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Tax Letter

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DRAFT LEGISLATION FOR 2016 TAX CHANGES

On December 7, 2015, the Department of Finance released a Notice of Ways and Means Motion (NWMM) that contains many of the income tax measures proposed by the new Federal Liberal government. This then became Bill C-2, which received First Reading in Parliament on December 9.

Some of these measures were summarized in our December 2015 Letter. These and other measures are discussed below. Unless otherwise noted, all changes are effective as of January 1, 2016.

MIDDLE RATE TAX CUT

The second federal tax bracket – for 2016, covering taxable income from $45,283 to $90,563 – is reduced from 22% to 20.5%. The bracket, along with all other tax brackets, is indexed each year to inflation.

HIGHEST TAX RATE INCREASED

Taxable income of individuals in excess of $200,000 (indexed after 2016) will be subject to a 33% federal tax rate, up from the previous 29% rate. (These rates are all before counting provincial tax, of course.)

Trusts, both *intervivos* (created during one's lifetime) and testamentary (created upon death), will be subject to a 33% flat tax on all taxable income. An exception will be made for graduated rate estates (basically, a deceased's estate for the first 36 months after death) and qualified disability trusts, which will be subject to the graduated tax rates that apply to other individuals.

Similarly, the federal flat tax that applies to the split income of a minor child (sometimes called the "kiddie tax") will be increased from 29% to 33%. The split income of a minor child includes items such as dividends and shareholder benefits from private corporations.

DONATION CREDIT CHANGE

Currently, the first $200 of charitable gifts made by an individual per year are eligible for a 15% federal credit and any excess donations are eligible for a 29% credit.

Due to the increased top tax rate of 33%, the credit will be amended for individuals with taxable income over $200,000. Basically, for annual donations in excess of $200, an individual will continue to claim a 29% credit rate, except that, a 33% credit will apply to the extent the individual's taxable income exceeds $200,000. In other words, the credit will be similar to deducting the donation from income, for federal tax purposes.

The Department of Finance provided the following example:

- If a taxpayer has $220,000 in taxable income and donates $10,000, a 33% credit rate applies to all donations above the first $200 (i.e., $9,800).
- If the same taxpayer donates $30,000 over the year, the 33% rate will apply to $20,000 of the donations (still 15% on the first $200, and 29% would apply to the remaining $9,800).

TFSA LIMITS

Beginning in 2009, the annual contribution limit for a TFSA (tax-free savings account) was $5,000, indexed for inflation and rounded to the nearest $500. For 2013 and 2014, the limit had been increased to $5,500 owing to inflation. Then the Conservative government increased the 2015 TFSA limit to $10,000.

The new legislation brings the annual limit back to the former $5,000 amount on an indexed basis, so it will be $5,500 for 2016 and indexed thereafter. The $10,000 limit for 2015 has not been reversed.

Furthermore, any unused TFSA room from 2015, based on the $10,000 limit for that year, can be carried forward. For example, if you had made maximum TFSA contributions as of 2014 and then contributed $6,000 in 2015, the extra $4,000 contribution room can be carried forward to 2016 or later.

TAX ON INVESTMENT INCOME OF PRIVATE CORPORATIONS

In order to prevent individuals from holding their investments in privately-held corporations and deferring tax, a higher corporate tax rate applies to the investment income of such corporations relative to business income.

Investment income other than intercorporate dividends

Basically, before 2016, a Canadian-controlled private corporation's "aggregate investment income" (net taxable capital gains and other income from property, other than most dividends received from other corporations) was subject to a federal corporate tax rate of 34.67%.

However, in order to maintain some integration between the corporate and individual tax systems (i.e. to prevent excessive double taxation), a Canadian-controlled private corporation (CCPC) was entitled to a refund of tax if it paid out dividends to its shareholders, generally equal to the lesser of ⅓ of dividends paid and 26.67% of its aggregate investment income.

Due to the new top marginal tax rate of 33%, the NWMM increases the federal corporate tax rate on aggregate investment income for CCPCs by 4 percentage points to 38.67%. In turn, the refund for CCPCs is increased, generally to the lesser of 38.33% of dividends paid by the CCPC and 30.67% of its aggregate investment income.

Dividends received by private corporations

Most inter-corporate dividends flow between corporations without regular "Part I" tax under the Income Tax Act. In particular, if your corporation receives a dividend from another corporation, it is normally deductible in computing taxable income so that your corporation is not subject to tax on the dividend.

However, if your private corporation receives a dividend from another corporation that is not "connected" to it (sometimes called "portfolio dividends" since these are typically investments in the public market), it must pay a special refundable Part IV tax. The other corporation will not be connected generally if your corporation does not control the other corporation and does not hold more than 10% of the shares or votes in the other corporation.

Before 2016, the Part IV tax was 33.33% of dividends received by a private corporation. The tax was refundable when the corporation in turn paid out dividends, generally $1 for every $3 of dividends paid by the private corporation to its shareholders.

Beginning in 2016, the NWMM increases the Part IV tax to 38.33% of dividends received by a private corporation. The tax is refundable at a rate of 38.33% of dividends paid by the private corporation to its shareholders.

FINANCE PROPOSES CHANGES TO RULES GOVERNING SPOUSAL AND SIMILAR TRUSTS

Certain spousal (or common-law partner) trusts and joint spousal (or common-law partner) trusts enjoy special tax treatment under the Income Tax Act. In most cases, property can be transferred into the trust on a tax-deferred basis, either during your lifetime, or upon your death (for a spousal trust). A spousal trust will have your spouse as beneficiary, and a joint spousal trust will have you and your spouse as beneficiaries (certain other conditions must be met).

As a typical example, you could set up a testamentary spousal trust under your will. On your death, property passing to the spousal trust would do so on a tax-free basis, without triggering capital gains (other property upon your death is normally subject to a deemed disposition at fair market value).

However, upon the death of your beneficiary spouse (or, for a joint spousal trust, the later of your death or your spouse's death), the trust is deemed to dispose of its properties at fair market value. This may generate capital gains or losses in the spousal trust at this later point in time.

Before 2016, any capital gains resulting from the deemed disposition on the spouse beneficiary's death were generally taxed to the spousal trust and not the beneficiary. Furthermore, any income of the trust up until that death was taxed to the trust, unless it was actually paid out to the beneficiary.

The government recently amended the rules effective as of January 1, 2016, providing that on the death of the beneficiary spouse, there will be a deemed year-end for the spousal trust. The amended rules further provide that capital gains on the deemed disposition at the beneficiary's death, plus any income of the trust in the year ending upon the death, will be deemed to be payable to the beneficiary and therefore taxed to the beneficiary rather than the trust ("beneficiary-taxed rule").

The beneficiary-taxed rule (paragraph 104 (13.4)(b) of the Income Tax Act) proved to be a concern to many in the tax community. The concern was that the deceased beneficiary could be subject to tax on such gains or income, even if the beneficiary did not receive any property or income out of the trust.

Not surprisingly, the Department of Finance was lobbied extensively by concerned parties. In response, on November 16, 2015 the Department released a "semi-comfort" letter addressed to the Canadian Bar Association / CPA Canada Joint Committee on Taxation, the Society of Trust and Estate Practitioners (STEP), and the Conference for Advanced Life Underwriting (CALU), under which it more-or-less proposed to alleviate the above-noted concern relating to the beneficiary-taxed rule. The letter is not as definite as comfort letters usually are, as Finance continues to review the issue, but it is likely that what it proposes will be enacted.

Under this proposal, the beneficiary-taxed rule would generally not apply. As such, the spousal trust would remain taxed on the capital gains resulting from the deemed disposition rule and on any income in the trust year ending on the beneficiary's death, effectively reinstating the pre-2016 tax rules.

However, the beneficiary-taxed rule would apply to a testamentary spousal trust if, among other criteria, the trust was created by the will of a taxpayer who died before 2017 and the trust and the beneficiary's graduated rate estate jointly elected to have that rule apply.

Assuming these proposals are enacted, the trust will be taxed on the deemed gains and income in the year ending at the time of the death of the spouse beneficiary, unless the joint election is made and the other criteria are met. Hopefully, more details on these proposed changes will be forthcoming in the near future.

CHARITABLE DONATIONS CREDIT FOR SPOUSAL AND SIMILAR TRUSTS

On a related note, if a spousal trust makes a charitable donation, it can claim it in the year of donation or in the subsequent five years.

In conjunction with the proposals described above, in the same comfort letter the Department of Finance proposes that a gift made by the trust after the beneficiary's death but in the same calendar year will be able to be claimed in the trust's year ending at the time of death, to offset any tax owing as a result of the proposed alternative treatment under which the trust is subject to tax in that year (as discussed above).

TAX-FREE TRANSFERS OF PROPERTY TO YOUR CORPORATION

OVERVIEW

Often, when you transfer property to a non-arm's length person such as a corporation that you control, you have a deemed disposition of the property for proceeds equal to the fair market value (FMV) of the property. Assuming the FMV exceeds the cost of the property, the transfer can trigger capital gains or ordinary income.

However, a special election under the Income Tax Act (a "section 85" election) allows you to transfer property on a tax-free or partially tax-free basis to a corporation if you receive at least one share of the corporation as consideration for the transfer. The election allows you to incorporate your business or investments on a tax-deferred basis.

In general terms, you and the corporation make a joint election under which you choose an elected amount for the property. The elected amount becomes your proceeds of disposition of the property transferred to the corporation. So if the elected amount equals your tax cost of the property, you will have no gain on the transfer and no tax payable.

In addition, the elected amount becomes the corporation's cost of the property.

Furthermore, the elected amount, less the value of any non-share consideration that you receive on the transfer, becomes your cost of the shares received as consideration from the corporation.

Example

> You own real estate capital property with a tax cost of $200,000 and a fair market value (FMV) of $500,000. You transfer the property to your corporation in consideration for 100 common shares in the corporation and $50,000 cash. The amount you and the corporation elect under section 85 is $200,000
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> The deemed proceeds of disposition on the transfer of the real estate will be $200,000, resulting in no capital gain or loss and no tax payable for you. The corporation's cost of the property will be $200,000. Your cost of the 100 common shares will equal $150,000 ($200,000 elected amount minus the $50,000 non-share consideration).

Although you would often choose an elected amount to completely defer any gain, you can choose an elected amount that will generate a gain, such as if you have losses that can offset the gain. In the above example, suppose you have a $30,000 net capital loss (half of actual capital losses) from last year that you are carrying forward. If you elect $260,000 on the transfer of the real estate, there will be a $60,000 capital gain, $30,000 of which will be a taxable capital gain included in your income. However, you will have no tax payable on the transaction if you used the $30,000 net capital loss to offset that taxable capital gain. At the same time, your corporation's cost of the property will be bumped up to $260,000, and your cost of the 100 common shares will be increased to $210,000 ($260,000 elected amount minus the $50,000 non-share consideration).

LIMITS ON THE ELECTED AMOUNT

The elected amount on the property transferred to the corporation is subject to the following general limits:

- It cannot exceed the FMV of the property;
- It cannot be less than the lesser of the FMV of the property and its tax cost; and
- It cannot be less than the FMV of the non-share consideration (sometimes called "boot") that you receive on the transfer.

FILING DEADLINE FOR SECTION 85 ELECTION

The joint election is due by the earlier of your tax-filing due date and the corporation's tax-filing due date for the taxation year in which the transfer of property takes place. An election may be filed late within 3 years of this date, although with a monetary penalty. The CRA has the discretion to allow a later election if it is "just and equitable" in the circumstances.

CAPITAL DIVIDENDS

A private corporation can elect to pay a "capital dividend" to its shareholder(s). The benefit of the election is that the dividend is not included in the shareholder's income, assuming the shareholder is a Canadian resident (withholding tax will apply if the shareholder is non-resident). Public corporations cannot make the election.

In general terms, a capital dividend reflects certain amounts that are tax-free to the private corporation, and that should be allowed to pass tax-free to the shareholders. For example, one-half of net capital gains are not taxed and therefore form part of the capital dividend. More specifically, the capital dividend will reflect the corporation's "capital dividend account" (CDA), which includes items such as:

- One half of the corporation's capital gains in excess of one-half of its capital losses;
- Most life insurance proceeds received by the corporation on policies where it was the beneficiary; and
- Capital dividends that the corporation received from other corporations.

The CDA for the purposes of the capital dividend is computed immediately before the earlier of the time that the dividend became payable and the time it was paid. (It is usually payable at the time indicated by the directors of the corporation in the corporate resolution declaring the dividend.) Similarly, the corporation must file the CDA election with the CRA by the earlier of these two times. The election is filed on Form T2054. Late filing may be allowed, but with a monetary penalty.

DIVIDEND EXCEEDS CDA

Normally, the dividend will not exceed the corporation's CDA, so the entire dividend is a capital dividend. If the dividend exceeds the corporation's CDA but the corporation still makes the election, the entire dividend remains non-taxable to the shareholder. However, the corporation will be subject to a penalty tax of 60% of the excess amount of the dividend. As an alternative to the penalty, the corporation may elect to treat the excess amount as a taxable dividend, meaning that the shareholders will include that excess amount in income as a dividend.

AROUND THE COURTS

MINI-STORAGE BUSINESS NOT ELIGIBLE FOR SMALL BUSINESS DEDUCTION

The small business deduction reduces the federal tax rate for the first $500,000 of active business of a Canadian-controlled private corporation to 11% (for 2015). The rate is reduced further to 10.5% for 2016 and another 0.5% per year until 2019, when it will be 9%.

Active business income includes most business income, but it does not include a "specified investment business", which is a business the principal purpose of which is to earn income from property (such as rent). An exception to the specified investment business rule applies if the corporation employs more than five full-time employees throughout the year.

In the recent case of *0742443 BC Ltd.,* the corporation carried on a business of providing self-serve storage facilities. The corporation claimed the small business deduction, but the CRA denied it on the grounds that the corporation was carrying on a specified investment business. The CRA position was upheld by the Tax Court of Canada, and the taxpayer further appealed to the Federal Court of Appeal.

The Court of Appeal upheld the decision and disallowed the corporation's small business deduction. The Federal Court held that the principal purpose of the corporation's business was to earn rental income by renting out its storage space. Even though it provided some other services such as snow removal at the facility, these services were simply incidental to the business of earning rental income, and the income was income from property.

NOTE: In the 2015 Federal Budget, the Department of Finance indicated that some businesses have expressed concern as to the application of the small business deduction rules in cases such as self-storage facilities and campgrounds. The Department announced a review of the circumstances in which income from a business, the principal purpose of which is to earn income from property, should qualify as active business income. It invited interested parties to submit comments. To date, the Department has not provided further comments in this regard. Furthermore, it is not clear whether the new Liberal government will follow through on this review, which was announced during the previous Conservative government's tenure. Hopefully more details will follow.

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