

TAX LETTER

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CHANGES TO THE “INCOME SPRINKLING” PROPOSALS CCPC INVESTMENT INCOME – STILL SOME TAX SAVINGS OPPORTUNITIES FOREIGN EXCHANGE GAINS AND LOSSES PRINCIPAL RESIDENCE EXEMPTION GRADUATED RATE ESTATES AROUND THE COURTS

CHANGES TO THE “INCOME SPRINKLING” PROPOSALS

In general terms, income sprinkling occurs where a private corporation pays out dividends to shareholders who are not necessarily involved in the business of the corporation, or where an individual receives income from the provision of goods or services through a trust or partnership to a “related business” carried on by a related person. The proposals will take effect retroactive to January 1, 2018, even though they will not be passed by Parliament for some time (and conceivably could be held up by the Senate). However, the proposals were amended significantly on December 13, 2017; the amendments are meant to simplify and improve the rules.

Under the income tax laws before 2018, a tax on split income (“TOSI”) often applies to the above types of income, but only to children who are under the age of 18 at year-end. The TOSI is a flat tax equal to the highest personal rate of tax, which obviously makes income splitting undesirable when it applies. The July 18, 2017 draft legislation proposed to extend the TOSI to private corporation

dividends and the other types of income received by adults in many situations.

The December 13, 2017 changes simplify the original proposals. In general terms, the changes provide that the TOSI will not apply in the following circumstances:

- It will generally not apply to income received from an adult directly or indirectly from an “excluded business”, generally meaning a business in which the adult is engaged on a “regular, continuous and substantial” basis, either in the relevant taxation year or any five previous taxation years;
- It will not apply to adults who are 25 or older by year-end, who receive income from an “excluded share” of a corporation, generally meaning the adult has a significant equity investment in the corporation (10% or more of the shares on a value and votes basis) that earns less than 90 per cent of its income from the provision of services, where the corporation is not a professional corporation and does

not derive its income directly or indirectly from a related business;

- It generally will not apply to a spouse of the owner of the related business if the owner significantly contributed to the business and is age 65 or over by the end of the year; and
- It will not apply to capital gains from the disposition of qualified farm or fishing property of the individual, or of qualified small business corporation shares that are eligible for the capital gains exemption, regardless of whether the exemption was claimed (except where the sale is by a minor to a non-arm's length person – this rule has been in place for several years).

As noted, the proposals take effect beginning on January 1, 2018. In this regard, one of the main criticisms regarding the proposals has been the lack of adequate time to restructure business affairs to take into account the proposals. Nonetheless, the January 1, 2018 start date appears to be set.

CCPC INVESTMENT INCOME – STILL SOME TAX SAVINGS OPPORTUNITIES

In the July 18, 2017 income tax proposals dealing with small business tax issues (see above), one of the main proposed changes relates to the taxation of passive investment income earned by a Canadian-controlled private corporation (“CCPC”) by using its after-tax business income. Under current rules, there is a tax deferral advantage because the active business tax rate for a CCPC (between 11% and 15% depending on the province) is significantly lower than the top marginal tax rate that could apply to the individual shareholder (50% or higher).

Even though the integration system of taxing dividends imposes tax on the individual receiving dividends so that the total tax rate is the same, the initial lower corporate tax rate leaves a CCPC with much more income that can be invested until it is eventually paid out.

The Department of Finance announced that it would eliminate that tax advantage, although the change would not be effective until a later date when specifics were provided (those specifics are expected to come in the 2018 Federal Budget). In general, the new system would impose a new tax on investment income of a CCPC so that the top rate of combined corporate and personal tax on such income would be much higher than the current rate – typically somewhere around 73%.

However, in October 2017 the Department back-tracked somewhat in response to a political uproar, and said that the first \$50,000 of CCPC passive investment income per year (representing a 5% return on up to \$1 million of investments) would not be subject to the new proposals.

So it will still be advantageous – to a certain point – to earn passive income inside of your CCPC. This is an advantage that you would not have if you carried on your business personally or through a partnership rather than through the CCPC. The following example illustrates the tax savings that can still result.

EXAMPLE

Assume

- 50% personal tax rate
- 13% tax rate on CCPC active business income

- 50% “refundable tax” on CCPC passive investment income
- Perfect “integration” between the personal tax and corporate tax, meaning that the total corporate and personal tax on CCPC income that is subsequently paid out as a dividend to a shareholder is equal to the CCPC shareholder’s marginal rate of tax
- \$500,000 of business income, and
- Rate of return on passive investments of 10%

Taxpayer 1 carries on a business personally and earns \$500,000 in year 1, leaving him with \$250,000 after the 50% (\$250,000) tax. He invests the after-tax amount at the beginning of year 2, earning another \$25,000 by the end of year 2. The \$25,000 is subject to 50% tax, leaving \$12,500. Taxpayer 1 is left with a total of \$262,500 (\$250,000 plus \$12,500).

Taxpayer 2 carries on a business through a CCPC, which earns \$500,000 of active business income in year 1, leaving it with \$435,000 after the 13% (\$65,000) tax. That amount is invested at the beginning of year 2, earning another \$43,500 by the end of year 2, when the maximum amount is paid out as a dividend to the shareholder Taxpayer 2. Assuming perfect “integration” between the personal and corporate tax, the \$43,500 of investment income will be subject to total tax of 50% (CCPC refundable tax net of refund, plus personal tax on dividends), leaving \$21,750. The \$435,000 part of the dividend will be subject to a further tax of \$185,000 tax in the hands of Taxpayer 2 (i.e. the \$185,000 tax plus the initial CCPC tax of \$65,000 equals 50% of the

\$500,000 business income), leaving \$250,000. In total, Taxpayer 2 is left with \$271,750 (\$250,000 plus \$21,750).

In the example, Taxpayer 2 has a significant advantage over Taxpayer 1, owing to the effective tax deferral of a large portion of the \$500,000 of business income. That is, since the CCPC was subject to initial tax of only 13% compared to Taxpayer 1 who was subject to initial tax of 50%, the CCPC had a “head start” in terms of how much it could invest. (As noted, the example assumes perfect integration between the personal and corporate tax. In most provinces the integration for CCPC investment income is currently less than perfect. So Taxpayer 2 might be left with less than \$271,750, but will definitely be left with more than the \$262,600 amount for Taxpayer 1.)

In short, business owners who carry on their businesses through a CCPC have significant tax advantages over those who carry on businesses personally. In addition to the small business tax rate for CCPCs, there is also the lifetime capital gains exemption for gains on shares of qualified small business corporations, and, as illustrated above, an advantage for earning passive investment income.

FOREIGN EXCHANGE GAINS AND LOSSES

If you realize a foreign exchange (FX) gain or incur a FX loss, it is normally treated as a capital gain or capital loss (unless, for example, you are in the business of buying and selling foreign currency). There are at least three ways in which you can have a FX currency gain or loss.

First, if you buy and later sell a foreign currency, both the “cost” and “proceeds” of the currency must be converted into and denominated in Canadian dollars. If the foreign currency has fluctuated against the Canadian dollar between the time of your purchase and sale, there will be an FX gain or loss.

EXAMPLE

You bought US dollars when the exchange rate was \$1 US = 1\$ Cdn, so your cost of the US dollars was \$1 Cdn per US dollar. You later exchange \$100,000 of the US dollars back into Canadian dollars when the exchange rate is \$1 US = 1.1 Cdn, so your proceeds are \$110,000. You will have a FX gain of \$10,000 Cdn. However, for individuals, the first \$200 of annual FX gains or losses on dispositions of foreign currency in any given year are not taken into account, so if this is your only FX gain or loss in the year, you would have a \$9,800 FX gain, and therefore a \$4,900 taxable capital gain included in your income (since only half of capital gains are taxed).

Second, you may have a debt or other liability denominated in a foreign currency. The amount of the debt (or liability) must be converted into Canadian dollars at the time the debt is incurred, and the amount of the repayment must be converted into Canadian dollars at the time of repayment. If the foreign currency has fluctuated in the meantime, you will have a gain or a loss.

EXAMPLE

You borrowed \$100,000 US dollars when the exchange rate was \$1 US = 1\$ Cdn, so the amount of your debt was

\$100,000 Cdn. You later repay the \$100,000 US loan when the exchange rate is \$1 US = 1.1 Cdn, so your repayment equals \$110,000 Cdn. You will have an FX loss of \$10,000 Cdn. Half of that, or \$5,000, will be an allowable capital loss.

Third, you may purchase a property in a foreign currency and later sell the property. Again, your cost of the property and the proceeds must be converted into Canadian dollars at the time of purchase and the time of sale, respectively.

EXAMPLE

You bought some real estate for \$100,000 US when the exchange rate was \$1 US = 1\$ Cdn, so your cost of the property was \$100,000 Cdn. You later sell the property for \$100,000 US when the exchange rate is \$1 US = \$1.1 Cdn, so your proceeds are \$110,000. Even though you will have no gain in terms of US dollars, you will have an FX gain of \$10,000 Cdn. Half of that, or \$5,000, will be a taxable capital gain.

PRINCIPAL RESIDENCE EXEMPTION

If you are a Canadian resident, you are normally eligible for the principal residence exemption if you have a gain on the sale of your home.

The *Income Tax Act* provides that the portion of the gain that is exempt from tax is:

Gain x (1 + the number of years you designate the property as your principal residence) / number of years you owned the property.

Therefore, if the property was your principal residence for all years you owned it, or all years but one, the entire gain is exempt. (The exempt fraction of the gain cannot exceed 1/1, since at that point the full gain is exempt.)

The “1+” in the numerator allows for the fact that you can designate only one property per year as your principal residence. (Actually, your entire family – meaning you and your spouse and unmarried minor children – can designate only one property per year.) Thus, if you sell a home and buy another one in the same year, you can designate only one home as your principal residence for that year. The “1+” makes sure that you don’t lose your exemption on the other home in respect of that year.

Normally, you can designate the property as your principal residence in a year if you or your spouse or children “ordinarily inhabit” the property during the year. The courts and the CRA allow a low threshold to meet the “ordinarily inhabit” requirement. For example, if you stay in your cottage for a couple of weeks a year, that will normally meet the “ordinarily inhabit” requirement for the year. (Of course, if you designate the cottage for some years, you cannot have the principal residence exception apply to your city home for those years.)

When you sell your principal residence, you must now report the sale on Schedule 3, *Capital Gains*, which is filed with your T1 tax return for the year of sale. (Before 2016, the CRA did not require reporting for the sale of a principal residence if it was your principal residence for every year that you owned it.) If the home was not your principal residence for all years of ownership, you must also file Form T2091, *Designation of a*

property as a principal residence by an individual.

Rental property for some years

There are special rules that apply where you live in your home and later rent it out, or conversely when you rent out a property and subsequently move into the home.

In either case, there is a “deemed disposition” rule in the Income Tax Act that deems you to have sold and repurchased the home at fair market value (possibly triggering capital gains that are taxed). However, you can elect out of that rule, meaning that there will be no deemed disposition. Furthermore, if you make the election, the property can qualify as your principal residence for up to four years while you rent it out, even if you do not ordinarily inhabit the property during those years (but subject to the usual rule that you can designate only one principal residence for any given year).

EXAMPLE

You bought a property and lived it in for 6 years. You moved out and rented out the property for 7 years. You then sold the property at a gain.

You can designate the property as your principal residence for the first 6 years. For the next 7 years, you can designate it for 4 years. As a result, you designate the property as your principal residence for a total of 10 years. This assumes you do not designate any other property as your principal residence for those 10 years.

Your exempt portion of the gain on the sale will be:

Gain x (1 + 10)/13, or 11/13ths of the gain.

Of the remaining gain, one-half will be a taxable capital gain which is included in your income.

Note: If you wish to use the election, you cannot claim capital cost allowance (tax depreciation) in respect of your home while it is rented out.

GRADUATED RATE ESTATES

Most trusts are subject to tax on their income at a flat rate equal to the highest marginal personal rate of tax. For example, if you set up a trust in Ontario during your lifetime and it earns and retains \$100,000 of taxable income, it will be liable to pay about 53% tax on that amount.

Most trusts must also have a taxation year that is the calendar year (ending December 31).

One notable exception, where the high flat tax and the calendar year requirement do not apply, is a "graduated rate estate" (GRE). (An estate is treated as a trust for tax purposes.) A GRE is subject to tax at the same graduated tax rates that apply to individuals. A GRE can have any fiscal period as its taxation year, including an off-calendar year or the calendar year.

In general terms, a GRE is your estate that comes into existence upon and as a consequence of your death. Your estate can qualify as a GRE for up to 36 months after your death, generally if it does not receive contributions from other persons (the details regarding the "contributions" are quite technical).

Once the 36 months are up, the estate will be subject to the high flat tax. It will also have a deemed taxation year end immediately before the end of the 36 months, and after that point in time will be required to have a calendar year taxation year.

Because of the option regarding the taxation year, a GRE can have either three or four taxation years.

EXAMPLE

A taxpayer dies on November 1, 2017.

If the taxpayer's GRE (through the executor or estate trustee) chooses a calendar-year taxation year, its first taxation year will be short and will end on December 31, 2017. The estate will have two more taxation years ending at the end of 2018 and 2019, and one more taxation year ending on October 31, 2020 (36 months after the death), for a total of four taxation years.

If the GRE uses a 12-month fiscal period as its taxation year right from the start, the first taxation year will end on October 31, 2018. The next two taxation years of the estate will end on October 31, 2019 and 2020, respectively, for a total of three taxation years.

In either case, every taxation year ending after the estate is no longer a GRE will coincide with the calendar year end.

Note that the GRE is a separate taxpayer from the deceased. A T1 tax return will normally be required for the deceased for the year of death. A T3 (trust) tax return will normally be required for the GRE for each of its taxation years (and for the estate's

taxation years after it ceases to be a GRE, assuming it remains in existence).

The GRE rules, which took effect in 2016, replace the old rules that applied for "testamentary trusts", meaning trusts set up by one's Will. Under the old rules, a testamentary trust was generally subject to the low tax rates that apply to individuals. Now, a testamentary trust is normally taxed at the top marginal rate (with limited exceptions for a "qualified disability trust").

AROUND THE COURTS

Cost of replacing parking lot roof deductible

A current expense is normally an expense that does not create significant value that endures into taxation years beyond the year of expenditure and is deductible in full in the year of expenditure.

Conversely, a capital expense is normally an expense that does create significant value that endures into later taxation years and are depreciable over time.

In the recent case of *Aon Inc.*, a corporation was allowed to fully deduct the cost of replacing a roof of a parking lot. The parking lot was mainly underground, below Aon's commercial buildings. However, some of the lot was outside, and that portion was covered by a roof made largely of concrete. Over the years, the roof deteriorated, due to weather conditions and in particular ice and salt. The taxpayer made recurring repairs over several years, but eventually the entire roof had to be replaced at a cost of over \$4 million.

The issue in the case was whether the cost of replacing the roof was current or capital. As

noted, the Tax Court held that the cost was a fully deductible current expense. In reaching this conclusion, the Court found that the purpose of the replacement was to make the garage function in the same way that it did previously, so that there was no increase in the garage's functionality or profitability, and the new roof did not substantially increase the value of the Aon's buildings compared to the value that would be seen with a garage in a good state of repairs. The Court concluded that this was not "a situation where the work has created something new... before the work there was a reinforced concrete roof; after the work there was a better built concrete roof". Therefore, the cost was a current expense and was fully deductible in the year it was incurred.

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This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.