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Tax Newsletter

Topics for discussion:

- Ministry of Finance update
- CRA audit activity
- Business use of home expenses
- A wild October
- CRA drops plans to register tax preparers
- Change to market settlement rule affects year-end tax selling
- Year-end planning
- Around the courts

Ministry of Finance update

Last month we provided commentary on the fall economic statement and what the government referred to as "small business week", dialing back the proposals initially announce on July 18th.

In the fall economic update, the government committed to rolling out new income splitting measures later this fall to be effective Jan 1, 2018 and passive income rules in the 2018 budget. There is approximately two more weeks to the end of fall and no legislation has been released. We have postponed 2018 compensation until these rules are released. We are hopeful the rules will be delayed and simplified as suggested by the Finance senate committee this week. The Senate committee plans to deliver its report to the Department of Finance later this month regarding the July 18th proposals and recommendations.

Until we have the final legislation and the Department of Finance commentary and position, our advice is to avoid payments to family members in 2018 who are under 25, and whomever you would have concerns to reasonableness compensation with respect to their capital and activity in the business. As such, increasing 2017 compensation to family members in 2017 should be considered and ideally, dividends should be paid prior to Dec 31, 2017 or corporate resolution providing for the dividend payments.

CRA audit activity

Recent Federal budgets have increased the operating budget of CRA by $1B over the next two years. The funds are ear-marked to hire auditors. In our practice this year, we have seen increased audit activity across the board. The hot topics we are seeing are as follows:

- Vehicle travel – it is highly recommended you keep a vehicle log book for business use as applicable at a minimum 2-3 months per year;
- Home office – justification for home office claims should be documented prior to filing so that support is available upon CRA review;
- Property sales – Principal residence claims, GST/HST new home buyer credit, information on assignments of condos and details as to whether used residential properties have undergone substantial renovations;
- Off shore investment funds – CRA is taking the position that if there is a tax benefit, it must have been one of the main reasons. A review of the deemed interest income rules and filing positions for offshore investment funds should be reviewed, and documentation as to why the funds were chosen should be accumulated for material transactions;
- Payroll audits – related to T4 discrepancy reporting by payroll providers as well as employee versus subcontractor relationships. Ensuring your 2017 T4's are filled correctly will hopefully eliminate future CRA audit headaches; and
- Reviewing affluent neighborhood postal codes to income reported looking for potential lifestyle discrepancies.

Business use of home expenses

The CRA released Income Tax Folio S4-F2-C2 on October 3, 2017 with the intent to elaborate on their treatment of business use of home expenses and the amendments for individuals. The basic premise of this section of the act has not been amended; however, there is an increased scrutiny over the deduction of expenses related to the work space. Ideally, the business use of home expenses are deductible when more than 50% of the business' functions are completed at home or, you have a segregated area exclusively used for business and attending clients. We recommend an objective review of whether your circumstances match the eligibility criteria above, and ensure reasonable amounts have been deducted in accordance with the general limitation. If you have two places of work, it may be necessary to determine your principal place of business.

Eligibility for business use of home expenses

If you use a portion of your home for the purposes of conducting business or in the capacity of an employee, you are not entitled to deduct expenses related to a self-contained domestic establishment (i.e. your home) unless either of the two conditions are met:

1. Must be a principal place of business;

   Principal is the operative word here; when you have two or more places where you conduct business, it refers to the chief or main place of business. For example, a work space in a contractor's home is used for administrative purposes (receiving work orders, bookkeeping, payroll, etc.) while the performance of the contracts is carried out at various locations. The work space represents the main place of business and in general, the work space must be used for more than 50% of the time [1].

2. Home office used exclusively to earn business income and on a regular and continuous basis to meet clients, customers, or patients.

   The work space needs to be a segregated area that is only used for business purposes. The CRA interprets the terms "meets" and "meetings" as face-to-face interaction and as a gathering of people by chance or arrangement respectively. The interpretation of "regular and continuous meetings" is dependent on the nature of the business. For instance, 10 meetings over a week (essentially 2 per day) meets the criterion, while having one or two meetings at irregular intervals does not.

Deductible expenses

The expenses related to a work space that are eligible for a deduction are listed below. The expenses must be prorated between business and personal use. For example, a reasonable appropriation would be area of the work space divided by the total useable space.

- Rent;
- Capital cost allowance ("CCA"): Depreciation claimed for tax purposes for tangible assets like furniture, computers, printers, etc. You should avoid claiming CCA on your work space at home to ensure your continued eligibility for principal residence exemption;

[1] For employees who's T2200 does not indicate more than 50% work from home CRA is automatically denying the claim.

- Property insurance;
- Property taxes;
- Interest on a mortgage;
- Operating costs (i.e. utilities, security system, cleaning costs); and
- Maintenance costs and minor repairs: Only for the costs that are related to the home office.
- Landscaping fees: An amount paid for landscaping of grounds around the building or other structures used primarily for the purposes of generating income can be deducted. However, this would be an aggressive stance because it would be difficult to prove that the primary purpose of landscaping of a residential property was to generate income and it would be questionable whether a garden is considered part of "work space" in home.

As an employee, it is necessary to have a completed and an approved Declaration of Conditions of Employment, Form T2200. Deductible expenses related to work space are limited to utilities, minor repairs, and rent. Commissioned employees are also allowed property taxes and insurance over and above the allowable expenses for the employees.

As a business owner, these costs are only deductible against business income and not passive income.

Restrictions on deductions

These expenses are only deductible to the extent that they don't exceed the income for the tax year and as a result, they cannot create or increase loss for income tax purposes.

Corporations

It is important to have a reasonable explanation as to why an employee or shareholder works from home, especially if the corporation has a permanent establishment. CRA questions whether it is reasonable considering the nature of the business, active or passive income, that the employees or shareholders conduct the business from home. This is a note of caution since there is increased scrutiny of home office expenses claimed by self-employed or employed taxpayers and corporations claiming large allowances and/or reimbursements for work space in home expenses.

When a corporation rents a space in a shareholder's home, which is converted into an office where a business is carried out on a regular and continuous basis, the rent would be a deductible expense for the corporation. Since the corporation is renting the space from the shareholder, a Declaration of Conditions of Employment, Form T2200, does not need to be completed. In this instance, the work space within the home is being used to generate business, not employment income.

However, if the shareholder decides to rent a portion of the home to the corporation, there could be a deemed disposition at the fair market value for the work space because there is more than one use of the home. CRA considers incidental rent to not create a deemed disposition. We typically do not recommend claims greater than 10-15%. The gain, if any, from the deemed disposition can be eliminated by the principal residence exemption. However, future increases at sale would not be subject to any principal residence exemption. These rules can have further unintended punitive HST consequences in relation to the change in use rules and self-assessment on sale rules. The shareholder would also be able to deduct rental expenses against the rent collected from the corporation which typically covers the detectible costs.

A wild October

On July 18, 2017, the federal government announced wide-ranging income tax proposals affecting private corporations. In the Economic Statement of October 24, 2017, they backed down from the original proposals, though some will remain. Here's a quick overview of the current status of the July 18, 2017 proposals:

- **Small business deduction:** The federal tax rate on Canadian-controlled private corporations (on active business income) for the first $500,000 of income per year, currently at 10.5%, will drop to 10% in January 2018 and to 9% starting January 2019. However, the related "gross-up" and dividend tax credit on dividends paid by private corporations to individual shareholders will also be reduced, so that once dividends are paid out, the effective total tax on the corporation and the shareholders will be the same as before.

- **Income sprinkling:** The proposals to prevent income splitting by imposing a high tax rate on dividends or salary paid to family members will proceed, but not in the form proposed on July 18. Adult family members who have contributed to the business will not be subject to the new rules. We won't have specifics until the draft legislation is released, likely in mid-December. However, the new rules might still take effect starting January 1, 2018.

- **Lifetime capital gains exemption:** The proposals to limit the exemption in various ways have been dropped.

- **Converting income to capital gains (dividend stripping):** These very technical proposals to amend section 84.1 and add new section 246.1 to the Income Tax Act have been dropped.

- **Passive income:** The proposal to tax a private corporation's passive income (investment income) at high rates, with insufficient offsetting of dividend tax credits, will proceed, but will not apply to the first $50,000 of a corporation's passive income each year. The effect will be to subject any additional passive income at rates well over 70% in many cases, once dividends are paid out to shareholders. However special exceptions will be made for venture capital and "angel" investors who fund growing businesses. Again, we won't have specifics until the legislation is released, likely in mid-December.

It remains to be seen, when the revised legislation is released in December, what the details of the changes are and how they impact businesses. The government said the legislation will be released "later this fall", so we will likely see it on December 20 (the last day of fall).

CRA drops plans to register tax preparers

In January 2014, the Canada Revenue Agency (CRA) began consultations on whether to introduce a system that requires anyone who prepares tax returns for a fee to be registered with the CRA. (Some other countries, including the United States, already have such a requirement.) We reported on this in our March 2015 Tax Letter.

The CRA now says it's "considering other options that would serve to implement the objectives of the proposed Registration of Tax Preparer Program (RTPP) through existing CRA programs and initiatives at lower costs."

Note that a form of registration is already effectively required. Any tax preparer who prepares more than 10 individual returns or 10 corporate returns is subject to a penalty if those returns are not filed electronically. And filing electronically requires the preparer to register for the CRA's "E-File" system. However, there are no training or qualification requirements, other than not having been involved in offensive or fraudulent tax activities.

Change to market settlement rule affects year-end tax selling

For many decades, the rule when selling stocks on the market was that "settlement" — actual completion of the sale — would happen in three days. This rule came into place long before there was computerized trading and electronic delivery of shares.

Since September 5, 2017, settlement of a share purchase or sale now takes place in **two business days**. This change applies to markets in both Canada and the U.S.

This affects year-end selling done for tax purposes. If you are selling shares to trigger a capital loss to use for 2017, or to trigger a capital gain to use up other losses, make sure to finalize your trade no later than December 27, 2017. Since December 28 and 29 are Thursday and Friday, your trade would "settle" on December 29. As December 30 and 31 are Saturday and Sunday, a trade on December 28 will not settle until January 1, 2018 and will not count for your 2017 tax return.

Year-end planning

It's December, and time to think of some tax planning ideas. If you wait until your tax return is due next April or June, it will generally be too late to change your tax situation for this year.

Income sprinkling

The new rules for income sprinkling may take effect in 2018 although the details are not yet known. If you have the option of having your corporation pay dividends to family members who are not involved in the business, and who have not contributed significantly to the business, consider paying those dividends before year-end for income-splitting purposes. Starting in 2018, such dividends may be taxed at the highest rate that can apply, if the "tax on split income" is applicable.

Of course, if the shareholders are children under 18, this "tax on split income" already applies to them until the year in which they turn 18.

Charitable donations

Charitable donations must be made by December 31, 2017 to be counted for this year.

Charitable donations receive special tax assistance. Donations that exceed $200 per year give you a tax credit calculated at the highest marginal rate. If your taxable income for 2017 (after all deductions) exceeds $142,353, the charitable donation credit is generally worth the same as a deduction (sometimes a little less, depending on the province). If your taxable income is lower, then the donation credit is better than a deduction, usually around 45%. (In Alberta and Nova Scotia, a special high credit for donations brings the value of the donation up to 50-54%.)

Another idea to consider is donating publicly-traded shares or mutual fund units to a charity. If you do this, you do not pay tax on any capital gain on the securities, but the donation is valued for tax purposes at its current fair market value. If you are considering donating to a charity and you have some securities that have gone up in value, donating the securities will be very tax effective.

You can claim charitable donations up to 75% of your "net income" for tax purposes. Net income is basically your income after most deductions, but before claiming the capital gains deduction (capital gains exemption) or any loss carryovers from other years.

In cases, make sure to get a tax receipt from the charity that meets all of the conditions specified in the Income Tax Regulations, or you will not be entitled to the credit.

Note that donations of property are valued at your cost of the property, if you acquired the property within the past 3 years or if you acquired it for the purpose of donating it. (This rule does not apply to publicly-traded securities or certain other property.) This prevents the so-called "gifting" schemes which used to attract many taxpayers who would purchase art or other goods for less than their appraised value and then donate the art to a charity for a high-value tax receipt.

Finally, if you (or perhaps a child of yours who is over 18) have not claimed any donations for years after 2007, a special bonus "super credit" or "stretch credit" of an extra 25% is available for the first $1,000 of donations, significantly reducing the cost of the donation. The last year that this bonus credit can be used is 2017. The credit can only be used once, so if you already used it since it was introduced in 2013, you cannot use it again.

<u>RRSP contributions</u>

If either you or your spouse are not yet 71 this year, then you can normally make contributions to a registered retirement savings plan (RRSP) and deduct them from your income for tax purposes. Your RRSP contribution limit for 2017 is based on your 2016 "earned income" as well as your pension adjustment (reflecting future pension credited to you in 2016 from your being a member of a company pension plan).

Your available RRSP contribution room should be printed on the Notice of Assessment that you received from the CRA after you filed your 2016 return in the spring of 2017. Your maximum contribution room for 2017 is:

18% of your 2016 earned income
(maximum $26,010 if your 2016 earned income exceeded $144,500)
minus
your pension adjustment
plus
any contribution room from earlier years since 1991 that you have not yet used up.

Your deadline for contributions for 2017 is March 1, 2018. However, if you have excess cash, you should consider making your 2018 contribution early in 2018. You can make that contribution any time from January 1, 2018 through March 1, 2019. Putting funds into an RRSP will allow them to grow tax-free, rather than you having to pay tax on any interest or investment income that you earn during the year. (You can also put money into a tax-free savings account, or TFSA, for which you get no deduction, but interest or investment income will not be taxable. As of 2017, your lifetime TFSA contribution limit is $52,000 if you were born before 1992.)

Consider also a contribution to a spousal RRSP. (This also applies to a common-law spouse or same-sex partner who meets the Income Tax Act's definition of "common-law spouse", even if you are not legally married.) Your maximum deductible contribution is the same regardless of whether you contribute to your RRSP or your spouse's, or some combination of the two. If your spouse is likely to have lower income than you in future years, then a spousal RRSP contribution will allow your spouse to take the income out down the road (once the last year during which you make any spousal contributions has passed, plus two more years). Your spouse will then pay tax on that income at a lower rate than you would if you withdrew the funds from your own RRSP.

A spousal RRSP is also useful if you are already over 71 but your spouse is younger. Once you reach the year in which you turn 71, you cannot contribute to your own RRSP and must convert your RRSP to an annuity or a registered retirement income fund (RRIF) from which you draw income every year. However, you can still make contributions to a spousal RRSP if your spouse is under 71 at year-end.

Trigger capital losses

Capital gains are half-taxed; that is, half of the gain is included in your income as a taxable capital gain. Capital losses can be claimed only against capital gains (and can be carried back three years and forward indefinitely against such gains).

If you have capital gains this year — for example, from selling some shares for a gain earlier in the year — you may wish to trigger capital losses by selling securities that have gone down in value.

Make sure the transaction is completed by December 27, in time for it to settle before the end of the year. As noted in the article "Change to market settlement rule" above, the settlement date for most stock trades in Canada is now two business days.

You should also ensure that you are not caught by the "superficial loss" rules. If you (or an "affiliated person", which includes a corporation you control) acquire the same (or identical) securities within 30 days of selling them, then your capital loss will be disallowed.

There are numerous other special rules for capital gains and losses. This is just a general overview.

Pay your instalments

If you have instalments to pay for the year, and you have not been paying them as per the notices you receive from the CRA during the year, now would be a good time to catch up. If you wait until next April, you will owe four months' additional interest, and possibly penalties, on the late instalments.

To avoid interest applying, instalments should be paid on March 15, June 15, September 15 and December 15. Prepaid or "early" instalments earn credit (called "offset interest") against interest that applies to late instalments for the same year.

You are allowed to calculate instalments based on any of three methods, without interest applying. The instalments can total your tax payable (on income from which tax is not withheld at source) for this year, or for last year, or based on the amounts that the CRA advises you. The CRA's notice to you for March and June is based on the total taxes you paid two years ago, and then for September and December the suggested instalments are adjusted so that the total for the year equals the amount you paid last year.

If you have not been paying your instalments, you should estimate as best as you can the tax that will be owing for the year on your self-employment and investment income (and other sources from which tax is not withheld), or use the numbers for 2016 (whichever is lower). You should then make a catch-up instalment payment as soon as possible, to reduce interest charges.

Where interest does apply to late instalments, it is calculated at 5% compounded daily, a rate that varies quarterly but has been largely unchanged since 2009. You do not get interest on overpaid instalments, other than as an offset to late instalments for the same year as explained above. But any interest you are required to pay is non-deductible.

Around the courts

Orthodontist denied GST/HST input tax credits

Most businesses can claim a full "input tax credit" (ITC) to recover all the GST/HST they pay on their expenses. That way, the real cost of the GST and HST is imposed only on consumers. However, businesses that make "exempt" supplies cannot claim ITCs, though they do not charge GST/HST on their services. Thus, the GST/HST is a real cost to such businesses. This includes physicians, dentists, and most other regulated health care providers.

Orthodontists provide dental services (which are exempt), but also sell braces, which are "zero-rated" as medical devices. No tax applies to a zero-rated supply, but the business is allowed to claim ITCs for its costs of making such sales. Because orthodontists provide both exempt services and zero-rated goods, the CRA has an administrative policy allowing orthodontists to claim 35% of their ITCs.

However, in a recent case, Dr. Brian Hurd Dentistry Professional Corp. v. The Queen, the Tax Court of Canada held that this policy is wrong. The Court ruled that what an orthodontist provides is a "single supply": the dental services and braces cannot be separated, since neither can usefully be supplied without the other. Under the law developed by the Courts over the past 20 years, a "single supply" has only one status for GST or HST purposes: that of the dominant element. The Court found that the dominant element was the dental services. Thus, the orthodontist's sales were all exempt, and he was unable to claim any ITCs.

This case will cause serious problems for orthodontists if the CRA decides to follow it and revise its administrative policy to disallow all ITCs. Since the decision was issued under the Tax Court's Informal Procedure, it is not a binding precedent, and the CRA may chose to ignore it; but given the Court's ruling, the CRA may feel that it should re-evaluate its policy to reach the correct legal result.

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