CANTAX PUBLICATIONS INC.

Editors
Neil Bernstein CPA.CA
H.B. Zimmer C.A.

Tax Education Services

TAX LETTER

April 2014

FEDERAL BUDGET TAX HIGHLIGHTS
CHARITABLE DONATIONS MADE BY YOUR ESTATE
ALLOWABLE BUSINESS INVESTMENT LOSSES
TAX-FREE GIFTS FOR EMPLOYEES
CAPITAL GAINS SPLITTING WITH YOUR MINOR CHILDREN
PRESCRIBED INTEREST RATES
AROUND THE COURTS

FEDERAL BUDGET TAX HIGHLIGHTS

The Federal government brought down its 2014 Federal Budget on February 11, 2014. Some of the more significant tax proposals in the Budget are summarized below.

- Adoption expense credit: The maximum adoption costs that qualify for the federal credit of 15% are increased to $15,000 per child, beginning in 2014 and indexed thereafter for inflation. The previous maximum costs were $11,669 for 2013.

- Medical expense credit: The amount eligible for the credit is being expanded to include the costs of an individualized therapy plan if the cost of the therapy would itself be eligible for the credit, and the plan is required to access public funding for specialized therapy or is prescribed by a medical doctor or occupational therapist (for physical impairments) or a medical doctor or psychologist (for mental impairments). Such therapy design services have also been exempted from GST/HST.

  The medical credit will also now include the costs of service animals specially trained to assist persons with severe diabetes (rather than only blindness and certain other impairments).

  These above changes to the medical expense credit apply to costs incurred after 2013.

- New “search and rescue” tax credit: For volunteers who provide search and rescue services on the ground, in the air, or in water, a non-refundable credit of 15% of

3285 Cavendish Blvd., Suite 475, Montréal, Québec H4B 2L9 • Telephone (514) 939-3270 • Fax (514) 939-2842
Email: info@cantaxpub.com

$3000 ($450) will be available beginning in 2014. Generally, the individual must volunteer at least 200 hours for search and rescue activities in the taxation year. This credit will be integrated with the existing volunteer firefighter credit so that time spent on the two activities can be combined, but only one such credit will be allowed.

- Extension of mineral exploration credit: Individuals who invest in flow-through shares are eligible for a 15% tax credit on certain mineral exploration expenses renounced to them by corporations. The credit is extended again by one year, to flow-through share agreements entered into on or before March 31, 2015.

- Addition to farmers' deferral for drought or flood: Farmers who dispose of breeding livestock during droughts or floods in certain regions are allowed to defer a portion of the sale proceeds from their income until the year following the sale (or sometimes to a subsequent year). Beginning in 2014, the deferral is extended to all breeding horses over 12 months of age (not just those kept for breeding in commercial production of pregnant mares' urine) and kept for breeding, and to breeding bees.

- Amateur athlete trusts: Qualifying performance income of an amateur athlete (e.g. endorsement income, prize money), is not considered income of the athlete if it is placed in an "amateur athlete trust" (and income in the trust is tax-free until paid out to the athlete). The qualifying performance income has not been considered "earned income" for RRSP contribution purposes, meaning that it did not add to the athlete's RRSP contribution room. For contributions to athlete trusts made after 2013, such income will be considered earned income for RRSP purposes.

- Extension of "kiddie tax": This tax, imposed at the highest marginal tax rate on minor children, is expanded to apply to business income or rental income earned by the child through holding an interest in a partnership (or trust) if a related person (e.g. a parent) is engaged in the business or rental activities of the partnership or has a direct or indirect interest in the partnership.

- Ending preferential tax treatment for testamentary trusts: The Budget followed up on proposals first announced in the 2013 Budget and subsequently in a June 3, 2013 Consultation Paper, under which testamentary trusts will generally be taxed in the same manner as inter-vivos trusts. Beginning in the 2016 taxation year, instead of being subject to graduated tax rates, testamentary trusts will be subject to flat tax at the highest federal marginal rate (29%). Testamentary trusts will also be required to have calendar year taxation years.

  Estates will generally be exempt from the new rules for the first 36 months of their existence. Furthermore, testamentary trusts with disabled beneficiaries who are eligible for the disability tax credit will have graduated tax rates rather than the top flat rate. (These proposals were also discussed in some detail in our October 2013 Tax Letter.)

- Estate donations: Under current law, a charitable donation made under a deceased's will is deemed to be made by the individual in the year of death. The Budget proposes a "more flexible" treatment for these donations, by allowing either the estate and / or the deceased to claim the charitable tax credit. This topic is discussed in more detail under the next heading in this letter.

- Change in employer remittance thresholds: Currently, an employer with an average monthly withholding amount of $15,000 or more (based on two-year old averages) is required to remit withheld taxes, CPP and EI on behalf of its employees twice a month. For an employer with an average withholding amount of $50,000 or more, the remittance is required four times a month. The 2014 Budget increases the former threshold for twice-a-month remittances to $25,000, and the four-times-per-month threshold to $100,000. These changes apply to amounts withheld after 2014.

- Repeal of five-year immigration trust exemption: Non-resident trusts set up by Canadian residents are generally subject to tax in Canada on their investment income under the complex non-resident trust and foreign accrual property rules. However, a long-running exception to this tax regime has applied to non-resident trusts set up by newly resident Canadians, generally for the first 60 months of their residency (sometimes called "immigration trusts"). The exception is being repealed. For trusts that were subject to the exemption before February 11, 2014, the exemption is repealed starting with taxation years that end after 2014. For all other non-resident trusts, the repeal is effective for taxation years ending after February 10, 2014.

- Charitable donations of ecological land: The carry-forward period for unclaimed donations of ecological land is increased to 10 years, up from the current 5 years. This change applies to donations made after February 10, 2014.

CHARITABLE DONATIONS MADE BY YOUR ESTATE

Under current rules, if you make a charitable donation under your will, the donation is deemed to be made by you in the year of your of death. The charitable credit can be claimed in that year or in the immediately preceding year. In either year, the amount of the donation that qualifies for the credit is limited to 100% of your "net income" (instead of the 75% limit that otherwise applies during your lifetime).

Similar rules apply where you designate a charity as a beneficiary under your RRSP, TFSA or RRIF.

Other charitable donations made by your estate (other than those made under your will) qualify for the credit for your estate in the year of donation. They can be carried forward for up to 5 years. They cannot be claimed on your terminal tax return.

As noted above, the 2014 Federal Budget proposes to change these rules, beginning with deaths in 2016. Under the new regime, charitable donations made under your will and RRSP-, TFSA- and RRIF-designated donations will be deemed to have been made by your estate. However, your trustee will have the flexibility to allocate the donation to the estate for its taxation year in which the donation is made, an earlier year of the estate, or to either of your last two taxation years. In other words, either your estate or you can claim the credit, or share the credit.

The new regime will apply where the donation is made within the first 36 months after your death. Other donations made by your estate will be claimable only by the estate, and will remain eligible for the 5-year carry-forward.

ALLOWABLE BUSINESS INVESTMENT LOSSES

An allowable business investment loss (ABIL) is similar to an allowable capital loss, except that it serves to reduce all forms of income and not just taxable capital gains. Therefore, in tax terms, it is more valuable than an ordinary allowable capital loss.

An ABIL is one-half of a business investment loss (BIL), which is a capital loss incurred on a disposition of certain types of small business investments. The BIL can arise on an actual disposition (e.g. a sale) or an elective “deemed” disposition.

For an actual disposition to an arm’s length party, a BIL is a loss on the disposition of a share or debt in a “Canadian-controlled private corporation” that is (i) a “small business corporation”, (ii) bankrupt and was a small business corporation at the time of bankruptcy, or (iii) insolvent and being wound up and was a small business corporation at the time of the winding up.

A deemed disposition for nil proceeds (thus triggering the loss and BIL) will occur if you make an election in your tax return for the relevant year. In addition to the criteria (i) through (iii) above, the following conditions must be met. In the case of a debt, the debt must have become bad in the year, generally meaning it is uncollectible. For a share, one of the following must be met: either (i) the corporation become bankrupt during the year; (ii) the corporation is insolvent and a windup-up order has been made in the year; or (iii) at the end of the year, the corporation is insolvent, it does not carry on a 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.

For these purposes, a Canadian-controlled private corporation is generally a Canadian private corporation that is not controlled by non-residents, public corporations, or a combination of the two.

A "small business corporation" is a Canadian-controlled private corporation where, at the time of disposition or any time in the preceding 12 months, all or substantially all of the corporation’s assets (on a fair market value basis) were (a) used principally in an active business carried on primarily in Canada, (b) shares or debt in other small business corporations (generally, it must own more than 10% of shares representing votes and value in the other corporation), or (c) a combination of assets described in (a) and (b).

As noted, an ABIL serves to offset all sources of income and not just taxable capital gains. An unused ABIL can be carried forward ten years to offset all sources of income in those years (for your losses incurred in taxation years before 2004, the carry-forward period was 7 years). After the tenth future year, the ABIL becomes a net capital loss, which can serve only to offset taxable capital gains in future years.

ABIL reduced by previous capital gains exemption

If you claimed the capital gains exemption in a previous taxation year, the amount of your BIL in a current year and therefore your ABIL will be reduced. Basically, the amount of the BIL is reduced on a dollar-for-dollar basis by the amount of capital gains previously sheltered by the capital gains exemption.

The capital gains exemption applies to gains realized on disposition of shares in qualified small business corporations, which are conceptually similar (but not identical) to the “small business corporation” shares that can generate an ABIL. It can also be used on certain shares in a family farming or fishing corporation.

The amount of the reduced BIL remains an ordinary capital loss, such that one-half of it becomes an allowable capital loss that can be used against taxable capital gains.

Example

In 2012, you claimed the capital gains exemption on $50,000 of taxable capital gains ($100,000 of capital gains). In 2014, you dispose of small business corporation shares and the resulting $170,000 loss otherwise qualifies as a BIL.

However, the BIL is reduced by $100,000, to $70,000, which means that your ABIL in 2014 is $35,000. This amount will apply to offset all sources of income. The remaining $100,000 becomes an ordinary capital loss, and half of that, or $50,000, is an allowable capital loss that can only be used to offset taxable capital gains.

TAX-FREE GIFTS FOR EMPLOYEES

As a general rule, gifts that you receive from your employer will be considered a taxable benefit and thus included in your income.

However, the CRA has an administrative policy under which non-cash gifts of up to $500 per year for special occasions are non-taxable. Similarly, an achievement or long-service award of up to $500 can be received free of tax every five years. In either case, the excess amount above $500 will be considered a taxable benefit.

The CRA policy does not apply to cash or near cash. For example, it does not apply to gift certificates even if they are for less than $500.

The CRA policy does not apply to non-arm's length employees or persons that are related to non-arm's length employees. For a corporate employer, a non-arm’s length employee will include someone who controls the corporation, is a member of a related group of persons that controls the corporation, or is related to such a person.

Lastly, the CRA states that an immaterial or nominal value “such as coffee, tea, T-shirts with employer logos, mugs, plaques, trophies etc.” are **not** a taxable benefit to employees.

CAPITAL GAINS SPLITTING WITH YOUR MINOR CHILDREN

Under the income attribution rules, if you give or lend property to your spouse or common-law partner, any income from the property or taxable capital gains from the disposition of the property will be attributed back to you and included in your income.

(Fortunately, there are some exceptions where the rules do not apply.)

Similarly, if you give or lend property to your minor child (under 18 years old), income from the property will generally attribute back to you and be included in your income. However, the income attribution rules do **not** apply to taxable capital gains realized by your minor children.

Therefore, for example, you can purchase land, publicly traded common shares or equity mutual funds (or other capital property that is expected to generate a capital gain) for your children and any subsequent capital gains will be taxed to them rather than you. In other words, you can legitimately split capital gains with your minor children.

One exception, where the capital gain will be attributed to you, applies if you previously transferred farm property to your minor child on a tax-deferred basis and the child then sells the farm property at a gain. Otherwise, there are no capital gains attribution rules that apply to minors.

Kiddie tax on certain capital gains

The so-called "kiddie tax" is not an income attribution rule. However, when it applies, it subjects the minor child to the top marginal tax rate on the affected income (and makes the parent jointly liable for the resulting tax). As such, it is just as effective as the income attribution rules (or even more) in combatting income-splitting with your minor children

Since it was first introduced in 2000, the kiddie tax has applied to dividends received on shares of private corporations (among other items of income). As a result, certain schemes were developed under which, instead of paying dividends on the shares, a sale of the shares was arranged to a related person (e.g. the child's parent). Any gain on the sale was not subject to the kiddie tax, and sometimes could be sheltered by the capital gains exemption.

The rules were subsequently amended to target these schemes. Since March 22, 2011, where a minor child disposes of a share in a private corporation to a non-arm's length person and realizes a gain, the gain is deemed to be a dividend received from the corporation. As such, it will be subject to the kiddie tax at the highest marginal tax rate (although, as with other dividends, the child will be eligible for the dividend tax credit).

PRESCRIBED INTEREST RATES

The Canada Revenue Agency (CRA) recently announced the prescribed annual interest rates that will apply to any amounts owed to the CRA and to any amounts the CRA owes to individuals and corporations. These rates remain unchanged from the first quarter of 2014 and are in effect from **April 1, 2014 to June 30, 2014.**

- The interest rate charged on overdue taxes, Canada Pension Plan contributions, and Employment Insurance premiums is 5%, compounded daily.

- The interest rate to be paid on late refunds (after 30 days) paid by the CRA to corporations is 1%, compounded daily.

- The interest rate to be 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

Legal fees in defending securities lawsuit not deductible

In the recent *Gouveia* case, the taxpayer incurred significant legal fees in defending himself against securities law infringements alleged by the Ontario Securities Commission (OSC), and subsequently under a class action lawsuit. The allegations related to activities that occurred while he was an executive with a corporation that was investigated by the OSC for securities law violations. The legal fees were incurred in subsequent taxation years in which the legal proceedings were commenced, while the taxpayer ran his own financial consulting business.

The taxpayer took the position that the legal fees were necessary to preserve his reputation in the financial community and thus were incurred for the purpose of earning income from his financial consulting business. He therefore tried to deduct the fees in computing his business income.

The CRA disallowed the deduction of the legal fees, on the basis that they were not incurred for business purposes and were personal in nature.

Upon appeal to the Tax Court of Canada, the Tax Court Judge agreed with the CRA and disallowed the deduction. The Judge ruled that the legal fees were incurred to protect the reputation of the taxpayer and therefore "were personal in nature and were not incurred to protect the income earning potential associated with his consulting business". Furthermore, the Judge held that legal fees incurred to preserve a person's reputation and capacity to earn business income were capital expenses and therefore not deductible even if they had not been personal expenses.

* * *