



SUMMER 2008

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Over-the-counter drugs and the medical expense tax credit

Millions of Canadians take over-the-counter (OTC) products and drugs, both to treat illnesses and in the hope of preventing them. As the use of OTC medications and other similar products has increased, so too have attempts by Canadian taxpayers to claim a medical expense tax credit for the cost of such products. And in some cases, the courts have allowed such claims, notwithstanding the contrary position taken by the Canada Revenue Agency.

Until earlier this year, the wording in the Income Tax Act (the Act) was such that the cost of a drug, medication, or other products purchased by a taxpayer would be eligible for the medical expense tax credit if the medication was:

- manufactured, sold, or used in the diagnosis, treatment, or prevention of a disease;
- prescribed by a medical practitioner; *and*
- recorded by a pharmacist.

That wording was broad enough for the courts to decide, in one case, that the cost of vitamins qualified as a medical expense. In another case, a taxpayer successfully made a claim on his tax return for the cost of a prescription for aspirin, as the Tax Court found that the requirements of the Act had been met with respect to his purchase of the aspirin.

Faced with a rising tide of such claims, and with the certainty that their numbers would only increase, the federal government took action. Earlier this year, as part of the 2008 Budget, a change was introduced to the wording of the provisions of the Act governing claims for the medical expense tax credit for medication costs. While the wording change appears slight, it will, in fact, have a major impact on taxpayers' ability to claim a medical expense tax credit for such costs.

Under the new wording, the credit will be claimable for the cost of drugs, medications, and other substances. The significant change lies in the second requirement:

- that are manufactured or sold for use in the diagnosis, treatment, or prevention of illness;
- that can lawfully be acquired for use by the patient only if prescribed by a medical practitioner or dentist; *and*
- the purchase of which is recorded by a pharmacist.

In effect, even where the first and third requirements are met and a prescription was obtained from a doctor or dentist for the drug or other substance, it will be possible to claim a medical

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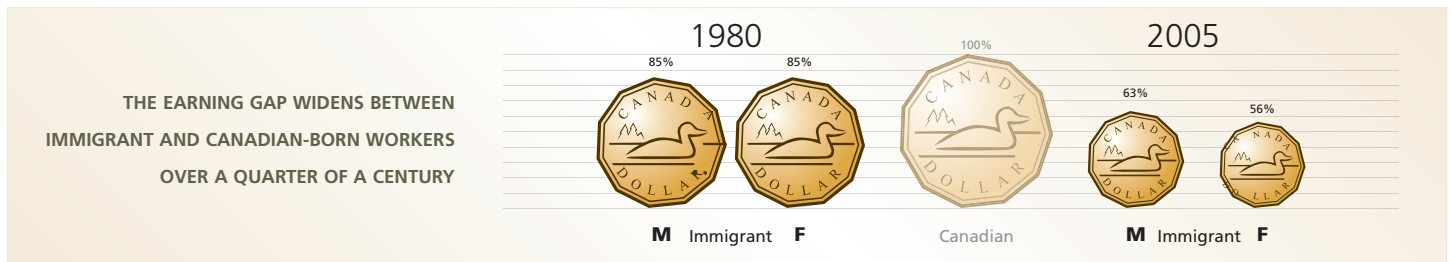
The rich get richer...

It's an old cliché that the rich get richer and the poor get poorer, and judging from 2006 census data recently released by Statistics Canada, it is also the current reality in Canada. That data, in which all income figures over the last quarter century (1980 to 2005) are expressed in inflation-adjusted, 2005 *constant dollars*, disclose an ever-growing earnings gap between the wealthiest and the poorest in Canadian society.

The data collected by StatsCan in the 2006 census showed that, between 1980 and 2005, median earnings among the top 20% of full-time full-year earners increased by 16.4%, while median earnings by those in the bottom 20% fell by 20.6%. Incomes of Canadians in the middle 20% were essentially stagnant, increasing over that 25 year period by just 0.1%.

As well, women who obtain a university degree have a much higher likelihood of closing the gender gap.

The other notable finding arising from the census data was the significant earnings gap between Canadian-born workers and recent immigrants and the degree to which that gap has widened over the past quarter century. StatsCan noted that in 1980, recent-immigrant men who had some employment income earned 85 cents for each dollar received by Canadian-born men. However, by 2005, that ratio had dropped to .63:1.00. The decline was even greater for immigrant women. While in 1980, they, too, earned .85 for every dollar earned by Canadian-born workers, that ratio had dropped by 2005 to .56:1.00. And unlike their Canadian counterparts, the achievement of



It's an article of faith in Canadian society that education and hard work will lead to increased prosperity, but some of the data collected by StatsCan could bring that into question. As StatsCan noted in its analysis, the relatively small change in median earnings by the Canadian middle class occurred during a period of strong economic growth as well as substantial increases in the educational attainment and experience of the workforce. In addition, in the 1980–2005 period, the number of families in which both parents worked full time nearly doubled. Notwithstanding all that, inflation-adjusted income for the middle income group of Canadians remained essentially flat.

It remains true, however, that the achievement of some sort of post-secondary educational qualification usually means a higher income. Across both genders and all age groups, full-time full-year earners with a university degree earned substantially more than their counterparts who did not have a high school diploma.

higher education didn't seem to make much difference for immigrants, as the earnings gap widened for both individuals with and without a university degree. There was, in fact, a greater earnings gap at higher education levels.

Overall, the 2006 census figures would seem to lend credence to the anecdotal evidence that the Canadian middle class is running hard to stay in the same place. And figures documenting the essentially stagnant income of those middle-income Canadians over the past quarter century may shed some light on the underlying reasons for record levels of consumer debt among Canadians.

The StatsCan publication, *"Earnings and Incomes of Canadians Over the Past Quarter Century, 2006 Census"*, is available free of charge on the Agency's Web site at: <http://www12.statcan.ca/english/census06/analysis/income/pdf/97-563-XIE2006001.pdf>. ♦

Tax-free savings accounts

What's the benefit?

RRIF TSFA
RRSP RESP
GIC

For individuals, the most significant tax measure announced in this year's federal Budget was the introduction of so-called Tax-Free Savings Accounts, or TFSAs. While the *tax-free* description is a bit optimistic, it's nonetheless true that the TFSAs represent one of the few opportunities available to Canadian taxpayers to accumulate savings in a tax-sheltered environment.

In terms of their structure and taxation, TFSAs look like a hybrid of Registered Retirement Savings Plans (RRSPs) and Registered Education Savings Plans (RESPs). Like RESP contributions, amounts contributed to a TFSA are not deductible from income – tax must be paid on those amounts in the same manner as on any other income of the taxpayer. However, once amounts are contributed to a TFSA, any investment income earned on the contributions – whether capital gains, dividends, or interest – is not taxed, on either a current basis or on withdrawal. In addition, like an RESP, original contributions are not subject to tax on withdrawal. Essentially, any funds that are held in a TFSA can be withdrawn free of tax.

As with an RRSP, contributions to a TFSA are subject to annual limits. For a TFSA, the annual contribution limit is \$5,000, regardless of the contributor's income. However, unlike an RRSP, any withdrawals of original contributions made from a TFSA are added to the taxpayer's contribution room for the following year. So, a taxpayer who makes a contribution of \$5,000 in January 2009 but withdraws \$3,000 later in that year will have a contribution limit of \$8,000 (\$5,000 plus \$3,000) for 2010.

In addition to being able to *top up* the TFSA to compensate for any amounts withdrawn, taxpayers will be able to carry forward, for an unlimited time, any unused contribution room. So, a taxpayer who made no contribution at all in 2009 would have contribution room for 2010 of \$10,000, representing the \$5,000 of the

current year's contribution room plus the carryforward of \$5,000 in contribution room from 2009.

Contributions can be made to a TFSA by any Canadian over the age of 17, and funds accumulated in the TFSA can be withdrawn for any purpose. The background papers issued with the Budget suggest that TFSAs will be usable to save for major purchases, such as a car or a down payment on a home, or as a hedge against unforeseen future needs, such as unexpected and costly home repairs. While TFSAs can, and undoubtedly will, be used for such purposes, it will also be possible to use a TFSA simply to provide a tax-sheltered environment in which excess current funds may compound, free of current tax.

Take, for example, a retiree who is compelled to withdraw funds each year from his or her Registered Retirement Income Fund (RRIF), but who has no need for some or all of those funds to meet current living expenses. If those funds were withdrawn as required and deposited into an ordinary savings account or invested in a Guaranteed Investment Certificate (GIC), tax would be payable both on the withdrawal and on any investment income earned. While the tax payable on the RRIF withdrawal can't be avoided, contributing the funds withdrawn to a TFSA will avoid the tax payable on investment income and allow the funds to continue compounding, as they did within the RRIF, on a tax-free basis.

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expense tax credit for the cost only if the prescription was necessary to obtain the drug. In other words, if the drug or other product (like vitamins or aspirin) can be bought over the counter, then having a prescription for it won't change it into something for which a medical expense tax credit can be claimed. If the prescription wasn't needed to buy the drug or product, then no medical expense claim will be allowed for the purchase.

The change will apply to all drug and other medication expenses incurred by taxpayers after February 26, 2008. ♦

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Finally, the Budget papers indicate that neither income earned within a TFSA nor withdrawals from the plan will affect eligibility for federal income-tested benefits and credits – an important consideration for seniors, whose eligibility for the age tax credit, the goods and services tax credit, and Old Age Security payments can all be eroded as income levels rise.

Once funds are deposited into a TFSA, the range of available investments is quite broad – essentially, TFSAs will be able to hold the same investments as an RRSP. And because all investment income earned within the plan may be withdrawn tax-free, the tax treatment accorded any particular type of investment

income (i.e., capital gains, interest, or dividend income) won't be a concern, and taxpayers will be able to make investment choices based solely on

investment – and not on tax considerations. That said, a taxpayer who has funds available to invest in excess of the amount that may be contributed to a TFSA would clearly be well advised to shelter the investments that receive the least favourable tax treatment (generally, interest income) within the TFSA.

Couples will be able to *double up* on the tax-free savings opportunity afforded by TFSAs, as the rules will permit a taxpayer to make a contribution to a TFSA using funds provided by his or her spouse. Income earned in the plan will then compound tax-free in the usual manner, and it may be withdrawn by the beneficiary spouse at any time, with no tax payable by either the contributor or the beneficiary spouse.

Canadian resident taxpayers over the age of 17 will be able to begin contributing up to \$5,000 per year to a TFSA on 1 January, 2009. The Canada Revenue Agency will be keeping track of contribution limits for each Canadian who files a tax return, in the same way that it currently does for RRSP contributions. Although the budget papers do not specify, it seems likely that a taxpayer's current TFSA contribution room will be provided on the Notice of Assessment issued for each year's tax return, as it currently is for RRSP contribution room limits. ♦



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