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TAX LETTER

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CCPCS AND INVESTMENT INCOME

Readers may recall that the 2018 Federal Budget restricted the tax advantages for a Canadian-controlled private corporation ("CCPC") when it generates investment income. This is aimed at CCPCs investing their after-tax business income that was subject to the small business corporate tax rate.

Basically, the new rules provide that where a CCPC (along with any associated corporation) earns more than $50,000 of investment income in a year, its small business limit, which is normally $500,000, is ground down for the next year. The small business limit is the maximum amount of CCPC active business income that is subject to the small business corporate tax rate, which varies from about 9% to 13% depending on the province. Business income above the small business limit is subject to the general corporate tax rate, which ranges from about 26% to 31% depending on the province.

The reason the government introduced the new rule is that CCPC owners had a significant advantage in earning investment income inside the CCPC relative to non-CCPC owners. For example, if an individual in a 52% tax bracket had a CCPC earning business income subject to a 12% tax rate, the CCPC would retain 88% of its income after-tax, which could be invested. Another individual in the same 52% tax bracket earning business income (or other income) personally would only have 48% of income after-tax to invest. Although the CCPC in the first case would be subject to a refundable tax on the investment income as it was earned, there would be an overall tax savings owing to the deferral of tax payable on the original business income.

The new rules provide a $5 grind-down in the CCPC small business limit in a particular year for every $1 that the total of the "adjusted aggregate investment income" of the CCPC (and any associated corporation) for its taxation year ending in the preceding calendar year exceeds $50,000. For example, if the CCPC's adjusted aggregate investment income is $80,000 in one taxation year, its small business limit will be reduced from $500,000 to $350,000 in the following taxation year (i.e. it is reduced by 5 x ($80,000 – $50,000)). As a result, once the adjusted aggregate income hits $150,000 or more in a year, the small business limit will be zero for the next year and the CCPC will pay the high rate of tax (about 26-31%) on all of its business income.

In general terms, "aggregate investment income" of a CCPC includes net taxable capital gains (i.e., half of capital gains, net of allowable capital losses), most forms of income from property like interest and rent, and portfolio dividends (dividends received from "non-connected" corporations). However, net taxable capital gains from the disposition of "active assets" are excluded from the definition. Active assets are generally properties used principally in an active business by the CCPC or a related CCPC, and certain shares in other CCPCs that carry on an active business in Canada. The exception is meant to allow CCPCs to invest in small start-up businesses and certain other corporations in Canada without being subject to the small business limit grind-down.

The new rules apply to taxation years that begin after 2018.

As noted, if the aggregate investment income grinds down the CCPC's small business limit, any business income above the limit will be subject to the general corporate tax rate of about 26% to 31%, depending on the province. Therefore, if you are in a high personal tax bracket, there can still be a tax advantage to earning investment income in the CCPC even if it is subject to the general corporate tax rate. For example, if you are in a 52% tax bracket and the general corporate tax rate is 26%, you would have 48% of income after-tax to invest personally, while the CCPC would have 74% of income after-tax to invest at the corporate level. So a tax deferral can still be available and advantageous.

CHANGE OF CONTROL OF CORPORATIONS

If a corporation undergoes a change in control, various income tax rules come into play. Most of these rules are restrictive in nature, and are generally meant to prevent the takeover of a corporation for the purpose of accessing its existing tax losses and credits that it has been unable to use because it is not profitable, and effectively transferring those losses to another business.

For these purposes, a change in control normally means the acquisition of more than 50% of the voting shares in the corporation. There are some exceptions – for example, if X purchases the shares of Yco from a person related to X who already controls Yco, there will not be a change in control.

A change in control also includes the acquisition of more than 75% of the shares of the corporation on a fair market value basis, regardless of the number of votes. Again, there are some exceptions – for example, there is no change in control if X acquires more than 75% of the shares of Yco but X already controlled Yco.

Some of the more significant change-in-control rules are summarized below.

Deemed taxation year-end and new year

A change in control results in a deemed year-end for the corporation immediately before the change in control, and a new year beginning at the time of the change of control. Since the deemed year end will

typically result in a shortened taxation year, the tax filing dates and balance-due dates for that year will be pushed up accordingly. (The filing date is six months after the year end; the balance-due date is 2 months after year-end, 3 months for certain CCPCs).

The year-end also uses up a year for purposes of the carryforward of various unused losses and credits that can be carried forward for a specific number of years. (However, as noted below, certain losses and credits cannot be used at all.)

The shortened taxation year will require a pro-rating of certain deductions. For example, capital cost allowance (tax depreciation) will have to be pro-rated, based on the number of days in the short year relative to a 365-day year.

Net capital losses

Normally, net capital losses (allowable capital losses [half of actual capital losses] in excess of taxable capital gains for a year [half of actual capital gains]) can be carried back three years or forward indefinitely. However, they cannot be carried over from pre-change of control years to post-change of control years, or vice versa.

In other words, there is a specific restriction that says net capital losses cannot be carried forward beyond a change of control or back before the change of control.

Write-down of unrealized capital losses

Immediately before the change of control, the corporation's capital properties with accrued losses – that is, where the fair market value is less than the adjusted cost base of the property – are subject to a deemed disposition and re-acquisition at fair market value. This results in the triggering of all accrued capital losses in the year ending before the change of control. Because of the rule discussed above, these losses cannot be carried forward to future years beyond the change of control.

However, the corporation can elect to trigger its accrued capital gains on other properties, in which case the cost of those properties is bumped up accordingly. The triggered gains can be offset by the accrued capital losses as noted above. Basically, this rule allows the corporation to elect on a property-by-property basis, a deemed disposition and deemed re-acquisition at any amount between the adjusted cost base of the property and its fair market value.

> Example
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> There is a change in control of Xco. Before the change of control, Xco owned a capital property with a $100,000 adjusted cost base and a $70,000 fair market value. This property is automatically written down to $70,000, leading to a $30,000 capital loss and $15,000 allowable capital loss in the year that is deemed to end before the change in control.
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> The corporation also owns another capital property with a $50,000 adjusted cost base and a $90,000 fair market value. The corporation can elect a deemed disposition and re-acquisition at $80,000, resulting in a capital gain of $30,000 and taxable capital gain of $15,000. This taxable capital gain can be offset entirely by the allowable capital loss. Meanwhile, the adjusted cost base of this property is bumped up to $80,000.

Non-capital losses

Normally, non-capital losses (most unused business and property losses in a year, other than net capital losses) can be carried back three years or forward 20 years. On a change in control, the carryovers are somewhat restricted.

Non-capital losses from a business before the change of control may be carried forward to years after the change of control, generally only to offset income from the same or similar business carried on after the change of control with a reasonable expectation of profit. Similarly, non-capital losses after the change of control from a business can be carried back to years before the change of control if the same or

similar business was carried on with a reasonable expectation of profit. Otherwise, non-capital losses cannot be carried forward or back beyond the change of control.

PRINCIPAL RESIDENCE EXEMPTION INCLUDING RENTAL PROPERTY

The principal residence exemption is one of the most widely used tax breaks under the Canadian income tax system. As most readers likely know, the exemption means that in most cases individuals pay no tax on capital gains realized on the sale of their home. However, there are various conditions that must be met. These are summarized below.

General conditions

The exemption is available only to Canadian resident individuals. It is not available to corporations or non-residents. However, the exemption can apply to a home owned anywhere in the world and not just in Canada.

The exemption is available only if the home is capital property. If it was purchased with the intention of resale (including "secondary intention"), it is considered inventory, not capital property, and the gain on sale is business profit, fully taxable (not half-taxed like capital property), and the principal-residence exemption is not available. Important note: if you buy a home or condominium pre-construction and sell it within a year or so after final closing – even if this is many years after you signed the original contract – the CRA will automatically presume that you intended to sell it all along (despite your protestations that your circumstances changed), and that the gain is business profit. The CRA actively reviews real estate sales records, and has assessed over a billion dollars of tax on such sales over the past four years, most of it on this kind of sale.

The amount of the exemption is based on a formula, and depends on the number of years of ownership that the home was your "principal residence". The formula will exempt all or part of the gain on the sale of your home. The formula is:

Exempt part of gain = gain x (1 + number of years of principal residence / number of years of ownership)

Thus, if the home is your principal residence for all of years of ownership, or all years but one, the entire gain will be exempt. (The fraction in brackets cannot exceed 1.) On the other hand, as an example, if the home is your principal residence for 4 years and you owned the property for 8 years, then 5/8ths of the gain will be exempt. The other 3/8ths will be a capital gain, and half of that will be a taxable capital gain included in your income.

The reason for the "1+" in the formula relates to another rule that says you and your family can designate only one home as your principal residence per year (for these purposes, your family includes your spouse or common-law partner and minor unmarried children). Therefore, if you sell a home and buy another one in the same year, as is typically the case, you can designate on resale one of those as your principal residence for that year. The "1+" rule ensures that the principal residence exemption with respect to the other home is not lost with respect to that year.

Your home can be designated as a principal residence for a year if you "ordinarily inhabit" the home during the year. This phrase has been defined liberally by the courts and the CRA. For example, if you stay at your cottage for 2 or 3 weeks during the year, that stay can satisfy the "ordinarily inhabit" requirement.

The designation as principal residence for all relevant years must be made in your tax return for the year in which you sell the home.

You must file Schedule 3, "Capital gains and losses", as well as Form T-2091 "Designation of a property as a principal residence by an individual". (For sales before 2016, the CRA allowed you to not report the gain at all if you had only one principal residence at a time. Now it must be reported, or you cannot claim the exemption.)

The home can be a regular house, a condominium, a co-operative housing arrangement, a trailer home, or even a houseboat.

Normally, the exemption covers the gain on the sale of the building and up to one-half hectare of the surrounding land. However, if your lot is greater than one-half hectare, the gain on the excess land may qualify for the exemption if you can show that the excess land was necessary for your use and enjoyment of your home. This could be the case, for example, if zoning by-laws have a minimum lot size that is greater than one-half hectare, so that you are required by law to have a bigger lot.

Trusts

It used to be the case that almost any trust owning and selling a home could qualify for the exemption, as long as the trust was resident in Canada and one of the beneficiaries or family members ordinarily inhabited the home. This rule was changed, so that currently only special types of trusts can qualify, such as certain spousal trusts and qualified disability trusts.

Renting out your principal residence

As noted, in order for your home to count as your principal residence for a year, you normally must ordinarily inhabit the home during the year. However, special rules in the Income Tax Act allow you to designate your home while you are renting out. The special rules apply in two instances. First, if you live in your home and subsequently move out and rent it to someone else, then during the rental period you can continue to designate the home as your principal residence for up to four years. Furthermore, if your move out of the home was caused by a relocation of your employment, the four-year period can be extended, if you subsequently move back to the home during the employment or by the end of the year following the year in which your employment is terminated.

Second, if you own a home that you rent out, and subsequently move in and inhabit the home, you can also designate the home as your principal residence for up to four years while you rented it out.

There are a couple of caveats to the above rules:

- First, you are still subject to the "one designated principal residence per year" rule. Thus, if you own another home and designate that other home as your principal residence for a year, you cannot designate the first (rented-out) home for that year.
- Second, if you wish to designate the home as your principal residence while you rent it out, you should not claim capital cost allowance (tax depreciation) on the home. Doing so will eliminate or at least reduce your ability to designate it as your principal residence during the rental period.

FOREIGN EXCHANGE GAINS AND LOSSES

Generally, you can realize a foreign exchange gain or loss for income tax purposes in one of three ways.

First, you can have a foreign gain or loss when you buy and sell a foreign currency. The gain or loss will be the difference between what you paid for the currency in Canadian dollars relative to what you realized on

the sale in Canadian dollars. In this case, a special rule in the Income Tax Act says you ignore the first $200 of net foreign exchange gains or losses for each year. Of the remaining net gain or loss, half will normally be a taxable capital gain or allowable capital loss, as the case may be. (However, if you are actively trading in foreign currency, it could be business income or loss.)

Second, you can have a gain or loss if you purchase and sell a property in foreign currency. In such case, the gain or loss will be the difference between the sale price, converted into Canadian dollars at the time of sale, and the purchase price, converted into Canadian dollars at the time of purchase. If the foreign currency fluctuated from the time of purchase to the time of sale, all or part of your gain or loss will be a foreign currency gain or loss.

> Example
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> I bought a condo in Florida five years ago for US$100,000, when the exchange rate was 1 USD = 1 Canadian dollar. As such, the condo cost me C$100,000. I sold the property recently for US$90,000, when the exchange rate was 1 USD = C$1.34 $.
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> Looking at only the US dollars, one would think I had a $10,000 loss.
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> However, for Canadian tax purposes, I bought the condo for $100,000 and sold it for $90,000 x 1.34, or $120,600, so I must actually report a capital gain of $20,600, half of which is included in my income as a taxable capital gain.

Third, you can have a foreign exchange gain or loss when you repay the principal amount of a debt or other liability denominated in foreign currency. The gain or loss will be the difference between the principal amount you repay, converted into Canadian dollars at the time of repayment, and the principal amount of the debt, converted into Canadian dollars at the time you incurred the debt.

> Example
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> I borrowed 100,000 euros, when the exchange rate was 1 euro = 1.4 Canadian dollar. As such, the loan was C$140,000 in Canadian currency. I later repaid the 100,000 euros when the exchange rate was 1 euro = 1.5 Canadian dollar. Therefore, I repaid C$150,000. Since I repaid $10,000 more in Canadian dollars than I borrowed, I will have a $10,000 foreign exchange loss, half of which will be an allowable capital loss.

The above discussion assumes that the properties or borrowing are on capital account. If, for instance, in the first example I was in the business of buying and selling properties, (including if I held the condo for only a short time), any foreign exchange gain or loss on the sale of the property would likely be considered by the CRA to be business income or loss, and therefore fully included in income or fully deducted, as the case may be.

AROUND THE COURTS

Legal expenses incurred by employee to avoid criminal charges not deductible

Under the Income Tax Act, employees can deduct from employment income only those expenses that are expressly permitted by the Act. One such deduction under paragraph 8(1)(b) of the Act is for legal expenses incurred for the purpose of collecting salary or wages owed to the employee.

In the recent Dauphin case, the taxpayer was the Mayor of Lachine, Quebec. He was the subject of a criminal investigation and incurred legal expenses in defending himself against those charges. He attempted to deduct the legal expenses, essentially on the grounds that they were necessary to keep his job and therefore to collect his salary or wages as required by paragraph 8(1)(b) of the Act. The CRA denied the deduction and the taxpayer appealed to the Tax Court of Canada.

The Tax Court agreed with the CRA and denied the deduction. The Court did not accept the argument that the taxpayer was trying to preserve his employment income. Rather, the legal fees were incurred to "save his reputation and to avoid criminal proceedings" and were therefore personal in nature.

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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.

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