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TAX LETTER

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FORGIVEN DEBT MAY HAVE TAX CONSEQUENCES

If you have a loan or debt that is forgiven or cancelled, you may be subject to adverse income tax consequences. The "debt forgiveness" rules under the Income Tax Act may apply to reduce some of your tax attributes or tax costs in a detrimental way, and in some cases, they may result in an income inclusion.

The debt forgiveness rules apply only if interest on the debt was or would have been deductible for you for income tax purposes. Basically, this means that the rules can apply to forgiven debt that was used for income earning purposes, such as to earn investment income like interest, dividends or rent, or if the debt is used in a business. Personal debt such as student loans, or loans to purchase a personal-use car or property or to finance a vacation, are not caught by the rules.

The rules can apply to both the forgiven principal amount of your loan and the forgiven interest on the loan, if any.

How the rules work

The forgiven amount is applied to reduce certain tax attributes or tax costs. There are various steps in the process. The main steps, in order, are as follows (the steps are set out in general terms; the specific mechanics are quite complex):

1. First, the forgiven debt reduces your non capital losses (i.e., business losses) and farm losses from previous years, if you have any. The previous years' losses are reduced in the order in which they arose.
2. Next, one-half of the remaining forgiven debt reduces your allowable business investment losses (ABILs) from prior years. After that reduction, if any, one-half of the remaining forgiven debt reduces

your net capital losses from prior years. The one-half rule applies here because only half of business investment losses and capital losses are otherwise deductible.

3. This rule is optional: You can elect to use any remaining forgiven debt to reduce the capital cost and the undepreciated capital cost of any depreciable property that you own. Any remaining forgiven debt can then be used to reduce certain resource expenses and resource pools (this latter rule is typically relevant only to corporations).
4. This step is also optional, but only if you have applied the rules in step 3 to the extent they can apply. You can use the remaining forgiven debt to reduce the costs of certain non-depreciable capital properties, such as investment properties. For properties that are shares or debt, you reduce the costs of shares or debt in corporations and partnerships in which you do not have significant holdings or to which you are not related.
5. If you have fully applied step 4, you can normally apply any remaining forgiven debt to reduce the costs of shares or debt in corporations and partnerships in which you have significant holdings or to which you are related.
6. Any remaining forgiven debt is deemed to be a capital gain, but only to the extent of your actual capital losses for the current year in excess of your actual capital gains for the year. The deemed capital gain can then be offset by those excess capital losses, meaning that you will not have a further taxable capital gain under this step. But this step only applies if you have applied the rules in steps 3 and 4 to the extent they apply (as noted above, those steps are optional).
7. If, after the application of the above steps, there is still a remaining forgiven debt, one-half of the amount is included in your income. As noted below, this inclusion is subject to the "eligible transferee" rule. Also, as noted below, a reserve may allow you to defer or spread out the income inclusion over time.

If you (the debtor) have an "eligible transferee", you can forego the income inclusion in step 7 to the extent you allocate the remaining forgiven debt to that transferee. The eligible transferee would then apply the allocated amount under the above steps to its tax attributes or tax costs. An eligible transferee includes a taxable Canadian corporation or Canadian partnership that you control, alone or along with one or more related persons. An eligible transferee also includes a taxable Canadian corporation or Canadian partnership that is related to you.

To the extent you do not allocate the remaining forgiven debt and therefore have an income inclusion under step 7, you may be able to deduct a reserve, which could partly or wholly offset the inclusion. Generally, the reserve equals the amount by which the remaining forgiven debt exceeds 20% of your income otherwise determined in excess of $40,000. Therefore, for example, if your income otherwise determined is $40,000 or less, you can deduct the whole forgiven debt amount as a reserve. Obviously, if your income otherwise determined is quite high, you might not get any reserve.

If you claim a reserve in the year, you add it back into income the next year, although you might qualify for another reserve in the next year under the same formula. The reserve is optional.

> Example
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> One half of your remaining forgiven debt this year is $20,000 and is included in your income under step 7 above. Your income otherwise determined for the year (i.e. not counting the $20,000 remaining forgiven debt inclusion) is $70,000. You can deduct a reserve of $20,000 minus (20% of $70,000 - $40,000), which equals $14,000.
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> In the next year, you will include the $14,000 amount back in income. Depending on your income for that year, you may be eligible for a reserve once again.

The reserve mechanism is different for a corporation. In very general terms, a reserve applies where the remaining forgiven debt exceeds 2 times the corporation's net assets, if any, which are computed using a specific formula in the Income Tax Act. If the net assets are zero or below zero, the entire forgiven debt qualifies for the reserve. To the extent this reserve does not apply, e.g. because the corporation has significant net assets, an optional reserve is allowed, which generally allows the corporation to spread out the income inclusion over five years.

TAXATION OF TRUSTS AND BENEFICIARIES

General rules

Trusts and estates are treated as individuals and taxpayers under the Income Tax Act. As such, they must report any income and pay tax on their taxable income, if any.

Although they are considered individuals, most trusts do not qualify for the graduated tax rates that apply to other individuals. Most trusts are subject to a flat tax equal to the *highest* marginal rate that applies to other individuals. The federal rate is 33% and the provincial rate depends on the province. The combined federal and provincial rate is typically around 50% or more.

The reason the high flat tax rate is used is to prevent income splitting through trusts. For example, if the graduated rates applied to trusts, you could set up multiple trusts and split your investment income, using the graduated tax rates, among the various trusts.

Two exceptions, where the regular graduated tax rates are available, apply to "graduated rate estates" and "qualified disability trusts". In general terms, the first is a deceased's estate for up to 36 months after death, with certain conditions. The second is a testamentary trust (set up under a deceased's will) with a beneficiary who is disabled and eligible for the disability tax credit; again, certain other conditions must be met. All other trusts are subject to the high flat tax rate.

A trust computes its income in much the same way as other taxpayers. However, it can deduct the income in a taxation year that is paid or payable to its beneficiaries in the year. (A couple of exceptions to this "paid or payable" rule are noted below.) The beneficiaries then include that amount in their incomes, and the individual beneficiaries will be subject to the regular graduated tax rates.

Every trust other than a graduated rate estate (GRE) must use a taxation year that is the same as the calendar year. A GRE can use the calendar year, or it can choose to have an off-calendar taxation year for up to 36 months. If it chooses an off-calendar year end, it will have a deemed year-end after 36 months (when it stops being a GRE) and after that it will have a December 31 taxation year end. This flexibility can be beneficial, as illustrated in the following example.

> Example
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> X dies on July 1, 2018. The graduated rate estate chooses a calendar year taxation year. Therefore, the first taxation year ends on December 31, 2018, and as such is a short taxation year. The next two taxation years end on December 31, 2019 and 2020, and the fourth taxation year is a short taxation year that ends on June 30, 2021. This means the trust has four taxation years (over 36 months) in which it can earn income subject to graduated tax rates, rather than three taxation years. In other words, it gets 4 chances instead of 3 to use the low marginal rates that apply to the lower brackets of taxable income.
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> As an alternative, the estate could choose to have a taxation year ending on June 30, through 2021 (i.e., as long as it is a GRE). In this case, the first three taxation years will end on June 30, 2019

to 2021. If the trust income is paid to a beneficiary, it is included in the beneficiary's calendar year in which the trust taxation year *ends*. For example, if the trust earns income in September 2018 and pays it out immediately to a beneficiary, the income is included in the beneficiary's 2019 income, because the trust's taxation year ends on June 30, 2019. This allows some deferral of tax.

There are various flow-though rules that maintain the character of the income in the beneficiaries' hands. For example, if a trust receives dividends from a Canadian corporation and pays them out to a beneficiary, the trust can designate them to be dividends for the beneficiary. The beneficiary can then claim the dividend tax credit. Similar rules apply to capital gains, including those that qualify for the capital gains exemption for the beneficiary (e.g. gains from shares in qualified small business corporations).

Deduction for income vested in beneficiary under 21

If the beneficiary is under the age of 21, and their right to trust income in a year has become "vested indefeasibly", the trust can deduct that income in the year even if it does not pay it to the beneficiary in the year. The beneficiary will then include the amount in their income. This rule allows the trust to retain more after-tax income, since the income will be taxed at the beneficiary's graduated tax rates, rather than the trust's high flat tax rate.

Since the beneficiary's right must be vested indefeasibly (basically meaning that the beneficiary has entitlement to the amount), it means that they should receive it in a later taxation year. The subsequent receipt of the amount will be considered a capital receipt, not subject to further tax. Certain other conditions must be met.

Preferred beneficiary election

This is another situation where the trust can claim a deduction even though it does not pay its income in the year to a beneficiary. The beneficiary must be a "preferred beneficiary", which generally means a disabled individual; again, certain other conditions must be met.

The trust can allocate an amount of its income to the preferred beneficiary, who includes it in their income. The trust deducts that amount from its income. The income is therefore taxed at the beneficiary's graduated tax rates even though it remains in the trust. If the amount is paid out in a later year, it will not be subject to further tax.

Election to pay out income but remain included in trust's income

Another rule allows a trust to pay its income to a beneficiary but **not** deduct that amount, so that it remains income for the trust but is not taxable to the beneficiary. The rule allows the trust to use loss-carryforwards to offset the income inclusion so that it does not pay tax on the amount.

Example

A trust has $40,000 of unused non-capital loss carryforwards from previous years (they can be carried forward for up to 20 years). In the current year, the trust has $40,000 of investment income. It pays out the $40,000 to its beneficiary.

If the trust makes an election and does not deduct the $40,000 paid to the beneficiary, the $40,000 income remains income of the trust. However, it can use its $40,000 non-capital loss carry-forward to offset the inclusion, resulting in no tax for the trust. The beneficiary receives the $40,000 free of tax.

This rule applies only if the loss carry-forward brings the trust's taxable income down to nil. This means that the loss carry-forward must completely offset the trust's income. For example, if only $30,000 of the trust's loss carry-forward in the above example was used, the trust could not make the election.

Deemed disposition dates for trust

In order to prevent trusts from deferring the taxation of accrued gains indefinitely, the Income Tax Act provides that most trusts are deemed to dispose of their properties and reacquire them at fair market value every 21 years. Any accrued gains and losses will be triggered upon the deemed disposition, which may result in tax being payable by the trust. There are exceptions. For example, the deemed disposition does not apply to mutual fund trusts.

For certain trusts, such as qualified spousal trusts and "alter ego" trusts, the first deemed disposition applies on the death of the beneficiary – the spouse for the former, and the person who created the trust (the "alter ego") for the latter. After that, the 21-year rule applies.

RE-ALLOCATION OF PROCEEDS ON SALE OF LAND AND BUILDING

If you own a building and the surrounding land that is used in your business, or as a rental property, you can depreciate the cost of the building for income tax purposes. The tax depreciation is called "capital cost allowance", and the depreciation pool at the end of every year is called the undepreciated capital cost (UCC).

If you sell the building for an amount that is less than the remaining UCC pool, you will have a terminal loss, which is normally fully deductible in computing your income.

If you sell the land for more than your adjusted cost base of the land, half of the resulting capital gain is included in your income as a taxable capital gain. (Unless you are in the business of selling land or you bought the land with the intention of resale, in which case it would be fully included as income from a business.)

So, if you sold both the building and the land as indicated above, at first blush you would have a fully deductible loss on the building but only a one-half inclusion on the land.

Unfortunately, the Income Tax Act provides a re-allocation rule in these circumstances. Generally, you must re-allocate some of the proceeds from the land to the building: the proceeds from the land, not exceeding the gain from the land, must be re-allocated to the building to reduce the terminal loss.

> Example
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> You sell a building and land used in your business. Your adjusted cost base of the land is $300,000 and the UCC pool of the building (the only property in its UCC class) is $150,000. The total sales price is $500,000, comprised of $400,000 for the land and $100,000 for the building.
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> Initially, you would compute a $100,000 capital gain on the land and a $50,000 terminal loss on the building. However, the re-allocation rule will shift $50,000 of the proceeds from the land to the building.
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> Accordingly, your proceeds for the land will be reduced to $350,000, resulting in a $50,000 capital gain and a $25,000 taxable capital gain. The proceeds for the building will be increased to $150,000, resulting in a nil terminal loss.

The re-allocation rule does not apply if there is no initial gain on the land, or if there is no initial terminal loss on the building.

AROUND THE COURTS

Supreme Court Confirms Linkage Principle for Hedging Transactions

In the *MacDonald* case, the Supreme Court of Canada upheld what has been known as the "linkage principle" applicable to certain derivative contracts. Basically, the principle holds that if there

is sufficient linkage between a derivative contract and the value or amount of a property, liability, or transaction, so that the derivative is effectively a "hedge", then the gains or losses on the derivative for income tax purposes take on the character of the property, liability or transaction being hedged.

MacDonald owned shares in the Bank of Nova Scotia. He arranged a substantial line of credit with TD Bank, pledging the shares as collateral for the line of credit. In addition, MacDonald entered into a "forward contract" with TD Securities, which is part of the same TD Bank group. Under the forward contract, MacDonald was required to pay amounts to TD Securities if the value of the shares increased over the forward price, whereas TD Securities was required to pay him if shares' value decreased below the forward price. Over the course of three years, the value of the shares increased, and MacDonald paid about $10 million to TD Securities under the forward contract.

MacDonald took the position that the forward contract was speculative in nature so that the $10 million constituted a business loss. If it was a business loss, it was fully deductible against his other sources of income. The Canada Revenue Agency (CRA) disagreed, arguing that the contract acted as a hedge of the value of the shares. Since the shares were capital property to MacDonald, the CRA assessed the $10 million as a capital loss. Only half of the capital loss was deductible, and only against MacDonald's taxable capital gains.

The Tax Court of Canada agreed with MacDonald's position. However, on appeal, the Federal Court of Appeal upheld the CRA assessment. The Court of Appeal held that there was sufficient linkage between the forward contract and the shares.

In a rare move, the Supreme Court of Canada granted leave to MacDonald to appeal further (the first technical income tax case the Supreme Court has agreed to hear in many years). However, in the end, the Supreme Court upheld the Court of Appeal decision. The Supreme Court concluded: "When considered in its full and proper context, it is clear that the purpose of the forward contract was to hedge against market price fluctuations that Mr. MacDonald's Bank of Nova Scotia shares were exposed to." Since the shares were capital property, the forward contract loss was a capital loss, not a deductible business loss.

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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