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TAX LETTER

IN THIS ISSUE

QUALIFIED DISABILITY TRUSTS

A qualified disability trust ("QDT") is a testamentary trust that can be set up for disabled beneficiaries who are eligible for the disability tax credit. A testamentary trust basically means a trust that is set up under your Will, and takes effect after you die.

You might consider setting up a QDT if you have a disabled relative, because of the tax advantage described below.

Most trusts are subject to a flat tax on all taxable income at the highest marginal tax rate (typically 50% or more depending on the province). However, a QDT is subject to the graduated tax rates that apply to individuals, so that they typically pay much less tax on their income relative to most other trusts.

There are various conditions required to meet the QDT status. Essentially, a QDT for a taxation year is a testamentary trust that meets all of the following tests:

- The trust arose on and as a consequence of the death of an individual;
- The trust is resident in Canada for the taxation year (this is normally determined by its "central management and control" – where the trust is controlled from);
- The trustee of the trust makes a joint election in the trust tax return for the taxation year with one or more beneficiaries ("electing beneficiaries") that are eligible for the disability tax credit;
- The electing beneficiary is named as a beneficiary in the will or other testamentary instrument that created the trust; and
- The electing beneficiary does not make such an election with any other trust for that trust's taxation year, meaning that each electing beneficiary can benefit from only one QDT per taxation year.

If a QDT no longer qualifies as a QDT in a taxation year, it may be subject to a "recovery tax", summarized below. A QDT can cease to qualify in a taxation year if

- None of the beneficiaries at the end of the year was an electing beneficiary in previous taxation years. In other words, at least one beneficiary must have been an electing beneficiary in a previous year; or
- The trust ceased to be resident in Canada; or

- An amount is paid or distributed to a beneficiary in the year who is not an electing beneficiary, unless the amount was deducted in computing the trust's income or was on account of an amount that was deducted by the trust in a previous year.

Basically, the last condition above prevents a QDT from retaining income in the trust, taxed at graduated rates, and then later distributing it tax-free as a capital distribution to a non electing beneficiary. If the trust does this, it will cease to be a QDT in the taxation year of that distribution.

The recovery tax, if applicable, is essentially imposed on the trust's taxable income for each previous year in which it was a QDT that was distributed in a later year to a non electing beneficiary as a capital distribution (so that the non-electing beneficiary receives capital of the trust that was previously taxed at graduated rates and not the highest flat tax rate). In general terms, the recovery tax is then levied at the highest marginal rate in excess of the tax payable for that previous year.

The provision is quite complex. In its Explanatory notes to the provision, the Department of Finance explains that… "no tax is recovered …on the amount of a trust's after-tax retained taxable income for a taxation year if that amount is distributed to one or more individuals during their lifetimes, those individuals were electing beneficiaries of the trust for the taxation year and no capital distributions are made to other beneficiaries before that amount, and similar amounts for other taxation years, are distributed to those individuals". Otherwise, the recovery tax could apply.

One further note: Graduated rate estates

We have discussed this issue before, but we note it here because a "graduated rate estate" (GRE) is the only kind of trust besides a QDT that is subject to graduated tax rates rather than the high flat tax rate that applies to other trusts. (Your estate is considered a trust for income tax purposes.)

In general terms, your estate, from the date of your death and for up to 36 months, can qualify as a GRE. More specifically, the following conditions must be met.

Your estate will be a GRE at a particular time in a taxation year if:

- No more than 36 months have passed since your death;
- Your Social Insurance Number is provided in the estate's tax return for the taxation year and for each of its earlier taxation years;
- The executor or trustee of the estate designates the estate as your GRE in its tax return for its first taxation year; and
- No other estate is designated as your GRE in a tax return for a taxation year. This means you can only have one GRE. (In most cases, a person has only one estate anyway.)

GIFTS AND NON-ARM'S LENGTH TRANSFERS

There are rules in the Income Tax Act that deal specifically with gifts and non-arm's length transfers of property. We summarize them below.

Gifts

If you give property to someone, you are deemed to dispose of the property for "fair market value" proceeds of disposition. This means you may have a capital gain or loss, depending on your adjusted cost base of the property (which is your original cost, with possible adjustments).

"Fair market value" normally means the highest price someone would pay on the open market in an arm's length transaction with full information.

The person who receives the gift is in turn deemed to have an adjusted cost base of the property, for capital gain / loss purposes, equal to its fair market value.

> Example
>
> I give property to my son. My adjusted cost base of the property is $10,000 and its fair market value is $50,000.
>
> I will have a capital gain of $40,000, one half of which will be included in my income as a taxable capital gain (if I have any allowable capital losses, that inclusion will be reduced).
>
> My son gets an adjusted cost base of the property of $50,000. So, if he later sells it for, say $60,000, he will have a capital gain of $10,000 and half of that will be included in his income.

The gift rule applies not only to gifts to individuals, but also to gifts to other entities. For example, if the above gift was made to a charity, I would still report the same taxable capital gain. However, I could claim the charitable tax credit for the fair market value of $50,000.

In general terms, the federal charitable tax credit is 15% of the first $200 of gifts in the year, plus the provincial credit which depends of the province, and typically brings up the percentage to around 20%. After that, if you are in the highest income tax bracket which for 2022 applies to taxable income **over** $221,708, you are eligible for a federal credit of 33% plus the applicable provincial rate, which can bring that up to around 50% or more, for gifts over $200 to the extent of your taxable income in the top tax bracket. If there is any remaining amount of gift, you get a federal credit of 29% plus the applicable provincial rate. If your taxable income is not subject to the highest tax bracket, the rate for donations over $200 remains at 29% plus the provincial rate.

> Example of charitable gift
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> Assume you made the $50,000 gift from the above example to a charity. You would still have a capital gain of $40,000 and a taxable capital gain of one-half of that amount included in your income (subject to the rule explained further below about publicly-traded shares or other securities).
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> You have taxable income in 2022 of $241,708, which is $20,000 over the top marginal tax rate threshold.
>
> You will get a federal credit of 15% of $200 plus the provincial credit. You will get the maximum federal credit of 33% on $19,800 plus the provincial credit. For the remaining $30,000 of the gift, you will get a 29% credit plus the provincial credit.

There is an additional tax benefit if your gift to the charity is a **publicly listed security**. In such case you still get the charitable tax credit as noted above, but you will have no capital gain, which obviously will save you even more tax.

Furthermore, there is no capital gain or loss if you give cash, since the adjusted cost base of the cash will equal its fair market value. An exception occurs if you give foreign currency, since that may fluctuate relative to the Canadian dollar; this is an exception that we will discuss in a future letter.

Non-arm's length transfers that are not pure gifts

These rules can be quite punitive.

They can apply to transfers between non arm's length persons, which include related persons as defined in the Income Tax Act. Related persons include you and your spouse or common-law partner (although there is a special rule for transfers to them, as discussed below), your siblings, your children, parents, grandchildren, and in-laws, among others. Related persons also include you and a corporation that you control or another related person controls. Interestingly, related persons do not include your cousins, nieces and nephews, and aunts and uncles.

The first rule can apply where you sell property to a non-arm's length person for proceeds that are **less than the property's fair market value**. In this case, you are deemed to have sold the property for fair market value. The apparent rationale for the rule is to prevent you from shifting accrued capital gains to a lower-taxed non-arm's length person. However, the rule is one sided, in that the purchasing person gets an adjusted cost base equal to what they actually paid, and not the fair market value. As illustrated in the example below, this can lead to double taxation.

> Example
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> I sell property to my son for $10,000. My adjusted cost base of the property is $10,000 and its fair market value is $50,000 at the time of the sale.
>
> I will have deemed proceeds of $50,000 and therefore a capital gain of $40,000 ($50,000 deemed proceeds less my adjusted cost base of $10,000).
>
> But my son's adjusted cost base of the property will remain the $10,000 that he paid for the property. So, for example, if he turned around and sold the property to a third party for $50,000, he would also have a capital gain of $40,000. Double taxation occurs.

The second rule can apply if you purchase property from a non-arm's length person **for more than its fair market value**. In this case, your adjusted cost base is ground down to the fair market value even though you paid more than that. But again, this rule is one-sided, in that the non-arm's length person's proceeds of disposition are whatever you actually paid. As the example below illustrates, this rule can also result in double taxation.

> Example
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> My son sells me property for $50,000. His adjusted cost base of the property and its fair market value are both $10,000.
>
> I have a deemed adjusted cost base of $10,000. However, my son's proceeds of disposition equal the $50,000 that I actually paid for the property, which means he will have a $40,000 capital gain.
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> If I later sell the property for more than $10,000, I will also have a capital gain. So again, this rule can result in double taxation.

Exception for transfers to spouse or common-law partner

If you sell or give property to your spouse or common-law partner, a **tax-free "rollover"** is allowed so that the above rules do not apply. Basically, you are deemed to have sold or given the property for proceeds equal to your adjusted cost base, and your spouse or partner picks up the same adjusted cost base.

However, you have the option to elect out of the rollover, in which case the above rules *do* apply. There are various reasons you might do this – for example, if you have unused capital losses, you could apply them to offset any resulting capital gain, while providing your spouse or partner with a stepped-up adjusted cost base.

> Example
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> I give property to my spouse. My adjusted cost base in the property is $10,000 and its fair market value is $50,000.
>
> With the rollover, I have deemed proceeds of $10,000 and therefore no capital gain. My spouse then has the same $10,000 adjusted cost base.
>
> However, say I have unused capital losses that I could use to offset a capital gain. If I elect out of the rollover, I will have deemed proceeds of $50,000 and a resulting capital gain of $40,000, which could be offset by my capital losses, thus resulting in a nil or low net taxable capital gain. My spouse would benefit from

> an increased adjusted cost basis of $50,000, which would decrease any capital gain (or increase any capital loss) when they eventually sell the property. Note however that the future capital gain or loss may be attributed back to me under the income attribution rules.

Unfortunately, you cannot get a capital loss by electing out of the rollover. This results from the superficial loss rules, discussed below.

SUPERFICIAL LOSSES

The superficial loss rules are intended to prevent you from selling a property at a loss where you or an "affiliated person" acquires the same or identical property within the time period described below. Where the rules apply, your capital loss will be denied.

The superficial loss rules apply where you sell capital property like securities, at a loss, and in the period beginning 30 days before the day of the sale and ending 30 days after the sale, you or an affiliated person acquire the same or identical property and own it at the end of that period. The period is therefore a total of 61 days (including the day of the sale).

An affiliated person includes your spouse or common-law partner, and a corporation that you or your spouse or partner control either together or individually. Control for these purposes normally means you and / or your spouse owning more than 50% of the voting shares of the corporation.

Interestingly, an affiliated person does not include your child, grandchild, parent or grandparent, or most other relatives. If one of these people acquires the property within the 61-day period, the superficial rules do not apply, so you can claim the capital loss. The benefit of claiming the capital loss is that it serves to offset any capital gains you have. And if you don't have sufficient capital gains in the year, you can carry back the capital loss three years or carry it forward indefinitely, to offset capital gains in those years.

As noted, when the superficial rules do apply, your capital loss on your sale of the property is denied (technically, it is deemed to be nil). However, the amount of the denied capital loss is added to the adjusted cost base of the same or identical property acquired by you or the affiliated person. Because of this addition, a capital loss might be claimable in a future year.

> Example
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> You sell 1,000 common shares in Acme Ltd. for $10 each. Your adjusted cost base of the shares is $20 per share. Before considering the superficial loss rules, your capital loss would have been $10,000.
>
> However, 20 days after sale, you purchase another 1,000 Acme common shares for $12 per share, and you still own them 30 days after the sale.
>
> Due to the superficial loss rules, your initial capital loss of $10 per share is denied and deemed to be nil. However, the adjusted cost base of each new Acme share is increased by that denied loss, so your adjusted cost base of the new shares becomes $22 per share (your purchase price of $12 per share plus the denied capital loss of $10 per share).
>
> Assume you later sell the new shares for $17 per share. You will have a capital loss of $5 per share. Half of that will be an allowable capital loss, which can be applied against any of your taxable capital gains.

As noted, the superficial loss rules can apply if you or the affiliated person acquires an "identical property".

Usually, the rules apply to securities, although technically they can apply to any capital properties. For shares in corporations, identical properties basically mean shares of the same class of the same corporation but not shares in different classes of the corporation. Thus, if you sell common shares in Acme. at a loss and purchase preferred shares of a different class in Acme, the shares are not identical such that the superficial loss rules do not apply.

A similar rule applies to units in mutual funds or exchange traded funds. Basically, they will be considered identical if the units are in the same fund and of the same class of units.

AROUND THE COURTS

In Canada, gambling winnings are not taxable unless the taxpayer is found to be in the business of gambling. The courts have been quite reluctant to find this to be the case. A recent court decision provides an example.

In the Duhamel case, the taxpayer earned significant amounts from gambling – for instance, in 2010 he won $4 million while playing the "Main Event" of the World Series of Poker. The CRA assessed Mr. Duhamel, claiming that his gambling activities amounted to a business and thus that the $4 million should have been included in his income.

The Tax Court of Canada disagreed with the CRA, and held that the evidence in the case showed, overall, that Mr. Duhamel's gambling did not show a business-like approach or a consistent ability to generate profits. In some other years he had very significant losses and he was basically gambling for fun and hoping to win, without a "system" for winnings. Therefore, the Tax Court found that he did not act as a "serious businessman" in the gambling activities, the activities were not exercised in a sufficiently business-like manner to qualify as business income, and he was not carrying on a gambling business. His winnings were therefore tax-free.

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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