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TAX LETTER

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EXTENSION OF MINERAL EXPLORATION TAX CREDIT

Under certain "flow-through" provisions in the Income Tax Act, investors can enter into an agreement to subscribe for common shares of a resource corporation. When the corporation incurs qualifying exploration expenses, these expenses can flow through to the investors who can deduct the expenses in computing their income. In addition, individuals who invest in flow-through shares are entitled to a credit of 15% of qualifying mineral exploration expenses incurred in Canada by the corporation.

The 15% credit was introduced years ago as a one-time credit, but it has been extended by every subsequent Federal Budget. The 2013 Budget was no exception. It extended the credit to flow-through share agreements entered into on or before March 31, 2014, which, pursuant to certain "look-back rules", can cover exploration expenses incurred by the corporation to the end of 2015.

2014 PRESCRIBED AUTOMOBILE AMOUNTS

On December 30, 2013, the Department of Finance announced the automobile expense deduction limits and prescribed rates for the automobile operating expense benefit that will apply in 2014. The amounts remain unchanged from the 2013 year. The amounts are as follows.

CCA, interest on car loans, and leasing expense limits

Persons carrying on a business are allowed to deduct car expenses incurred in the course of the business. Similarly, certain employees can deduct their car expenses incurred in the course of employment (for these purposes, driving from home to work and back is personal driving, not employment driving).

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For 2014, the monetary limits for tax depreciation or capital cost allowance (CCA) in respect of a car that you own, interest expense incurred on borrowed money used to buy a car, or leasing costs in respect of a car that you lease are as follows (the amount apply to cars purchased or car leases entered into after 2000 and through the end of 2014):

- The maximum cost of your car on which CCA can be claimed is $30,000 plus applicable federal and provincial sales tax;
- The maximum allowable interest deduction for car loans is $300 per 30-day period in the year; and
- The general limit on deductible leasing costs is $800 per 30-day period in the year plus applicable federal and provincial sales tax. However, the deductible lease payments can be reduced further, generally if the manufacturer's list price of your car exceeds the capital cost ceiling.

Tax-free car allowances

Employees can receive a tax-free car allowance from their employers if the allowance is reasonable. For these purposes, the allowance will **not** be considered reasonable if it is based on something other than the kilometres driven in the year in the course of employment.

From the employer's perspective, if certain monetary limits are not exceeded, the entire allowance is normally deductible. For 2014, the monetary limits are 54 cents for the first 5,000 kilometres driven in the course of employment and 48 cents for each additional kilometre driven. For the Yukon Territory, Northwest Territories and Nunavut, the allowance limits are 58 cents for the first 5,000 kilometres driven and 52 cents for each additional kilometre driven.

Employee car benefits

Where an employer provides an employee with a car and pays any of the employee's personal operating costs, there will be an operating expense benefit included in the employee's income. For 2014, the prescribed rate used to determine this benefit is 27 cents per kilometre driven for personal purposes. For employees who are employed principally in selling or leasing automobiles, the prescribed rate is 24 cents per personal kilometre.

As an alternative, if the employee's work kilometres for the year exceed the personal kilometres, the employee can elect that the operating expense benefit be ½ of the "standby charge" for the year. In this case, the employee must inform the employer in writing before the end of the year. The standby charge is an amount determined by formula, and is meant to reflect the benefit of having a car available for personal use (see the section below).

The amount of the benefit is reduced by the amount repaid by the employee in the

year or within 45 days after the year. If the employee repays all of the expenses, no benefit is included.

AUTOMOBILE STANDBY CHARGE FOR EMPLOYEES

If your employer provides you with a car in the year, you will be required to include in your income a "standby charge" for the year. The standby charge is determined by formula under the Income Tax Act and is meant to reflect tthe personal benefit that you enjoy by using the car during the year.

If the car is owned by your employer, the standby charge is 2% of the employer's cost of the car including sales taxes (GST, HST, QST and PST), multiplied by the number of 30-day periods in the year that you have use of the car. GST is the federal goods and services tax; HST is the harmonized goods and services tax for a "participating" province; QST is the Quebec Sales Tax; PST is the provincial retail sales tax in Saskatchewan, Manitoba and BC.

If the car is leased by your employer, the standby charge equals 2/3rds of the lease cost including sales taxes for the period in which you use the car. The lease cost for these purposes does not include insurance costs paid by your employer under the lease, if any (insurance costs paid by your employer will be reflected in your operating cost benefit, described in the article above).

In either case – employer-owned or leased car – the standby charge is reduced if your kilometres driven in the course of work exceed your kilometres driven for personal purposes for the year, **and** your personal kilometres do not exceed 1,667 per month. The benefit is also reduced to the extent you pay your employer in the year for the use of the car.

There is an alternative reduced standby charge for employees employed principally in selling or leasing automobiles, where an employer-owned car is made available. The alternative method is available at the option of the employer. This method uses a 1.5% rate instead of 2% of the cost the car. Furthermore, the cost of the car is deemed to be the greater of (i) the average cost of all new cars acquired by the employer in the year for sale or lease, and (ii) the average cost of all cars (new or used) acquired by the employer in the year for sale or lease.

2013 CRA MEAL AND VEHICLE RATES FOR MOVING EXPENSES

If you moved in 2013 to carry on a business or to work at a new employment location, you are allowed to deduct certain moving expenses. Generally, the deduction is allowed if your new home is at least 40 kilometres closer to the new business or work location relative to your former home.

The deductible expenses include your car travel costs, such as the cost of gas incurred in the move. You can also deduct your and your family expenses for meals consumed in the course of the move. Furthermore, you can deduct the cost of meals and lodging near your old home or new for up to 15 days (say, if your new home was not yet ready for habitation).

In the case of car travel and meal expenses, you can claim your actual expenses to the extent they are reasonable. You need to keep your receipts.

Alternatively, you can use the "simplified method" allowed by the Canada Revenue Agency (CRA). For moves in 2013, the CRA simplified method allows a flat rate meal amount of $17 per meal per person, to a maximum of $51 per day per person. This amount remains unchanged from the previous year. For the simplified method of calculating car expenses, the 2013 per kilometre rates are shown in the chart below (the rates apply in respect of the province from which your move originated).

Province/Territory Kilometre

Alberta 51.5
British Columbia 51.0
Manitoba 47.5
New Brunswick 49.5
Newfoundland and Labrador 53.0
Northwest Territories 58.5
Nova Scotia 51.0
Nunavut 58.5
Ontario 55.0
Prince Edward Island 50.5
Quebec 57.0
Saskatchewan 45.5
Yukon 63.5

If you use the simplified method, the CRA provides that you do not have to keep detailed receipts for actual expenses. However, the CRA "may still ask you to provide some documentation to support your claim".

In the case of the simplified moving expense, you must keep track of the number of kilometres driven in the course of the move, and then multiply them by the applicable rate.

TAX-DEFERRED TRANSFERS TO YOUR CORPORATION

Under the Income Tax Act, you are allowed to transfer certain types of property to your corporation on a tax-deferred "rollover" basis, so that you don't have to recognize accrued gains on the property. Alternatively, instead of a full deferral, you can opt to have a partial deferral, depending on the "elected amount" that applies to the transfer. The elected amount becomes your proceeds of disposition of the property (and the corporation's cost). The full or partial tax deferral can apply if you receive at **least**

one share in the corporation as consideration for the transfer.

There are restrictions on the elected amount. Generally speaking, the elected amount:

- cannot exceed the fair market value of the property transferred to the corporation;
- cannot exceed the fair market value of any non-share consideration you receive back from the corporation; and
- cannot be less than the lesser of the fair market value of the property and your tax cost of the property.

As noted, the elected amount becomes your proceeds of disposition of the transferred property. The elected amount also becomes the cost of the property for the corporation.

Additionally, the elected amount, net of the fair market value of any non-share consideration received from the corporation, becomes your cost of the shares received on the transfer. The cost of any non-share consideration you receive is its fair market value.

Example

You transfer capital property to a corporation in exchange for 100 common shares in the corporation and a promissory note of $40,000. Your cost of the property was $50,000 and its fair market value was $100,000.

If the elected amount is $50,000, your proceeds of disposition of the property will be $50,000, such that you will have no gain on the transfer. The corporation's cost of the property will also be $50,000.

Your cost of the promissory note received from the corporation will be $40,000. Your cost of the 100 common shares will be $10,000 – that is, the $50,000 elected amount net of the value of the $40,000 promissory note.

If instead you elected $70,000, you would have a gain of $20,000. Assuming the property was capital property, you would include ½ of that, or $10,000, in your income as a taxable capital gain. You might consider such a "partial" rollover if you have net capital losses that could be applied to offset the gain. This treatment would provide a higher cost of the property to the corporation ($70,000), and a higher cost to you of the shares received back from the corporation ($30,000, being $70,000 minus the $40,000 amount of the promissory note).

For closely-held corporations, it is generally not beneficial to try to trigger a loss on the transfer (by electing an amount that is less than your cost of the property), since the superficial loss rules

will often apply. The superficial loss rules will apply if you and the corporation are affiliated (e.g. you or your spouse controls the corporation, in addition to other scenarios).

The elected amount is made in a joint election made between you and the corporation. It must be filed with the CRA on or before the earlier of your tax filing date and the corporation's tax filing date for the taxation year in which the transfer is made.

You can file up to 3 years late, or even later than that if the CRA accepts that the circumstances of your case are such that it would be "just and equitable" to do so. However, a late-filed election carries a financial penalty. The penalty is the lesser of (i) $100 per month or part month that you are late (to a maximum of $8,000), and (ii) 0.25% of the amount by which the fair market value of the property exceeded the elected amount, multiplied by the number of months or part months that you are late.

Lastly, note that the election is available only for "eligible property", which includes:

- capital property;
- eligible capital property (e.g. goodwill, customer lists); and
- inventory other than land.

Both resident and non-resident shareholders can make the election. However, for non-residents, land (that is capital property) is eligible only if it was used by the non-resident in a business carried on in Canada, *and* it was transferred along with all or substantially of the assets of the business (generally, 90% or more in value) to the corporation, *and* the corporation was controlled afterwards by the non-resident or a person related to the non-resident.

DEDUCTION OF PREMIUMS FOR LIFE INSURANCE USED AS COLLATERAL

Normally, you cannot deduct life insurance premiums for income tax purposes because they are considered personal in nature (and life insurance benefits, when paid, are not taxable). However, a special rule in the Income Tax Act allows a deduction, generally where you are required to assign the policy to a financial institution as collateral for a loan. The deduction is allowed if the loan is used for the purpose of earning income from a business or property.

Furthermore, the amount of the deduction is limited to the "net cost of insurance of the year" in respect of the policy. The net cost of insurance is determined using actuarial principles in the manner set out in regulations to the Income Tax Act.

The deductible amount is also limited to the amount "as can reasonably be considered to relate to the amount owing from time to time during the year" under the loan. As an example, the CRA states

that if the life insurance coverage under an assigned policy is $500,000, and the amount owing under the loan throughout the taxation year is $200,000, the amount deductible is limited to 40% of the lesser of the premiums payable and the net cost of pure insurance under the policy for the year.

The deduction is also available to persons other than the person whose life is insured. For example, a corporation can make the deduction if it takes out a loan and meets the above requirements in respect of a life insurance policy that it takes out on the life of a key employee of the corporation.

However, in the 2013 Federal Budget the government introduced rules that will prohibit the deduction of the life insurance premiums if they relate to a leveraged insured annuity (LIA) policy. Generally speaking, an LIA policy involves a loan used to acquire an annuity that is payable until at least the death of the insured, where the loan is repayable at or after the death, and both the policy and the annuity are assigned to the lender. Premiums for the life insurance in an LIA policy will not be deductible for taxation years ending after March 20, 2013, if the loan was incurred after that date. A similar denial of the deduction for premiums will apply to a leveraged "10/8 policy". In general terms, a 10/8 policy involves a life insurance policy, or an investment account under the policy, being assigned as collateral on the loan, and either the interest rate payable on an investment account under the policy is determined by reference to the interest rate payable on the loan or the maximum value of an investment account under the policy is determined by reference to the amount of the loan. (These changes were also discussed in our May 2013 Letter regarding the 2013 Federal Budget.)

PRESCRIBED INTEREST RATES

The CRA recently announced the prescribed annual interest rates that will apply to any amounts owed to the CRA and to any amounts the CRA owes to individuals and corporations for the first quarter of 2014. These rates are calculated each calendar quarter. The new rates are in effect from January 1, 2014 through March 31, 2014. The interest rates have decreased by 1 percentage point from the last quarter of 2013.

- The interest rate charged on overdue income taxes, Canada Pension Plan contributions, and Employment Insurance premiums is 5%, compounded daily.
- The interest rate to be paid on late refunds paid by the CRA to corporations is 1%, compounded daily.
- The interest rate to be paid on late refunds paid by the CRA to other taxpayers is 3%, compounded daily.
- The interest rate used to calculate taxable benefits for employees and

shareholders from interest-free and low-interest loans is 1%.

AROUND THE COURTS

Allowing charity to use part of home rent-free did not qualify as donation

In order to qualify for the charitable donation credit, you must make a gift of property to a registered charity or similar organization. A gift normally involves the voluntary transfer of property, including cash, for no consideration.

In the recent *Carson* case, the taxpayer and his wife allowed a registered charity to use two rooms in their home without charging rent. The taxpayer claimed the charitable donation credit on the basis that he (and/or his wife) made a gift to the charity equal to the value of the rent for those rooms that the charity did not have to pay. In other words, he took the position that providing free-rent to the charity was the equivalent of giving a gift to the charity equal to the rent that would have otherwise been paid.

The CRA denied the credit, and its decision was upheld by the Tax Court of Canada. The Tax Court found that there was no gift of property to the charity. The Court discussed an alternative scenario, under which the taxpayer and his wife could have charged rent to the charity, and then in turn donated the rent back to the charity. Under that alternative scenario, the donation back to the charity would have qualified for the donation credit. However, in the case at hand, the mere provision of rental property without charging rent did not constitute a transfer of property, so there was no gift and no credit available.

In past Tax Letters (e.g. the December 2013 Tax Letter), we have discussed this type of situation in the context of providing voluntary services to a charity for no payment. In such case, you cannot claim a credit based on the value of the voluntary services that you provide to the charity. However, if the charity pays you for the services and you in turn donate that payment back to the charity, you are allowed to claim the credit in respect of the payment because it qualifies as a voluntary transfer of property and therefore a gift to the charity. This can be useful because the credit for donations that exceed $200 in the year is worth more than the cost of the tax on the income, unless you are in the top tax bracket.

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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.