Quarterly Newsletter – Personal – February 2014

Tax Free Income

It's that time of year again when we turn our minds to paying our taxes. We are governed to pay tax on virtually everything we receive during our lifetime by virtue of the Canadian *Income Tax Act*. There are, however, some items of income that escape tax entirely and we will discuss a few of them here. These are distinct from the exemptions and credits that are allowed on some of the more common income items. We will deal only with those items that are exempt from tax by their nature.

Listed here are some of the income items that are not taxed. It is by no means an exhaustive list but it does capture the more common ones.

- Capital element of annuities
- Certain military or civil service pension payments
- Certain proceeds from Life Insurance plans
- Damages for personal injury
- Exempt prizes
- Gifts and inheritances
- Income earned in a Tax Free Savings Account
- Lottery and gambling winnings
- Non-taxable dividends paid by a Canadian corporation
- Payments to foster parents

Capital element of annuities

The capital element of a "mixed annuity payment" is not taxable income. When reported to you on T5 or T4A slips, it is not included in income. Rather, it should be specifically excluded. The capital element represents a payment back to you of the total investment made to purchase the annuity. The capital element of a payment is calculated by the annuity provider. Only the income portion should be included on the T5 or T4A slips. It follows then that the capital portion of certain annuity payments will not qualify as pension income and the pension income deduction.

Certain military or civil service pension payments

Civil and military service pensions, allowances, or compensation under the following Acts or Orders are not subject to tax:

1) *Pension Act* — which provides for pensions payable on the death or disability of members of the armed forces owing to service therein;
2) *Civilian War Pensions and Allowances Act* — which provides for pensions for certain civilians who suffered injury during the Second World War;
3) *War Veterans Allowance Act* — which provides for pensions for certain veterans and their widows, widowers, and orphans;

4) *Gallantry Gratuities and Annuities Order* — which provides awards to members of Canadian Forces for conspicuous and distinguished service during war;
5) *Aeronautics Act* — which provides for pensions on the death or disability of a person resulting from an unscheduled flight undertaken in the course of public duty;
6) *War service* — pensions on account of disability or death arising out of a war received from another country if allied with Canada at the time of the war and similar relief is accorded by that country;
7) *Per diem ex gratia* — payments made by Veterans Affairs Canada to veterans who were prisoners of the Japanese during the Second World War, or their surviving spouses, or to Canadian airmen who were incarcerated in Buchenwald or their surviving spouses;
8) *RCMP pensions* — or compensation if paid under specified sections of the *Royal Canadian Mounted Police Pension Continuation Act* or the *Royal Canadian Mounted Police Superannuation Act*, in respect of injury, disability, or death.

Certain proceeds from Life Insurance plans

In 1983, amendments to the *Income Tax Act* were introduced which altered the taxation of life insurance policies and annuities. These amendments are generally designed to include in income the actual or accruing income on the savings element of life insurance policies and annuities. However, the mortality gain arising on the death of the insured remains exempt.

There is also no income inclusion in respect of a disposition of the following life insurance policies:

1) A policy that is issued pursuant to a registered pension fund or plan, a registered retirement savings plan, a registered retirement income fund, an income averaging annuity contract, a deferred profit sharing plan, or a tax-free savings account; and

2) an annuity contract that is purchased with the proceeds of a registered retirement savings plan received as a refund of premiums by a surviving spouse or common-law partner over 71 years of age, or by a child that was dependent by virtue of physical or mental infirmity.

Damages for personal injury

Amounts in respect of damages for personal injury or death may be received by an injured taxpayer or by a dependant of a deceased taxpayer on account of special damages (e.g., compensation for out-of-pocket expenses such as medical and hospital expenses, and accrued or future loss of earnings) and general damages. Examples of general damages are compensation for pain and suffering, the loss of amenities of life, the loss of earning capacity, the shortened expectation of life, and the loss of financial support caused by the death of the supporting individual.

All amounts received by a taxpayer or the taxpayer's dependant, as the case may be, that qualify as special or general damages for personal injury or death, will be excluded from income regardless of the fact that the amount of such damages may have been determined with reference to the loss of earnings of the taxpayer in respect of whom the damages were awarded.

Exempt prizes

Prizes recognized by the general public and awarded for meritorious achievement in the arts, sciences, or service to the public are exempt from tax altogether. However, this rule does not apply to any amount that can reasonably be regarded as having been received as compensation for services rendered or to be rendered.

It would appear that this exemption is aimed at high-profile awards such as a Nobel Prize or the Governor General's Literary Award. However, the rule is general and presumably will apply to such things as community service awards provided they cannot be considered compensation for services. Prizes received in the course of or by virtue of employment or business activity will not qualify for the exemption.

Gifts and inheritances

Gifts and inheritances are not taxed under Canadian law provided if it is not a gift of income. If, at any time, you have transferred or assigned to a person with whom you were not dealing at arm's length the right to an amount which would otherwise have been included in your income, the amount transferred must be included in your income (or the income of the recipient depending upon the circumstances) for the year.

Income earned in a Tax Free Savings Account (TFSA)

In 2009, individuals 18 years of age and older acquired $5,000 of TFSA contribution room each calendar year. In 2010, the $5,000 limit was indexed to inflation and the annual additions to contribution room rounded to the nearest $500. In 2013, that contribution room was increased to $5,500 per year.

While contributions to a TFSA are not deductible, income, losses, and gains in respect of investments held within a TFSA, as well as amounts withdrawn, will not be included in computing income for tax purposes or taken into account in determining eligibility for income-tested benefits or credits delivered through the income tax system (e.g., the Canada Child Tax Benefit, the Goods and Services Tax Credit, and the Age Credit). Nor will such amounts be taken into account in determining other benefits that are based on the individual's income level, such as Old Age Security benefits, the Guaranteed Income Supplement, or Employment Insurance benefits.

Because investment income within, and withdrawals from, a TFSA are not taxable, interest on money borrowed to invest in a TFSA is also not deductible.

Lottery and gambling winnings

Lottery winnings are classified as a windfall gain and are not taxable. However, income earned from such winnings are taxable in the normal course. The courts have also classified gambling winnings as a windfall gain and will not be taxable income. This is not necessarily the case where there is an indication of systematic pursuit of gain to the extent that the activity constitutes a business. The flip side, of course, is that where there is not a business, losses will not be deductible.

The courts specifically looked at the following factors in reaching its decision in determining that occasional gambling winnings are not taxable: the taxpayer's profit and loss experience in past years; the taxpayer's training; his intended course of action; the capability of the venture to show a profit; and other factors such as the taxpayer's skill level, his management of risk, his discipline, and the frequency of his play.

Non-taxable dividends paid by a Canadian corporation

A private corporation may elect to pay a “capital dividend” out of a surplus account called its “Capital Dividend Account”. Generally its capital dividend account consists of the non-taxable portion of capital gains realized by the company since 1971 but the category includes several other items, notably, the proceeds of life insurance policies of which the company is a beneficiary. This type of dividend is not taxable and should not be reported on your income tax return.

It is probable that you will not receive a T5 information slip showing these non-taxable capital dividends, but you will likely receive notification from the company which paid the dividends explaining the special nature of them.

Payments to foster parents

Social assistance payments ordinarily made on the basis of a means, needs, or income test under a program provided for under the laws of Canada or a province are specifically exempt income provided they meet the following tests:

1) payments are exempt to the extent the payments were received directly or indirectly for the benefit of a foster child who is neither the recipient, the spouse, or common-law partner of the recipient, nor related to the recipient;
2) no child benefit payments (or similar provincial payments by Quebec or Alberta) are paid to anyone in respect of the foster child for the period for which the payment is made; and
3) the foster child resides in the recipient's principal place of residence, or that residence is maintained for use as a residence of the foster child, throughout the period for which the social assistance is paid.

If these criteria are met, the foster child payments will not be taxable and thus will not add to anyone's net income.