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TAX LETTER

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FEDERAL BUDGET HIGHLIGHTS
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FEDERAL BUDGET HIGHLIGHTS

The federal government released its 2013 budget on March 21, 2013. The following is a summary of some of the main income tax measures.

- **First-time "super credit" for donors**: The current federal charitable donation credit is 15% of the first $200 of donations and 29% of the remaining donations in the year. These amounts will be increased for "first time donors". The credit will be 40% on the first $200 of donations and 54% of the amount donated in excess of $200, up to a maximum donation amount of $1,000. It will apply only to cash donations. For these purposes, you will be considered a ''first time donor'' if you and your spouse or common-law partner have not claimed the charitable credit in any taxation year after 2007. The enhanced credit is a temporary measure and applies to donations made after March 20, 2013. It can be claimed only once, in your return for the 2013 year or for any year up to 2017.

- **Increase in capital gains exemption**: The current capital gains lifetime exemption allows individuals to realize, on a tax-free basis, capital gains of up to $750,000 on qualified small business corporation shares or qualified farm or fishing properties. Starting in 2014, the threshold is increased to

$800,000, and after 2014 the threshold will be indexed to inflation.

- **Safety deposit boxes**: For taxation years beginning after March 20, 2013, the cost of renting a safety deposit box, even if necessary for business or investment purposes, will no longer be deductible.

- **Change in dividend tax credit**: For "non-eligible dividends", generally meaning dividends received from a small business corporation out of its business income eligible for the small business deduction (see the section later in this letter), individual shareholders must "gross up" the dividend by 25% and are then allowed a dividend tax credit equal to 2/3 of the gross up. For such dividends paid after 2013, the gross up will be 18% and the dividend tax credit will be 13/18 of the gross up (which will have the effect of slightly increasing the overall tax on the dividends).

- **Extension of mineral exploration credit**: Individuals who invest in flow-through shares are eligible for a 15% tax credit on certain mineral exploration expenses renounced to them by corporations. The credit is extended by one year, to flow-through share agreements entered into on or before March 31, 2014.

- **Phase-out of LSVCC credit**: Individuals can claim a 15% federal tax credit for the cost of up to $5,000 of shares of labour-sponsored venture capital corporations (LSVCCs) in a taxation year. The credit will be reduced to 10% for 2015 and 5% for 2016, and eliminated after 2016.

- **Deemed disposition for "synthetic disposition transactions**": The government was concerned about certain transactions in which taxpayers try to defer tax or obtain tax benefits by economically disposing of a property while continuing to own it for income tax purposes. As a result, these "synthetic disposition transactions" will be deemed to create dispositions for income tax purposes, generally for arrangements entered into or extended after March 21, 2013.

- **Character conversion transactions:** The government was also concerned about so-called "character conversion transactions", which are transactions using derivatives that can change the character of income from ordinary income (fully included) to capital gains (only ½ included). Many of these transactions will no longer be effective, generally for agreements and arrangements entered into after March 20, 2013.

- **Loss-trading rules for trusts**: Currently, upon the change in control of a corporation, many losses, credits, deductions and similar amounts that arose before the acquisition of control are denied or restricted after the change of control. These rules will be extended to trusts where a person becomes a "majority-interest beneficiary" or a group of persons becomes a "majority-interest group of beneficiaries" of the trust.

- **Extension of accelerated CCA for manufacturing and processing**: Under current rules, certain machinery and equipment acquired by a taxpayer after March 18, 2007 and before 2014 primarily

for use in manufacturing or processing can claim accelerated CCA (tax depreciation) of 50%. The budget extends this treatment by two years, so that such property acquired in 2014 or 2015 will qualify.

- **Restricted farm losses**: Currently, so-called part-time farmers can deduct up to $8,750 of their farming losses per year from other sources of income ($2,500 plus ½ of the next $12,500). Full-time farmers can deduct all of their losses. The Budget provides that the full-time deduction will be allowed only if the taxpayer's other sources of income are subordinate to farming (this overrules a recent Supreme Court of Canada decision). The restricted deduction for part-time farmers will increase to $17,500 of farm losses per year ($2,500 plus ½ of the next $30,000). These changes apply to taxation years that end after March 20, 2013, so for individuals they apply starting 2013.

- **Broadening the change in corporate control provisions**: Currently, on the change of control of a corporation, many losses, credits, deductions and similar amounts that arose before the acquisition of control are restricted or denied after the change of control. For these purposes, "control" generally means owning shares with more than 50% of the votes required to elect the board of directors. The budget extends these provisions to transactions where 75% of the fair market value of all of the corporation's shares (even if non-voting) are acquired by a person or group, if it is reasonable to conclude that one of the main reasons actual control was not acquired was to avoid the restrictions that would otherwise apply (as described above). The new rule generally applies after March 20, 2013, with some exceptions for agreements signed before March 21, 2013.

- **"Stop International Tax Evasion Program":** The government announced that it will pay cash rewards to individuals with knowledge of major international tax non-compliance if they provide information to the Canada Revenue Agency, where the information leads to the collection of outstanding taxes. The reward will apply only if the information results in total additional assessments exceeding $100,000 in federal tax, and will be 15% of the federal tax collected (but not including penalties, interest or provincial taxes).

- **End to tax benefits of certain borrowings against life insurance:** The government was concerned about so-called "10/8" arrangements, which involve investing in a life insurance policy (earning say 8% income in the policy) along with a borrowing against that investment for the purpose of creating an annual interest-expense tax deduction (of say 10%). As such, the Budget provides that for taxation years that end after March 20, 2013, where a life insurance policy is assigned as security or collateral on a borrowing, and either the interest rate payable on an investment account under the policy is determined by reference to the interest rate payable on the borrowing, or the maximum value of an investment account under the policy is determined by reference to the amount of the borrowing, a deduction for interest on the borrowing that relates to a period after 2013 will be denied, and a deduction for a premium that relates to a period after 2013 will be

denied. Similarly, tax benefits will be denied with respect to certain “leveraged insured annuity policies”.

EMPLOYEE LOANS

If you receive a no-interest or low-interest loan from your employer with interest that is less than an arm’s length rate (basically, one that would apply from a money-lender where the loan was not received by virtue of your employment), you may be subject to the deemed interest benefit provisions of the Income Tax Act.

Basically, the rules provide that you will include in your income a benefit equal to the prescribed rate of interest computed on the loan while the loan remains outstanding. For these purposes, the prescribed rate is set each calendar quarter. The rate is currently 1%.

The amount included in your income is reduced by the amount of interest you pay on the loan in the year or by January 30 of the following year. In other words, as long as you pay the prescribed rate of interest, there will be no benefit included in your income for the year.

Furthermore, if the benefit is included in income, you get an offsetting interest deduction to the extent that you use the loan for the purpose of earning income. Thus, if you use the loan to purchase an income-earning property, the benefit will be included in your income but you will get an offsetting deduction, resulting in no net tax cost. If you use part of the loan for income earning purposes and the other part for personal purposes, then your interest deduction will be the proportionate amount.

Example

On January 1, 2012, you received a $10,000 interest-free loan from your employer. The prescribed rate of interest throughout 2012 was 1%. You used half of the loan to purchase mutual funds, and the other half to buy a motorcycle for your personal use.

You will include 1% x $10,000, or $100, in income as a deemed benefit. You will get an offsetting deduction of 1% x $5,000, or $50.

Home purchase loans

In addition, if you receive a “home purchase loan”, you are subject to a special rule that may reduce the income inclusion. Basically, a home purchase loan is one that is used to acquire a home in which you or a related person live.

During the first five years of a home purchase loan, the maximum interest rate that will apply in determining your benefit is the prescribed rate that was in effect *at the time of the loan*, even if the prescribed rate increases during that time (effectively a “cap” on the benefit). Furthermore, if the prescribed rate decreases below the rate that was in effect at the time of the loan, the lower rate will apply.

As an example, if your employer provided you with an interest-free home purchase loan during the current quarter ending on June 30, 2013, the deemed interest benefit will not exceed 1% per year – the current prescribed rate – for the first five years of the loan. If the term of the loan is more than 5 years, the “cap” rule applies only for the first 5 years.

Home relocation loans

Home relocation loans are given further preferential tax treatment. Generally, a home relocation loan is a loan used to acquire a home when you move to carry on employment. The new home must be at least 40 kilometres closer to your new employment location relative to your old home.

A home relocation loan will be considered a home purchase loan and therefore gets the treatment described above. In addition, you are normally allowed to deduct the deemed interest benefit in respect of up to $25,000 of the loan for up to five years.

In other words, you will have no net benefit in those years in respect of the deemed interest on the first $25,000 of your home relocation loan.

BUSINESS CAR EXPENSES

If you carry on a business, you are allowed to deduct car expenses incurred in the course of your business. The deductible expenses include expenses spent on gas, vehicle license, insurance, lease cost, maintenance, repairs, and, if you own the car, capital cost allowance (tax depreciation). You can also deduct interest expense on a loan to purchase your car. The expenses for leases, interest and capital cost allowance are subject to certain dollar limits.

Of course, the expenses must be apportioned, based on the extent to which you use the car in your business.

Therefore, you need to keep records or a logbook that tracks your business use of the car. Historically, the CRA's administrative requirement was that your logbook should record all of your use for the relevant year.

However, the CRA now allows a simplified logbook method to keep track of your business use of the car. Under the simplified method, you must first establish a logbook for one complete year, which becomes your “base year”.

Once you have established the base year, you can subsequently use a three month sample logbook to establish business use for the subsequent year. The three month sample logbook can be used if the business use for the subsequent year is within 10 percentage points of the base year.

In determining your deductible expenses in a year, the business use of the car is calculated by multiplying the business use as determined in the base year by the ratio of the sample period and base year period. The CRA provides the following formula for this calculation:

> (Sample year period % ÷ Base year period %) × Base year annual % = Calculated annual business use for subsequent year

The simplified method is illustrated by the CRA as follows:

> **Example:**
>
> X has completed a logbook for a full 12-month period, which showed a business use percentage in each successive quarter of 52/46/39/67, respectively, and an annual business use of the vehicle as 49%. In a subsequent year, a logbook was maintained for a three-month sample period of the second quarter (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 second quarter (April, May and June) was 46%. The business use of the vehicle would be calculated as follows:

(51% ÷ 46%) × 49% = 54%

In this example, the CRA will accept, in the absence of contradictory evidence, the calculated annual business use of the vehicle for the subsequent year as 54% (since the calculated annual business use is 3 percentage points higher, which is within 10 percentage points of the annual business use in the base year).

If the annual business use in a subsequent year goes up or down by more than 10 percentage points, the CRA will not accept the base year as an appropriate indicator of annual usage in that later year. In such case, if you wish to use the simplified method, you will have to establish a new base year.

SMALL BUSINESS DEDUCTION

By virtue of the "small business deduction", a Canadian-controlled private corporation (CCPC) is eligible for a reduced rate of tax on the first $500,000 of its active business income for a year. The reduced federal rate is 11% (compared to the general corporate rate of 15%), and the reduced federal-provincial rate depends of the province in which the corporation is resident. For example, in Ontario, the combined reduced rate is 15.5% (compared to the combined general corporate rate of 25%).

In the case of CCPCs that are "associated" – for example, corporations that are controlled by the same person or group of persons, among other examples – the $500,000 threshold must be shared amongst the CCPCs. For example, if there are two associated CCPCs, they can choose to share the $500,000 income threshold that will be eligible for the reduced rate in any proportion that they choose (e.g. 250 000 $ each, or 400 000 $ and 100 000 $).

For the purposes of the small business deduction, the "active business income" of a CCPC includes most types of business income. However, it especially does not include income from a personal services business or a specified investment business.

A "personal services business" is basically a business carried on by the corporation where a specified shareholder (generally, owing 10% or more of the shares in a class of the corporation) or a person related to the shareholder provides services to another party, and would be considered an employee of the other party but for the existence of the corporation. (In simpler terms, this means an incorporated employee.)

A "specified investment business" is a business the principal purpose of which is to derive income from property, such as interest, dividends, rents and royalties.

However, the CCPC will **not** be considered to carry on a personal services business or specified investment business if it employs at least 5 full-time employees throughout the relevant year.

Lastly, the small business deduction is phased out once the corporation's taxable capital exceeds $10 million and is eliminated if the taxable capital is $15 million or more. The "taxable capital" includes shares and debt

invested in the corporation, among other items.

PRESCRIBED INTEREST RATES

The CRA recently announced the prescribed annual interest rates that will apply in the second quarter of 2013 to amounts owed to the CRA and to amounts the CRA owes to individuals and corporations. These rates are calculated each calendar quarter. The rates below are in effect from April 1, 2013 through June 30, 2013. (The same rates applied in the first quarter of 2013 and throughout 2012 and 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 by the CRA to corporations is 1%, compounded daily.
- The interest rate to be paid on late refunds paid to taxpayers that are not corporations 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

Travel expenses allowed for medical tax credit

In general terms, reasonable travel expenses to obtain medical services for a patient can qualify for the medical expense credit for a person accompanying the patient, if the patient is incapable of travelling without the assistance of an attendant, and the place where the medical services are provided is at least 80 kilometres from where the patient lives. It must be shown that substantially equivalent medical services are not available in the patient's locality.

In the recent *Jordon* case, the taxpayer's wife suffered a brain aneurysm and was required to stay at a hospital and rehab centre in Regina, Saskatchewan, which was 120 kilometres from their hometown (which did not have such facilities). She stayed there for treatment for about 6 months. The taxpayer drove his wife to Regina and also drove her home after the 6 months. The CRA allowed the taxpayer to claim these travel expenses for the purposes of the medical tax credit.

However, the taxpayer also drove to Regina about 100 times during the six months to visit his wife, and claimed travel and meal expenses for those visits. The CRA denied the latter claim on the grounds that he was not "accompanying" his wife during this travel.

On appeal, the Tax Court of Canada allowed the taxpayer to claim all of these travel and meal expenses. The Court ruled that the "accompanying" requirement (as described above) applies to travel expenses incurred by the accompanying person during the patient's period of treatment, and not just those expenses incurred when the patient actually travels with the person.

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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.