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TAX LETTER

April 2013

REPLACEMENT RULES FOR CAPITAL PROPERTY SHAREHOLDER LOANS SALE OF BUILDING WITH TERMINAL LOSS AND LAND WITH GAIN CAPITAL GAIN RESERVES ELIGIBLE AND NON-ELIGIBLE DIVIDENDS INTEREST DEDUCTION "SHUFFLE" AROUND THE COURTS

REPLACEMENT RULES FOR CAPITAL PROPERTY

If you sell a capital property (let's call it the "initial property") at a gain, but replace the property with a "replacement property" within a specified period of time, it is possible to defer the recognition of the gain on the initial property. There are two types of dispositions that qualify for the deferral.

First, the rule applies to so-called "involuntary" dispositions such as theft, destruction, or expropriation of property (in these cases your proceeds of disposition are typically your insurance proceeds, or expropriation proceeds received from the government).

Second, the rule applies to voluntary (actual) dispositions of "former business property", which basically means land and buildings used primarily for business purposes but not including a rental property.

In order to qualify for the deferral on an *involuntary* disposition, you must acquire the replacement property by the end of the second taxation year following the year of the disposition. For *voluntary* dispositions of former business property, you must acquire the replacement property by the end of the first taxation year following the year of disposition.

In either case, the deferral is elective. The election is made in your tax return for the

year in which you acquire the replacement property.

In order to defer the entire gain on the initial property, you must spend at least the amount of proceeds of disposition from that property in acquiring the replacement property. Basically, for every dollar of proceeds that is not spent on acquiring a replacement property, that amount of the gain will not be deferred.

The amount of the deferred gain on the initial property serves to reduce the adjusted cost base of the replacement property. As such, the gain is only deferred and not eliminated, because the new property will effectively inherit the accrued gain.

Example

In year 1, you sell a capital property that qualifies as a "former business property" and has an adjusted cost base of \$100,000 for proceeds of \$180,000, resulting in an \$80,000 capital gain (1/2 of which would otherwise be a taxable capital gain included in your income). In year 2, you purchase a replacement property within the specified period of time for \$180,000, and make the election to defer the gain on the initial property.

Since you spent the entire \$180,000 proceeds on the replacement property, the entire \$80,000 gain is deferred and not taxed in year 1. The adjusted cost base of your replacement property is reduced by \$80,000, from \$180,000 to \$100,000.

On the other hand, if you spent only \$160,000 on the replacement property, \$20,000 of the capital gain would not be deferred, so one-half of that, or \$10,000, would be a taxable capital gain in year 1.

The remaining \$60,000 capital gain would be deferred. The adjusted cost base of the replacement property would be reduced by \$60,000 to \$120,000.

Meaning of "replacement property"

For the above rules, a new property will qualify as a replacement property generally if it is reasonable to conclude that it was acquired to replace the initial property; *and* it was acquired for a use that is the same as or similar to the use of the initial property; and, if the initial property was used for the purpose of earning income from a business, the new property was acquired to earn income from that or a similar business.

Deferral of Recapture on Depreciable Property

The same types of dispositions described above can qualify for a deferral of "recapture" realized on the disposition of a depreciable capital property. Recapture generally occurs where the proceeds of disposition of the property exceeds the undepreciated capital cost (UCC) of the property – effectively "recapturing" excess tax depreciation previously claimed. If there is no deferral, the recapture is fully included in income.

In order to defer the inclusion of the recapture, you generally need to spend an amount at least equal to the recapture on the replacement property. The deferred amount will normally decrease the UCC of the replacement property. The time periods specified above apply for the recapture deferral.

SHAREHOLDER LOANS

If you are a shareholder of a corporation or do not deal at arm's length with a shareholder of a corporation, and you receive a loan from the corporation, a special rule in the Income Tax Act provides that the full amount of the loan may be included in your income and thus subject to tax. Fortunately, there are exceptions where this rule does not apply.

First, the rule does not apply if you repay the loan in full by one year after the end of the corporation's taxation year in which you received the loan, as long as the repayment was not part of a series of loans and repayments. For example, if the corporation has a taxation year ending on December 31, and you receive a loan from it during 2013, you can repay it by the end of 2014 and the income inclusion will not apply.

Another exception applies if the corporation is in the money-lending business and *bona fide* arrangements are made for the repayment of the loan within a reasonable time.

Perhaps the most common exception applies to shareholders who are also employees of the corporation. If you are **not** a "specified employee" (see below), this exception can apply if you receive the loan in your capacity as employee and *bona fide* arrangements are made for the repayment of the loan within a reasonable time.

If you **are** a specified employee, further criteria must be met – the loan must be used for one of the following purposes:

- To purchase treasury shares (i.e. newly issued shares) from the corporation;
- To purchase a home or other dwelling; or

- To purchase a car to be used for employment purposes.

For these purposes, a specified employee is generally one who owns at least 10% of the share of any class in the corporation or who does not deal at arm's length with the corporation. Furthermore, for the purposes of the 10% threshold rule, you are deemed to own shares owned by any non-arm's length person (e.g. your spouse and children, among others).

Deduction for repayment

If the rule applies and you are required to include the loan in your income, you get a deduction when you repay the loan. You get a partial deduction if you repay part of the loan.

Deemed interest rule may otherwise apply

If the shareholder loan rule does not apply because you fall within one of the exceptions, you may still be subject to a deemed interest rule if the loan is made at a rate that is less than an arm's length commercial rate (one that would apply if the corporation was in the money lending business). Basically, where this rule applies, you will be required to include the prescribed rate of interest under the Income Tax Act on the loan while it is outstanding.

However, the inclusion will be reduced to the extent you pay interest for the relevant year or by January 30 of the following year. So if you pay the prescribed rate of interest that applied throughout the year, there will be no net inclusion. For these purposes, the prescribed rate is set every calendar quarter, and it is currently 1% and has been that rate since 2010.

SALE OF BUILDING WITH TERMINAL LOSS AND LAND WITH GAIN

Land is considered non-depreciable capital property (unless you are in the business of selling land). A building is normally considered depreciable capital property, on which tax depreciation (capital cost allowance or CCA) can be claimed.

As a result, if you sell a building used for income earning purposes along with its land, it is possible that you could have a capital gain on the land and a terminal loss on the building. The capital gain will occur if your proceeds of disposition for the land exceed your adjusted cost base of the land. A terminal loss on the building can occur if your proceeds for the building are less than its undepreciated capital cost (UCC), and you own no more buildings in the same "class" of depreciable property. The UCC is basically the original cost of the building less CCA previously claimed on the building (with certain other adjustments).

Only one-half of a capital gain is included in income as a taxable capital gain. On the other hand, a terminal loss is fully deductible in computing income. As a result, it could be advantageous to have more proceeds allocated to the land (only one-half of gain taxed) and less proceeds to the building (to possibly trigger a terminal loss).

Unfortunately, a special rule will apply where you have a capital gain on the land and a terminal loss on the building. In general terms, you must re-allocate the proceeds from the land to the building to reduce or eliminate the terminal loss, up to the extent of the gain. The re-allocation will reduce the capital gain on the land.

Example

You own a building used in your business and the surrounding land. Your UCC of the building is \$150,000 (no others in the depreciable class). Your adjusted cost base of the land is \$100,000. You sell the property for 260 000 \$ and the proceeds are allocated in the sale agreement as follows: \$130,000 for the building and \$130,000 for the land.

Before the re-allocation of proceeds, you would have had a \$20,000 fully deductible terminal loss (\$150,000 UCC minus the \$130,000 proceeds), and a capital gain of \$30,000, of which \$15,000 would have been a taxable capital gain. Thus, your deductible loss would have exceeded your included gain by \$5,000.

After the re-allocation of \$20,000 of the proceeds to the building, you will have no terminal loss. Your proceeds on the land will be reduced to \$110,000, so you will have a capital gain of \$10,000 of which \$5,000 will be included in your income as a taxable capital gain.

CAPITAL GAIN RESERVES

If you sell capital property at a gain, one-half of the gain is a taxable capital gain and is normally included in your income in the year of sale.

However, if some or all of the proceeds of disposition from the sale are due in a later year (or years), you can claim a reserve which will have the effect of deferring the inclusion of part of the gain to the later year.

Basically, in computing your gain for the year of sale, you can deduct a portion of the gain, equal to the lesser of:

The gain x (proceeds due after the year / total proceeds); and

4/5 of the gain

The following (second) year, you must add back the reserve you deducted, and if some proceeds are still due after that second year, you can claim another reserve. In this second year, the latter part of the formula above (the fraction) becomes 3/5 of the gain. Another reserve, if applicable, can be claimed in the third year and fourth year (the fraction becomes 2/5 and 1/5 respectively), and by the fifth year a reserve can no longer be claimed.

Put another way, you can defer the gain to the extent you haven't received the proceeds, but you must recognize 1/5 of the gain each year. As a result, the most you can spread out the inclusion of the gain is 5 years.

Example

In year 1, you sell a capital property for a gain of \$100,000. You receive half the proceeds in year 1. Another 25% is due in year 2 and the remaining 25% in year 3.

Year 1: You can deduct a reserve equal to the lesser of $\frac{1}{2} \times \$100,000$ (50 000 \$) and $\frac{4}{5}$ of \$100,000 (80 000 \$), The lower amount is \$50,000. Therefore, you will report a capital gain of \$50,000, one-half of which, \$25,000, will be included in your income as a taxable capital gain.

Year 2: You add back the \$50,000 reserve from year 1. But you can deduct another

reserve equal to the lesser of the unpaid fraction $25\% \times \$100,000$ (25 000 \$) and $\frac{3}{5}$ of \$100,000 (60 000 \$). The low amount is \$25,000. Therefore, you will report a capital gain of \$25,000 (\$50,000 – \$25,000), one-half of which, \$12,500, will be a taxable capital gain in year 2.

Year 3: You add back the \$25,000 reserve from year 2. No further reserve is available since you have received all of the sale price. You will have a taxable capital gain of \$12,500.

Longer reserve for certain properties disposed of to child

A longer reserve period, which can spread out the inclusion of your gain for up to 10 years rather than 5, is available if you dispose of certain types of property to your child at a gain. The types of property include certain types of qualified farm and fishing property, and qualified small business corporation shares.

ELIGIBLE AND NON-ELIGIBLE DIVIDENDS

If you receive a taxable dividend from a Canadian corporation, it will be either an eligible dividend or a non-eligible dividend. In general terms, a non-eligible dividend is one received from a Canadian-controlled private corporation (CCPC) out of its business income that is eligible for the small business corporate tax rate (applicable to first \$500,000 of active business income per year). An eligible dividend is generally paid from a corporation whose income is subject to the general (higher) corporate tax rate rather than the small business rate. It is "eligible" in the sense of being eligible for a lower rate of tax in your hands as a dividend.

The corporation paying you the dividend must notify you whether it is an eligible dividend.

The significance, from the shareholder's perspective, is that an eligible dividend provides a more generous gross-up and dividend tax credit (DTC) mechanism. This mechanism provides the shareholder with a credit in respect of tax paid at the corporate level, so as to partially or wholly alleviate the so-called double tax on dividends (the corporation's income is taxed and any dividend is then paid out of the corporation's after-tax income).

The gross-up theoretically reflects the underlying corporate tax that was paid, so that you pay tax on what is presumed to be the corporation's original income and you get a credit for the tax the corporation paid. Thus, in theory you are taxed at your own personal rate on the income earned through the corporation.

For eligible dividends, the federal gross-up amount is 38% of the dividend, and the DTC is 6/11 of the gross-up amount or 15.02% of the entire grossed-up dividend. For non-eligible dividends, the federal gross-up is 25% of the dividend, and the DTC is 2/3 of the gross-up. The provinces also have gross-up and DTC amounts for provincial tax purposes, which differ from province to province.

Owing to the gross-up / DTC mechanism, an individual can receive a significant amount of eligible dividends without paying any tax, if they have no other income – often as much as 40 000 \$. (Of course, the corporation has already paid some tax on its income before paying the dividend.) The exact amount will depend on the province.

Example of DTC mechanism with eligible dividend

John is 19 years old and his only source of income for 2012 was \$40,000 of eligible dividends from shares of CIBC that he inherited from his grandfather. He is resident in Ontario. For 2012, the Ontario provincial DTC was 6.4% of the grossed up dividends.

John must report \$40,000 plus the 38% gross up in his income for 2012, resulting in a total income of \$55,200. Before the DTC mechanism, he would have initial federal and provincial tax payable on the \$55,200 of about \$10,507 after the basic personal tax credit.

However, the combined federal and provincial DTC is $(15.02\% + 6.4\%) \times \$55,200$, which totals \$11,824. Therefore, John pays no tax for 2012, because the DTC more than offsets the initial tax calculation. (Technically, you use the federal DTC to reduce the federal tax and the provincial DTC to reduce the provincial tax, but in this example the result is the same.) Unfortunately, the excess DTC is not refundable. (We have also ignored the Ontario Health Premium in this example – John will have to pay that.)

As noted, for other provinces, the actual tax payable will differ because of different provincial DTC amounts and provincial tax rates.

INTEREST DEDUCTION “SHUFFLE”

If you borrow money for the purpose of using the money to earn income from business or property, you can deduct the

interest in computing your income. On the other hand, interest on personal loans is not deductible. Therefore, all other things being equal, it obviously makes sense to use your borrowings for income-earning purposes before personal purposes.

Furthermore, if you have current income-earning investments (stocks, bonds, mutual funds etc.) and are thinking of borrowing for personal purposes, you can effectively shift the borrowing and make it for income earning purposes. That is, you can sell your investments, use the proceeds for personal purposes, and then borrow to re-purchase your investments. Since the borrowings would be used directly to purchase the income-earning investments, the interest would be deductible.

One catch with the above scenario is that the sale of your investments may generate capital gains. Thus, the strategy works best with investments with little or no accrued gains. (If you sell the investments at a loss, the superficial loss rules will apply to deny the loss if you re-acquire the same investments within 30 days of the sale.)

AROUND THE COURTS

Purchase of “luxury” items for employee-children deductible as wages

In the recent *Bruno* case, the taxpayer ran a window-coverings business. Two of her teenage children worked for her on a part-time basis, mainly on the weekends and holidays. The taxpayer did not pay the children cash wages. Instead, she agreed to buy them certain luxury items (i.e. items other than basic necessities) in lieu of wages. Although the children could choose their items, the taxpayer retained a veto as to

whether they would be purchased. On her tax return, the taxpayer deducted the purchase price of the luxury items as salary or wages paid to her employees.

The CRA denied the deduction, on the grounds that the expenditures were personal in nature and further that the children did not have sufficient discretion over the expenditures.

On appeal to the Tax Court of Canada, the Judge held “if the children are owed wages in reasonable amount, a deduction may be claimed if the wages are paid in the form of purchasing luxury personal items chosen by the children.” However, owing to the lack of sufficient details about all of the purchases, the Judge could not determine exactly how many of them qualified as such. Therefore, as a rough measure, the Judge allowed 50% of the purchases as a deduction.

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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.