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TAX LETTER

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PHASE-OUT OF LSVCC CREDIT

The federal income tax credit for investments in a Labour-Sponsored Venture Capital Corporation (LSVCC) is being eliminated, effective for the 2017 year. Generally speaking, LSVCCs are mutual fund corporations that are sponsored by labour unions or organizations and that typically invest in small, start-up businesses. The federal government announced in the March 2013 Budget that the LSVCC program is no longer considered effective and will be phased out.

Historically, you obtained a 15% federal tax credit for purchasing up to $5,000 of LSVCC shares per year for a maximum credit of $750. As part of the phase-out and elimination of the credit, it is reduced to 10% ($500) for 2015 and 5% ($250) for 2016 and will be gone by 2017.

Of course, many LSVCCs are leaving the LSVCC regime and may continue on in some other form. As a result, the government has introduced rules under which an LSVCC can "orderly exit" the federal tax credit program. Basically, the proposals will remove investment requirements and penalties that may otherwise apply to LSVCCs.

PROPOSED CHANGES FOR ELIGIBLE CAPITAL PROPERTY

Under current rules, eligible capital property (ECP) of a business is subject to a tax regime that is similar to the capital cost allowance (CCA) regime that applies to depreciable property. ECP includes certain intangible properties, such as purchased goodwill, customer lists, the cost of obtaining trademarks, and incorporation costs.

Basically, 3/4 of the cost of the ECP is added to a pool called the "cumulative eligible capital" pool. An annual deduction of 7% of the pool on a declining balance basis is allowed to be deducted from the related business income. On the sale of an ECP, there may be "recapture" of previously deducted amounts, similar to the recapture that applies to depreciable property. Conversely, there may be a terminal loss (a deduction of the outstanding pool) when you no longer carry on the business and have no ECP of any value.

When you sell ECP for proceeds greater than your original cost, the excess is treated similarly to a capital gain, in that only ½ of the excess is included in your income. However, the ½ excess is treated as business income rather than a taxable capital gain (unless it is ECP in respect of a farm or fishing property that is subject to the capital gains exemption).

In other words – for those readers familiar with the depreciable property CCA rules – the ECP rules generally mirror the CCA rules, but with a number of technical differences.

The Department of Finance has finally decided to fold the ECP rules into the CCA system, in order to simplify compliance for taxpayers and their advisors. In the February 2014 Federal Budget, it announced a proposal to eliminate the current system and replace it with a new CCA pool for ECP. Since then the Department has been consulting with the tax and business communities, and will announce the implementation of the proposals after the consultation.

Under the proposed rules, the new pool will consist of the full cost (rather than 3/4) of ECP and will be depreciable on a declining-balance basis at 5% per year (close to the current rate of 7% of 3/4). The new pool will be subject to the "half-year" rule that applies to most depreciable property (acquisitions in a year are effectively depreciable at half the regular rate).

Expenditures that do not relate to a specific property of the business will be added to the cost of the goodwill of the business. Conversely, receipts that do not relate to a specific property will be treated as proceeds of disposition received for goodwill.

When a property in the new pool is sold at an amount exceeding its original cost, the excess will be treated as a (half-taxed) capital gain. As noted earlier, under the current regime the ½ inclusion is typically treated as business income.

There will be transitional rules for ECP owned before the date on which the new rules are finally implemented. It is proposed that existing ECP pool balances will be transferred to the new CCA class. For the first ten years, a 7% depreciation rate will apply to the transferred pool amount. The Department of Finance also indicated that "special rules" will be announced to simplify the transition for small businesses.

As of March 2015, the Department had not yet issued draft legislation to implement these proposals.

AUTOMOBILE EXPENSES

If you use a motor vehicle in the course of a business, you can deduct reasonable expenses that relate to the business use of the vehicle. The deductible expenses include those for gas, oil, minor repairs, maintenance, insurance and licenses.

You can also deduct tax depreciation – known as capital cost allowance (CCA) – although the amount that you can claimed is capped at a maximum as discussed below. Other deductible expenses that are subject to a maximum include interest on a car loan and leasing costs if you lease the vehicle (also discussed below).

Limits on CCA, interest and leasing expenses

As noted, these deductions are capped at maximum amounts. These limits apply to vehicles purchased or leased from 2001 through 2015 (2016 limits will be announced in late December 2015). The limits are:

- The maximum cost of your car on which CCA can be claimed is $30,000 plus applicable federal and provincial sales taxes;
- 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 plus applicable sales taxes. The deductible lease payments can be reduced further, generally if the manufacturer's list price of your car exceeds the capital cost ceiling amount.

Tracking business expenses

Since the deductions can be claimed only for business use and not personal use, you must pro-rate your total expenses based on your business distance travelled relative to total distance travelled. (For these purposes, business travel does **not** include driving from home to work and back.)

Although the best evidence of business travel is a detailed logbook dealing with the entire taxation year, the Canada Revenue Agency (CRA) allows a simplified method based on a 3-month sample logbook. In order to use this simplified method you must first complete one full year of a logbook of business travel to establish a "base year". Subsequently, you can use a three-month sample logbook in any year and use that sample to determine the whole year's business versus personal use, as long as the usage is within 10% of the results of the base year.

The CRA provides the following example:

> **Example**
>
> An individual has completed a logbook for a full 12-month period, which showed a business use percentage in each quarter of 52/46/39/67 and an annual business use of the vehicle as 49%. In a subsequent year, a logbook was maintained for a three-month sample period during April, May and June, which showed the business use as 51%. In the base year, the percentage of business use of the vehicle for the months April, May and June was 46%. The business use of the vehicle would be calculated as follows:
>
> $(51\% \div 46\%) \times 49\% = 54\%$
>
> In this case, the CRA would accept, in the absence of contradictory evidence, the

calculated annual business use of the vehicle for the subsequent year as 54%. That is, the calculated annual business use is within 10 percentage points of the annual business use in the base year – it is not lower than 39% or higher than 59%.

Employees

Employees can deduct the same type of motor vehicle expenses if they are required to use their vehicles in the course of employment. In order to qualify for the deduction, the employee must be ordinarily required to carry on the employment duties away from the employer's place of business or in different places, and be required under the contract of employment to pay the related motor vehicle expenses. (The contract can be written or oral.)

You must obtain a signed Form T2200 from your employer, certifying that you meet the requirements for the deduction. The CRA no longer required you to file the form with your tax return, but you need to keep a copy in case the CRA asks for it.

You cannot deduct these expenses if you receive a tax-free motor vehicle car allowance for the year from your employer. Similarly, you cannot deduct any expenses that are reimbursed by your employer.

2015 AMOUNTS FOR EMPLOYEE CAR ALLOWANCES AND BENEFITS

Tax-free car allowances

Employees can receive a tax-free car allowance from their employers if the allowance is both (a) reasonable and (b) based on the kilometres driven in the year in the course of employment. The CRA typically allows a tax-free allowance up to the maximum amount deductible for the employer.

In this regard, the limit on the employer's deduction of tax-free car allowances is increased for 2015 to 55 cents for the first 5,000 kilometres driven in the course of employment and 49 cents for each additional kilometre driven (each amount increased by 1 cent over the 2014 amount). For the Yukon Territory, Northwest Territories and Nunavut, the allowance limits are 59 cents for the first 5,000 kilometres driven and 53 cents for each additional kilometre driven (also up 1 cent).

Employee operating expense benefits

If your employer provides you a motor vehicle and pays any of your personal operating costs, you must include in income an operating expense benefit. For 2015, the prescribed rate used to determine this benefit remains at 27 cents per kilometre driven for personal purposes. For employees who are employed principally in selling or leasing automobiles, the prescribed rate remains at 24 cents per personal kilometre.

(As an alternative, if your work kilometres for the year exceed your personal kilometres, you can elect that your operating expense benefit be ½ of the "standby charge" included in your income for 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.)

CHANGE OF CONTROL OF CORPORATIONS, AND SIMILAR RULES FOR TRUSTS

When a corporation undergoes a change in control, there are various income tax restrictions that can apply to the corporation. Most of the restrictions relate to the use of certain tax attributes after the change in control.

Upon the change of control of a corporation, there is a deemed taxation year end for the corporation. This will normally result in a short taxation year, with pro-rated CCA and certain other expenses. It also means that carryforwards of losses and other amounts can expire one year sooner. A separate tax return must be filed for that "short" year.

Other notable rules and restrictions:

- Net capital losses incurred before the change in control cannot be carried forward after the change of control, and those incurred after cannot be carried back to years before the change of control. (A net capital loss for a year is the allowable capital losses in excess of the taxable capital gains for the year.)

- Capital properties with accrued losses are subject to a write-down of cost to fair market value on the acquisition of control. Those triggered losses cannot be carried forward. However, an election can be made to deem dispositions of other capital properties with accrued gains in order to step up their cost bases, and the triggered losses can be used to offset those triggered gains.

- Non-capital losses incurred before the change in control can be carried forward, but only to offset income from the same or a similar business to that carried on by the corporation prior to the change in control. Otherwise, the losses cannot be carried forward. A similar restriction applies to post-control losses carried back to pre-control losses.

- Restrictions also apply to the carry-forward or carry-back of investment tax credits and scientific research and development expenses.

For purposes of these restrictions, "control" means so-called *de jure* (legal) control by a person or group of persons. Generally, this means the ownership of shares with more than 50% of the votes required to elect the corporation's board of directors.

There are some exceptions where a change in control does not occur, even if a person acquires more than 50% of the voting shares. For example, if you acquire shares from a person related to you, the acquisition of the shares will not, in itself, result in a change in control of the corporation.

In addition to the change in *de jure* control of a corporation, amendments introduced in 2013 deem that control of a corporation is acquired in certain share acquisitions. The amendments deem an acquisition of control of a corporation to occur when a person or group of persons acquires shares of the corporation that have more than 75% of the fair market value of all the shares of the corporation (without otherwise acquiring *de jure* control of the corporation). However, these new rules apply only if it is reasonable to conclude that one of the main reasons that *de jure* control of the corporation was not otherwise acquired (i.e. more than 50% of voting shares were not acquired) was to avoid the above-noted change in control restrictions.

Similar rules apply to trusts

Similar tax restrictions apply to trusts. However, instead applying upon the change of control of a trust (since a trust is controlled by its trustees), they apply when a person or group becomes a **majority-interest beneficiary** or majority-interest group of beneficiaries of the trust. Typically, this entails the acquisition of more than 50% (on a fair market value basis) of the income interests or capital interests in the trust.

As with the corporate rules, there are some exceptions where the trust rules do not apply, even if you acquire more than 50% of such interests. For example, they normally do not apply if you acquire the interest from an "affiliated person", such as your spouse or controlled corporation, among others.

PRESCRIBED INTEREST RATES

The CRA recently announced the new prescribed interest rates that apply to amounts owed to the CRA and to amounts the CRA owes to individuals and corporations. The amounts are subject to change every calendar quarter. The following rates are in effect from April 1, 2015 to June 30, 2015, and remain unchanged from the last several quarters.

- The interest rate charged on overdue taxes, Canada Pension Plan contributions, and Employment Insurance premiums is 5%, compounded daily.
- The interest rate paid on late refunds paid by the CRA to corporations is 1%, compounded daily.
- The interest rate 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

Rectification of corporate articles allowed — stock dividend was legally effective

The recent Lau decision is one of several cases that have dealt with the legal remedy of "rectification" and its relevance for income tax purposes. The case involved a complex series of transactions and corporate reorganizations that took place in British Columbia.

Simplified, the facts were as follows. A corporation (the "Company") issued stock dividends of $17.6 million to one of its major shareholders G, who sold the stocks for a $17.6 million promissory note. After another series of transactions, G became the owner of another promissory note ("new note") of the same value that had been effectively issued to another party in consideration for the first note. G then transferred the new note to another corporation to which he owed $17.6 million and in which he was a shareholder, to pay off that loan.

The CRA assessed G and added the $17.6 million to his income on the basis that the other corporation had provided him with an unpaid shareholder loan. The CRA took the position that the articles of the Company did not give its directors authority to set redemption values for its issued stock unless it received property for the stock (which it did not receive on the issuance of the stock dividend). As a result, the stock dividend was legally invalid, which meant the subsequent transactions were invalid and G therefore never repaid his shareholder loan to the other corporation.

G appealed the CRA assessment to the Tax Court. He also petitioned the Supreme Court of British Columbia, arguing that it was always intended that the articles of the Company should allow the directors to issue stock dividends and set redemption values, even if it did not receive consideration for the issued shares. The Supreme Court allowed the petition, holding that it was clear from the evidence that all of the involved parties intended that the stock dividend shares could be issued by the Company. The Court therefore issued a **rectification order**, which amended the articles of the Company retroactively to give its directors the authority to issue the stock dividend shares.

As a result, G's appeal to the Tax Court will take into account the effect of the rectification order. Presumably, this will result in the $17.6 million not being included in G's income, although there may be other tax consequences (the Tax Court decision has not yet been issued).

No capital loss on loss of employee's client base

In the recent *Martin* case, the taxpayer was a financial advisor and broker from 1996 through 2010. He was quite successful and established a large and loyal client base, which followed him even when he changed brokerage firms. However, in 2010, his employment with his brokerage firm ("Peak") was terminated and he was unable to find another position. His clients decided to stay with Peak. Unfortunately, the taxpayer's financial position worsened to the point that he subsequently had to claim insolvency and lost many of his personal assets.

In his tax return for 2010, the taxpayer made the interesting claim for a capital loss on the "disposition" of his client base. His position was that the client base was a valuable asset, which was taken from him by Peak. He computed the loss, using an assumed cost base equal to the estimated present value of his lost future revenues, and zero proceeds of disposition. In addition, he increased the amount of the loss, claiming that his disposition costs included the value of his assets that were seized by creditors upon his insolvency.

Not surprisingly, the CRA disallowed the entire loss. On appeal, the Tax Court confirmed the CRA position and also denied the loss. The Court held that the taxpayer did not own the client base, and therefore it was not his property to dispose of. In any event, the Tax Court held that the taxpayer did not pay for the client base and therefore it had no cost to him; it was not appropriate to estimate the cost using an estimated value. Furthermore, it was not proper to include the value of his assets seized on insolvency as taxable disposition costs.

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