**PARSONS & CUMMINGS LIMITED**
MANAGEMENT CONSULTANTS

245 Yorkland Blvd., Suite 100 Willowdale, Ontario M2J 4W9
Tel: (416) 490-8810   Fax: (416) 490-8275
Internet: www.parsons.on.ca

# TAX LETTER

May 2012

**FEDERAL BUDGET HIGHLIGHTS**
**TAX-FREE ROLLOVERS TO CERTAIN TYPES OF TRUSTS**
**HOME OFFICE EXPENSES**
**ASSOCIATED CORPORATION RULES**
**PRESCRIBED INTEREST RATES**
**AROUND THE COURTS**

## FEDERAL BUDGET HIGHLIGHTS

The Federal government introduced its 2012 budget on March 29, 2012. The budget contained various income tax measures. Some of the more notable tax changes are summarized below.

- The extension of the 15% Mineral Exploration Tax Credit for individuals investing in flow-through shares whereby a corporation renounces mining expenditures and they can be claimed by the individual. The credit has been extended in several past federal budgets, and will be extended further to flow-through share agreements entered into by the end of March 2013.

- Amendments to the provisions dealing with workplace group sickness and disability plans. The budget provides that employees will generally be required to include in income the value of employer contributions to such plans, except for wage-loss replacement plans where the benefits are payable on a periodic basis (as such benefits are already taxed).

- Retirement compensation arrangements (RCAs) are generally retirement plans set up for executives above the normal registered pension plan limits. The budget proposes that RCAs can be subject to the penalty taxes on "advantages” and “prohibited investments” that currently apply to registered retirement savings plans (RRSPs) and registered retirement income funds (RRIFs).

- The reduction of the investment tax credit for expenses on scientific research and experimental development (SR&ED)

from 20% to 15%, beginning in 2014. (The enhanced 35% investment tax credit that applies to certain Canadian-controlled private corporations remains at 35%.) Also, beginning in 2014, capital expenses incurred for SR&ED will not qualify for a current income tax deduction or the investment tax credit.

- The phasing out and elimination of the investment tax credit of 10% in respect of qualified property used in oil and gas or mining activities in the Atlantic provinces and prescribed offshore regions. The credit will be reduced to 5% for property acquired in 2014 and 2015, and will be eliminated for property acquired after 2015.

- The phasing out and elimination of the 10% investment tax credit for taxable Canadian corporations in respect of "pre-production mining expenditures". The credit for pre-production *exploration* expenditures will be reduced to 5% for expenses incurred in 2013 and eliminated after 2013. The credit for pre-production *development* expenditures will be reduced to 7% in 2014, to 4% in 2015, and eliminated after 2015.

- The phasing out and elimination of the overseas employment tax credit (OETC) that currently applies to certain employees employed outside of Canada. The OETC can reduce Canadian tax on income earned from the overseas employment by 80% (on a maximum of $100,000 of employment income). The 80% amount will be reduced to 60% for 2013, 40% for 2014, 20% for 2015, and it will be eliminated after 2015. The full credit will still be available through 2015 for projects committed to in writing before March 29, 2012.

- Allowing corporations to make “split-dividend designations” and late designations in respect of eligible dividends. Currently, when a corporation pays a taxable dividend, it must notify the shareholder if the dividend is an eligible dividend (and thus eligible for a higher dividend tax credit). Basically, an eligible dividend is one paid out of the corporation’s business income that is subject to the general corporate tax rate (as opposed to the lower rate applicable to small business income). The budget proposes that a corporation may designate, at the time it pays a taxable dividend, any portion of the dividend to be an eligible dividend. The CRA will also be allowed to accept a late designation of an eligible dividend. These proposals apply to taxable dividends paid on or after March 29, 2012.

- Various relieving measures for registered disability savings plans (RDSPs):

  Currently, if the beneficiary of an RDSP is an adult, the holder of the plan must be either the beneficiary or, if the beneficiary lacks the capacity to enter into the plan contract, the beneficiary's guardian or other legal representative. The budget will temporarily allow certain family members to become the plan holder of the RDSP for an adult individual who might not be able to enter into a contract. This measure will apply from the date that it becomes law (i.e. receives Royal Assent).

  Under current rules, any government grants paid into an RDSP in the 10 years preceding a withdrawal from the RDSP must generally be repaid to the government. Under a new “proportional repayment” rule, for each $1 withdrawn from an RDSP, $3 of any government grants paid into the plan in the 10 years preceding the withdrawal must be repaid (rather than the entire amount of grants in the last 10 years). This measure will apply to withdrawals made from an RDSP after 2013.

Increasing the maximum amount that may be withdrawn annually from an RDSP where the government grants paid into the plan exceed private contributions made to the plan. This measure will apply after 2013.

Extension of the period after the beneficiary is no longer eligible for the disability tax credit (DTC). Currently, if the beneficiary is no longer eligible for the DTC in a taxation year, the RDSP must be terminated by the end of the following year. The budget will allow the RDSP to remain in place for up to 4 years after the year in which the beneficiary is no longer eligible for the DTC, provided that a medical practitioner certifies in writing that it is likely that the beneficiary will be eligible for the DTC in the foreseeable future. This measure will apply to elections made after 2013.

Income earned in a registered education savings plan (RESP) may be rolled over tax-free into an RDSP for the same beneficiary. Among other requirements, the beneficiary must have a severe and prolonged mental impairment that can reasonably be expected to prevent him or her from pursuing post-secondary education. This measure will apply to rollovers of RESP investment income made after 2013.

## TAX-FREE ROLLOVERS TO CERTAIN TYPES OF TRUSTS

Normally, when you set up a trust and contribute property to the trust, the contribution takes place at fair market value for income tax purposes. Therefore, if the property has an accrued gain, you will be required to recognize the gain for income tax purposes.

However, there are certain types of trusts to which property can be contributed on a tax-free “rollover” basis. When you contribute property to one of these trusts, the property is deemed to be disposed of at your cost of the property, such that you will not recognize any gain on the contribution for income tax purposes.

### Spousal trust

Perhaps the most common trust for these purposes is the spousal trust. This is a trust under which your spouse (or common-law partner) is entitled to receive all of the income of the trust that arises before your spouse's death, and under which no person except your spouse may receive any of the income or capital of trust before that death. For these purposes, “income” does not include capital gains, so your spouse does not have to be entitled to the capital gains that arise before his or her death. Note also, that although no one else can receive the capital during your spouse’s lifetime, your spouse is not required to receive the capital (although he or she is allowed to receive it).

Property of the trust can be transferred out to your spouse on a tax-free rollover basis. If property is transferred out to another beneficiary during your spouse’s lifetime, the rollover does not apply, and the trust will be deemed to have disposed of the property at its fair market value.

Once your spouse dies, the income or capital of the trust can go to other beneficiaries under the trust (e.g. your children or other beneficiaries) under the terms of the trust.

A spousal trust can also be set up under will, to take effect upon your death. Normally, when you die, you are deemed to have disposed of your properties at their fair market value. However, a tax-free rollover applies if the property is left to a spousal trust. The same income and capital requirements as described above apply. In addition to a trust set up under your will, a spousal trust can include a trust set up under provincial dependant's relief legislation.

Although, as discussed, a tax-free rollover applies to transfers of property to a spousal trust, you can elect that the rollover not apply. In this case, the property will be deemed to be disposed of at its fair market value. This might be beneficial if you have tax losses that you could use to offset any triggered capital gains, or if the property includes qualified small business corporation shares that are eligible for the $750,000 lifetime capital gains exemption. The election out of the rollover will result in a higher tax cost for the trust. However, the election cannot trigger a loss, owing to the superficial loss rules.

For a spousal trust set up under your will, the election out of the rollover is made by your executor or the administrator of your estate. In this case, losses can be triggered because the superficial loss rules do not apply upon death.

Lastly, upon the death of your spouse, the assets in the trust will be subject to a deemed disposition at their fair market values at that time. Therefore, any accrued gains will normally be subject to tax in the trust at that time.

### *Alter ego* trusts

An *alter ego* trust is often set up to avoid provincial probate taxes (called estate administration tax in some provinces), for purposes of confidentiality, or for future protection from creditors. For income tax purposes, a tax-free rollover is allowed into such a trust.

A trust qualifies as an *alter ego* trust if it is set up by you when you are 65 or older, the trust is one under which you are entitled to receive all of the income of the trust that arises before your death, and no one except you can, before your death, receive any of the income or capital of the trust. You can elect out of the rollover, although any accrued losses will be denied under the superficial-loss rules.

Similar to the spousal-trust rules, property of an *alter ego* trust can be transferred out to you on a tax-free rollover basis. However, if property is transferred out to any other beneficiary during your lifetime, the rollover does not apply, and the trust will be deemed to have disposed of the property at its fair market value.

On your death, the trust will be deemed to have disposed of its assets at their fair market values at that time, which may result in tax payable by the trust.

After your death, income or capital of the trust can be paid out to other beneficiaries of the trust pursuant to the terms of the trust.

### Joint spousal trusts

A joint spousal (or common-law partner) trust is typically set up for the same reasons as *alter ego* trust, but by a taxpayer who is married (or has a common-law partner – treated the same as a spouse for income tax purposes).

A trust qualifies as a joint spousal trust if it is set up by you when you are 65 or older, under which you and / or your spouse are entitled to receive all the income of the trust that arises before the latter of your deaths and no one except you or your spouse can, before the latter of your deaths, receive any of the income or capital of the trust. Again, you can elect out of the rollover, but any accrued losses will be denied under the superficial-loss rules.

Similar to the trusts discussed above, upon the latter of your deaths, the trust will be deemed to have disposed of its properties at their fair market values.

## HOME OFFICE EXPENSES

If you run a business from your home office, you are allowed to deduct certain home office expenses. However, certain requirements must be met.

In particular, the home office must either be

(i) your principal place of business, i.e. your main office; **or**

(ii) used exclusively for the purpose of earning income from your business (i.e. no other purpose), **and** used on a regular and continuous basis for meeting clients, customers or patients of your business.

Your home office expenses cannot create a business loss. However, to the extent that such expenses exceed your business income for a year (after other deductions), the excess can be carried forward and used in any later year against income from the same business.

The types of home office expenses that qualify for the deduction include: general maintenance and repair costs; heat and utilities; rent; property tax; home insurance; and mortgage interest.

If the expense relates to the entire house, you must pro-rate the expense on a reasonable basis and only deduct the portion that relates to the home office. This is normally done based on the size of the home office relative to the size of your house. For example, if the office is 1/10$^{th}$ of the size of your house (based on square footage), only 1/10 of your heat and utilities, maintenance, rent, property tax, house insurance, mortgage interest, etc., will qualify for the deduction.

Furthermore, if your office is used partly for personal purposes, you must further pro-rate the above-noted expenses to account only for the business use portion of the office. Thus, if the office was used 75% of the time for business, then 75% of the expenses as determined above would qualify.

### Employees

Employees may also deduct certain home office expenses. Similar to the business home office requirements, the home office must be either the place where the employee principally performs the duties of the office or employment, **or** used exclusively for employment purposes and used on a regular and continuous basis for meeting customers in the ordinary course of employment. Furthermore, the employee must be required to pay the expenses under the contract of employment. This contract can be oral or written. The employer must sign Form T2200, certifying that the employee meets the requirements.

However, most employees cannot deduct property taxes, home insurance, or mortgage interest. Commissioned employees can normally deduct property taxes and home insurance premiums, although their total expenses cannot exceed their commission income for the year. Commissioned employees cannot deduct mortgage interest.

## ASSOCIATED CORPORATION RULES

The "associated corporation" rules in the Income Tax Act are relevant in determining or limiting certain income tax preferences that apply to corporations. For example, if you and your family members own various corporations, all corporations that are associated with each other will be required to share the "small business deduction" that allows a reduced rate of corporate tax on the first $500,000 of active business in a year of a Canadian-controlled private corporation. Thus, for example, there are 3 associated corporations, they will have to share the deduction in respect of $500,000 active business income in the aggregate, and allocate the small business deduction among them.

The associated corporations' ability to claim investment tax credits and certain other tax preferences may also be affected.

The associated corporation rules are quite complex, and it not practical to discuss the entirety of the rules here. However, the following corporations will be associated with each other:

- Two (or more) corporations controlled by the same person
- Two (or more) corporations controlled by the same group of persons
- Two corporations where one corporation controls the other
- Two corporations if one is controlled by a person (person A) and the other is controlled by a person (person B) who is related to person A, where either person A or B owns at least 25% of the shares of any class of each corporation.

For these purposes, "control" includes the ownership of shares with more than 50% of the corporate votes. However, it also includes control "in fact", that is, in certain circumstances where someone has influence that could result in control in fact of the corporation.

Furthermore, there are various deeming rules that provide that a corporation will be deemed to be controlled by a person for the purposes of the associated corporation rules (but generally not for other income tax purposes). For example, there is deemed control by a person if the person owns shares of the corporation having a fair market value of more than 50% of the fair market value of all the shares of the corporation (with or without votes), or common shares of the corporation having a fair market value of more than 50% of the fair market value of all of the common shares of the corporation (with or without votes).

On top of this, for these purposes you are deemed to own any shares of the corporation owned by your children who are under 18. However, this will not be the case where it can reasonably be considered that your child manages the business and affairs of the corporation and does so "without a significant degree" of influence from you.

Due to the complexity of the associated corporation rules, if you and your family members own multiple corporations, you should seek professional tax advice on ways to structure your corporate holdings so as to minimize the application of the rules.

## PRESCRIBED INTEREST RATES

The rates below are the same that applied to the previous quarter and throughout 2011.

- 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 to corporations is 1%, compounded daily.
- The interest rate to be paid on late refunds 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

### Trust resident in Canada even though sole trustee resident in Barbados

For many years, conventional wisdom held that a trust was normally resident in the country in which the majority of its trustees were resident. In the recent *St. Michael's Trust* case (also known as *Garron* and as *Fundy Settlement*), the Supreme Court of Canada held otherwise, ruling that a "central management and control" test should be applied to determine the residency of a trust. The case involved two Canadian resident individuals (Dunin and Garron) who set up trusts for themselves and their family members as beneficiaries of the trusts. The trustee of each trust was a trust company resident in Barbados, and the settlor of the trust was an individual resident in the island of St. Vincent. Dunin and Garron set up the trusts believing them to be residents of Barbados, and not Canada. Nonetheless, the Supreme Court, upholding earlier decisions of the Tax Court of Canada and the Federal Court of Appeal, ruled that the trusts were resident in Canada because their central management and control was in Canada, as Dunin and Garron effectively managed and dictated the activities of the trust. The Court agreed with the Tax Court's findings that the Barbados trustee performed only basic administrative functions such as the signing of documents, and that it otherwise deferred to the recommendations of Dunin and Garron. Since the trust was found to be resident in Canada, it was subject to Canadian tax on all of its income.

For Canadian taxpayers setting up non-resident trusts, it will be important to provide that any non-resident trustee perform its functions independently, and that any suggestions from the Canadian residents be just that – i.e. suggestions that the trustee can take into account in making its decisions, but that do not unduly bind or control the actions of the trustee.

* * *