

It's also possible to carry forward for up to five years donations which were made in a particular tax year. So, if donations made in 2010 don't reach the $200 level, it's usually worth holding off on claiming the donation and carrying forward to the next year in which total donations, including carryforwards, are over that threshold. Of course, this also means that donations made but not claimed in any of the 2005, 2006, 2007, 2008, or 2009 tax years can be carried forward and added to the total donations made in 2010, and the aggregate amount claimed on the 2010 tax return.

Finally, when claiming charitable donations, it's possible to combine donations made by oneself and one's spouse and claim them on a single return. Generally, and especially in provinces and territories which impose a high income surtax—Ontario, Prince Edward Island, and the Yukon—it makes sense for the higher-income spouse to make the claim for the total of charitable contributions made by both spouses.

- *Tax-free savings account withdrawals*

Each Canadian aged 18 and over can contribute up to $5,000 per year to a Tax-Free Savings Account (TFSA). Although no deduction from income is permitted for TFSA contributions, no tax is paid on any income earned by contributed amounts. In addition, amounts not contributed in a particular taxation year are carried forward and added to the taxpayer's contribution room for the next year. Finally, where amounts are withdrawn from a plan, the withdrawn amount is added to the taxpayer's TFSA contribution limit for *the following year*.

As many taxpayers learned to their cost during 2010, the withdrawal/recontribution rules are perhaps more complex than they first appear to be. A number of taxpayers withdrew funds from a TFSA in 2009 and then recontributed some or all of those funds before the end of the year. In doing so, some of those taxpayers became liable for a penalty tax on overcontributions for the year. Fortunately for them, the Canada Revenue Agency (CRA) determined that, as 2009 was the first year that the program was in place and taxpayers (and in some cases, it seemed, financial institutions) might have been confused about how the rules would apply, penalty tax would not necessarily be assessed. However, the CRA made it clear that this administrative concession would apply only for the 2009 taxation year and that taxpayers who went “offside” with respect to excess contributions in future years should expect to have the penalty tax provisions applied.

So, to recap the rules: a taxpayer who contributes $5,000 to a TFSA during 2010 but withdraws $2,000 of that contribution during the year will have a $7,000 TFSA contribution limit for 2011 (made up of the usual $5,000 limit for 2011 plus the $2,000 withdrawn the previous year). Consequently, taxpayers who currently have funds in a TFSA but are planning to make a withdrawal in early 2011—perhaps to pay for a winter vacation—should think about making that withdrawal before the end of 2010, so as to preserve the option of replacing the funds in the plan during 2011. If the same taxpayer waits until January of 2011 to make the withdrawal, he or she won’t be eligible to replace the funds until 2012—and doing so during 2011 could result in the assessment of a penalty tax.

- *Spousal RRSP contributions*

Under Canadian tax rules, a taxpayer can make a contribution to a registered retirement savings plan (RRSP) in his or her spouse’s name and claim the deduction for the contribution on his or her own return. When the funds are withdrawn by the spouse, the amounts are taxed as the spouse’s income, at a presumably lower tax rate. However, the benefit of having withdrawals from a spousal RRSP taxed in the hands of the spouse is available only where the withdrawal takes place no sooner than the end of the second calendar year following the year the contribution is made. Therefore, where a contribution to a spousal RRSP is made in December of 2010, the spouse can withdraw that amount as of January 1, 2013 and have it taxed in his or her hands. If the contribution isn’t made until January or February of 2011, the contributor can still claim a deduction for it on the 2010 tax return, but the amount won’t be eligible to be taxed in the spouse’s hands on withdrawal until January 2014. It’s an especially important consideration for couples approaching retirement who may plan on withdrawing funds in the relatively near future.

- *Take a look at tax instalment amounts*

Millions of Canadian taxpayers (particularly the self-employed and retired Canadians) pay income taxes by quarterly instalments, with the amount of those instalments representing an estimate of the taxpayer’s total tax liability for the year.

The final quarterly instalment will be due on December 15, 2010. By that date, almost everyone will have a reasonably good idea of what his or her income will be for 2010 and so will be in a position to estimate what the tax bill will be for the year. While the tax return forms to be used for the 2010 tax year haven’t yet been released by the CRA, it’s possible to arrive at an estimate by using the 2009 form. Increases in tax credit amounts and tax brackets from 2009 to 2010 will mean that using the 2009 form will result, if anything, in a slight overestimate of tax liability for 2010.

Once one's tax bill for 2010 has been estimated, it's possible to compare that figure with the total of tax instalments already made in 2010 and determine whether the tax instalment to be paid on December 15 can be adjusted downward.

Things that can wait (for a bit)

- *100% deduction for computer and computer software acquisitions*

The 2009 federal budget included an announcement of an enhanced deduction for businesses acquiring computer hardware or systems software. The enhanced deduction was actually structured as a special capital cost allowance class for qualifying acquisitions, which could then be depreciated at a rate of 100% per year. The "half-year" rule which limits any deduction to one half the usual amount in the year of acquisition would also not apply to acquisitions of assets which qualified for this special class. In order to qualify for the deduction, acquisitions had to be acquired after January 27, 2009 and before February 2011. That window is now coming to an end, and in order to take advantage of the 100% deduction, any acquisitions of qualifying assets must be done by the end of January 2011. Note that where the purchase is made in January 2011, the deduction must be taken on the 2011 tax return. In order to take advantage of the deduction for 2010, the purchase needs to be made by the end of this calendar year.

- *RRSP contribution deadline*

Most taxpayers are aware that the deadline for making an RRSP contribution to be claimed on the 2010 tax return falls at the end of February 2011. More precisely, the deadline is 60 days after the end of the calendar year which, in 2011, will be March 1.

Where the March 1 deadline happens to fall on a Sunday, the federal government has typically made an administrative concession by allowing contributions to be made on the next business day of March 2. However, in 2011, March 1 is a Tuesday, so taxpayers should not anticipate receiving any kind of extension with respect to the deadline. To be eligible for deduction on the 2010 return, RRSP contributions will have to be made by midnight Tuesday, March 1, 2011.

Things that can wait until April 2011

- *Pension income splitting*

It's unusual to be able to wait until tax filing time to make a decision on tax-planning strategies for the previous year. However, when it comes to pension income splitting, there's no need to address the issue any sooner.

Splitting pension income can provide significant tax benefits to couples who are able to utilize that strategy. However, the "splitting" of such income is entirely notional—that is, there is no requirement that pension payments actually be made to the spouse who is designated to receive them for tax purposes. Rather, when filing the income tax return in the spring of 2011, a calculation can be made of how pension income can be split between two spouses to create the best tax result, and to file both returns on that basis.