Jonathan Paquet
CPA, CA, partner

Tax Letter

Marcil Lavallée

Monthly Newsletter | **February 2016**

2016 AMOUNTS FOR EMPLOYEE CAR ALLOWANCES AND BENEFITS

DEDUCTIBLE TAX-FREE CAR ALLOWANCES

Employers can normally deduct reasonable tax-free car allowances provided to employees. The limit on the employer's deduction of tax-free car allowances is determined each year on a per-kilometer basis. It usually stays the same as the previous year or increases.

However, in 2015 the price of gas dropped significantly. As a result, for 2016, the limit actually decreased by 1 cent per kilometre from the 2015 amounts, to 54 cents for the first 5,000 kilometres driven in the course of employment and 48 cents for each additional kilometre driven. For Yukon, the Northwest Territories and Nunavut, the allowance limits are similarly decreased by 1 cent per kilometre to 58 cents for the first 5,000 kilometres driven and 52 cents for each additional kilometre driven.

EMPLOYEE CAR BENEFITS

If your employer provides you a car vehicle and pays any of your personal operating costs, you must include an "operating expense benefit" in your employment income. For 2016, the prescribed rate used to determine this benefit under regular rules is reduced by 1 cent to 26 cents per kilometre driven for personal purposes. For employees who are employed principally in selling or leasing automobiles, the prescribed rate is reduced to 23 cents per personal kilometre.

Alternatively, if your work kilometres for the year exceed your personal kilometres, you can elect that your operating expense benefit equal ½ of the "standby charge" included in your income for the year (the stand-by charge is determined by a different formula meant to measure the benefit of using the car for personal purposes).

PRINCIPAL RESIDENCE EXEMPTION (AND SOMETIMES IT CAN APPLY TO RENTAL PROPERTIES !)

Readers are likely aware of the principal residence exemption under the Income Tax Act ("Act"), which normally exempts all or part of the gain from the sale of your home from income tax. For example, if you have lived in the home during all years during which you owned it (or all years but one), the rule will normally exempt the entire gain on the sale of the property. If you have lived in the residence for fewer years, typically only a part of the gain will be exempt.

A special rule in the Act allows to rent out your home for a specified period and still claim the exemption in respect of the rental period.

BASIC CALCULATION FOR EXEMPTION

In general terms, the exempt portion of the gain realized on the sale of your residence equals :

> (Gain before exemption) x (1 + # years as your principal residence / number of years of ownership)

For example, say you owned a home in 10 consecutive calendar years and it was your principal residence during 9 of those years. The entire gain would be exempt, as the fraction in the brackets would equal 1. The same would be the case if it was your principal residence for all 10 years, as the exempt portion cannot be greater than the gain itself (i.e. the fraction above cannot be greater than one).

On the other hand, if it was your principal residence for 6 years, your exempt portion of the gain would be $^{7}/_{10}$ths of the gain.

For the purposes of numerator of the above fraction, you only count years that the home was your principal residence in the years during which you were resident in Canada for income tax purposes.

For the purposes of the denominator, the number of years of ownership includes years in which you owned the property either solely or jointly with another person (such as your spouse). The property does not have to be located in Canada, so foreign property you own can qualify.

The purpose of the "1 +" part of the formula relates to the fact that you can designate only one home per year as your principal residence for that year (after 1981). Thus, if you sell a home and buy a new one in the same year "X", you can only designate one of those as your principal residence for that year; but the "1 +" part ensures that the other property can still qualify for the exemption when you sell it, even though it was not designated as your principal residence for year X.

DESIGNATION OF ONE HOME PER YEAR

As noted, you can normally designate only one property as your principal residence in any particular year (assuming it meets the conditions discussed below). More specifically, after 1981, only one home per family unit can be designated in any one year. For these purposes, a family unit includes you, your spouse or common-law partner, and unmarried children under the age of 18. So, for example, the fact that your 19-year old son owns a home in a year does not affect your designation of a home that you own in the same year.

MEANING OF PRINCIPAL RESIDENCE

Normally, a residence qualifies in a year if you, your spouse (or common-law partner) or former spouse (or former common-law partner) or your child (which term has an extended definition) ordinarily inhabits the residence in the year. (The former spouse is allowed for these purposes since, under family law, your former spouse may be allowed possession of the home even though you own it.)

The courts and the Canada Revenue Agency (CRA) take a liberal interpretation of "ordinarily inhabits", so, for example, if you stay at your cottage for 2 or 3 weeks a year it can qualify as your principal residence for that year.

The catch, as noted above, is that you can designate only one property per year per family unit as your principal residence. The designation need not be made each year; it is normally done when you sell the property and are required to report the gain, if any, on your tax return for the year of sale. Furthermore, if the entire gain on the sale is exempt owing to the principal residence exemption, the CRA does not require the designation with your tax return for the year.

RENTAL PROPERTY MAY QUALIFY

Although the general rule requires you to "ordinarily inhabit" the property for the year in which you designate it as your principal residence, a special rule applies where you live in your home and later rent it out, or where you rent out a property and later move in.

In either case, you can make an election and designate up to 4 years of the rental period as years in which the property is your principal residence. In the former case (live in first, then rent out), you make the election in your tax return for the year in which you move out and start to rent it. In the latter case, you can make the election in your return for the year in which you dispose of the property (or within 90 days of the CRA making a demand for the election, if that is earlier). The election also prevents the application of certain "change-in-use" rules, which would otherwise deem the property to be disposed of at fair market value at the time of change in use from personal-use to rental or rental to personal-use, as the case may be.

However, remember again the rule that you can designate only one property as your principal residence per year. Therefore, if you own another property in which you live (while you rent out the rental property), only one can qualify in any given year.

Example

You owned and lived in your home from 2005 to 2010, and then you moved out and rented out the home. This period covers 6 calendar years of "ordinarily inhabiting" the home. You rent it out until 2015, and then you sell the home. Years 2011 through 2015 constitute another 5 years of ownership.

Assuming you make the election, your home can qualify as your principal residence during 4 years in the 2011 through 2015 period (assuming you do not designate another property for those 4 years).

Using the above formula, your entire gain will be exempt:

- Exempt part = Gain x (1 + 10 years as principal residence / 11 years of ownership)
- = entire gain exempt

Lastly, you can claim more than 4 years of principal residence status for the property while you rent out the property, generally if you are required to move because of the relocation of your employment, and you move back into your home during your employment or by the end of year following the termination of your employment.

ALLOWABLE BUSINESS INVESTMENT LOSSES (ABILS)

An ABIL is a special type of allowable capital loss that is subject to preferential tax treatment. The special rule relating to an ABIL is that, unlike an ordinary allowable capital loss, it is deductible against all sources of income and not just taxable capital gains. Generally speaking, other allowable capital losses can be deducted only against taxable capital gains.

What is an ABIL? It is one-half of a "business investment loss", which in turn is a capital loss incurred on certain dispositions of debt or shares in small business corporations. The details follow.

BUSINESS INVESTMENT LOSS FROM ACTUAL DISPOSITION

A business investment loss includes a capital loss from an actual disposition to an *arm's length person* (generally, a person not related to you) of

- a share of the capital stock of a small business corporation, or
- debt in a Canadian-controlled private corporation (CCPC) that is
  - a small business corporation,
  - bankrupt and that was a small business corporation at the time it became a bankrupt, or
  - a corporation that was insolvent and a small business corporation at the time a winding-up order was made in respect of the corporation.

For these purposes, a CCPC is generally a Canadian private corporation that is not controlled by non-residents or public corporations or a combination thereof. Thus, for example, a private Canadian corporation controlled by Canadian individuals will normally qualify as a CCPC.

In general terms, a small business corporation is a CCPC, all or substantially all of the fair market value of the assets of which is attributable to assets used principally in an active business carried on primarily in Canada by the corporation or by a corporation related to it, or debt or shares in other small business corporations. The CRA takes the view that "all or substantially all" normally means 90% or more. Although these criteria can be met at the time of the disposition of the shares or debt of the corporation, the corporation can qualify as a small business corporation if it meets the criteria at any time in the 12 months preceding the disposition of the shares or debt.

BUSINESS INVESTMENT LOSS FROM DEEMED DISPOSITION

Additionally, a loss on a "deemed disposition" of the debt or shares as described above can qualify as a business investment loss. A deemed disposition will occur if you make an election in your tax return for a year in respect of

- A debt owing to you at the end of a taxation year that is established to be a "bad debt" (it is uncollectable) in the year, or
- A share in a corporation owned at the end of the year, where
  - the corporation has become bankrupt during the year,
  - the corporation is insolvent and a "winding up" order has been made in the year, or
  - the corporation is insolvent, neither the corporation nor a corporation controlled by it carries on business, the fair market value of the share is nil, and it is reasonable to expect that the corporation will be dissolved or wound up and will not commence to carry on business.

Basically, when you make the election you will have a deemed disposition for nil proceeds, which will result in a capital loss on the share or debt, thus leading to the business investment loss.

USE OF ABIL

As noted, an ABIL can be used to offset all sources of income in a year and not just taxable capital gains. Essentially, it is treated as a non-capital loss rather than a net capital loss. Also, it must be applied against all income for the current year to bring income to zero, even if no tax would otherwise be payable.

If there are excessive (unused) ABILs in a year, they can optionally be carried back three years or forward ten years to offset any amount of income from any source in those years. However, after the tenth year forward, the ABIL leaves the pool of non-capital losses and rejoins the pool of net capital losses which can be deducted only against taxable capital gains in any year from that point on.

ABIL REDUCED BY CAPITAL GAINS EXEMPTION

The amount of your ABIL is reduced to the extent that you previously claimed the capital gains exemption. That exemption allows you to receive tax-free capital gains of up to (for 2016) $824,176 ($412,088 taxable capital gains) during your lifetime from disposition of certain types of property such as qualified small business corporation shares (there is now a $1 million limit for qualified farm or fishing property).

The reduced business investment loss remains a capital loss, one-half of which is an allowable capital loss that can be deducted against taxable capital gains.

Example

Some years ago, John claimed the capital gains exemption in respect of $50,000 of capital gains ($25,000 of taxable capital gains). He has not otherwise claimed the exemption. In 2015, John incurred a business investment loss of $110,000 on the sale of small business corporation shares.

John's business investment loss of $110,000 will be reduced by $50,000 to $60,000. One-half of that amount, or $30,000, will be deductible against all sources of income. The remaining $50,000 portion of the loss will be an ordinary capital loss. One-half of that, or $25,000, will be deductible against taxable capital gains only.

FOREIGN INVESTMENT REPORTING: SIMPLIFIED VERSION

A special reporting rule in section 233.3 of the Income Tax Act requires you to file an information return with the CRA if the total cost of your foreign investment property at any time in the year exceeds $100,000. This form, T1135, requires quite detailed information. The property that must be reported includes foreign securities in your Canadian brokerage accounts, and any securities in foreign brokerage accounts, as well as many other assets. However, investments in your RRSP, RRIF or TFSA need not be reported as you don't own them directly.

Starting in 2015, if the total cost of your foreign investment property exceeds $100,000 but is less than $250,000, a simplified version of reporting with fewer details is allowed – basically you check a box indicating the type of investment property you own, though you still have to list the income or gains you've earned on such property. New Part A of the T1135 is used for this simplified reporting.

The detailed reporting is found in Part B, and applies where the cost of your foreign investment property is $250,000 or more.

PRESCRIBED INTEREST RATES

The CRA recently announced the new prescribed interest rates that apply to amounts owed to the CRA and to amounts the CRA owes to individuals and corporations. The amounts are subject to change every calendar quarter. The following rates are in effect from January 1, 2016 to March 31, 2016, and remain unchanged from the last several quarters.

- The interest rate charged on overdue taxes, Canada Pension Plan contributions, and Employment Insurance premiums is 5%, compounded daily.
- The interest rate paid on late refund paid by the CRA to corporations is 1%, compounded daily.
- The interest rate paid on late refunds paid by the CRA 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

POOLED TIPS AT RESTAURANT WERE SUBJECT TO CPP AND EI WITHHOLDING

In the recent Andrew Peller Ltd. case, the taxpayer was a company that operated some restaurants at its wineries. In the restaurants, the taxpayer employed numerous servers, wait staff, bus persons, and so on. Instead of allowing servers or wait staff to retain for themselves the tips they received from customers, the taxpayer had a system under which the tips were pooled into one large "account", and later divided up and paid to the various employees in the restaurants.

The issue in the case was whether the taxpayer Peller, when distributing the pooled tips to the various employees, should have withheld Canada Pension Plan (CPP) and Employment Insurance (EI) premiums (as it would be required to do, if it paid regular salary or remuneration). The taxpayer did not withhold, arguing that the tips were not really part of the employees' earnings paid by the taxpayer; rather they were paid by the taxpayer's customers and effectively passed on by the taxpayer as an agent or nominee (and customers do not have to withhold of course).

The CRA disagreed and argued that the taxpayer had indeed paid the tips to the employees, as required under a broad interpretation of the CPP and EI legislation. As a result, the taxpayer was assessed in respect of the CPP and EI it did not withhold. On the taxpayer's appeal to the Tax Court of Canada, the CRA assessment was upheld.

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.

Marcil Lavallée

Marcil-Lavallee.ca

OTTAWA
400-1420 place Blair Place
Ottawa ON K1J 9L8
T 613 745-8387
F 613 745-9584

GATINEAU
125-1160 boul. St-Joseph Blvd.
Gatineau QC J8Z 1T3
T 819 778-2428
F 613 745-9584

Marcil Lavallée, S.E.N.C. | G.P.

Société de comptables professionnels agréés
Partnership of Chartered Professional Accountants

BHD / IAPA
Nos partenaires canadiens et internationaux
Our Canadian and International Partners