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Tax Newsletter

Topics for discussion:

- Low prescribed interest rates: Potential tax planning
- US tax reform
- Change of control of corporation
- Loss carryovers
- Unearned income
- Prescribed automobile rates for 2018
- Prescribed interest rates
- Around the courts

Low prescribed interest rates: Potential tax planning

As noted near the end of this letter, the government recently announced the prescribed interest rates that apply for the first quarter of 2018. The basic prescribed rate remains at 1%, where it has been since July 2009 (except for one quarter in 2013). The low 1% rate makes certain tax planning techniques particularly attractive. The low 1% rate is slotted to increase to 2% on April 1, 2018. The Bank of Canada's 3-month treasury bill auction in early January was at 1.17% and as such, we know the prescribed rate will be increasing to 2% come April 1, 2018. We suspect the 1% rate will be a thing of the past. Clients considering this planning need to get started as soon as possible to insure the necessary steps are in place prior to April 1, 2018.

Interest-free employee loans

An interest-free loan from your employer will subject you to an imputed interest benefit that is included in your income. The benefit is based on the prescribed rate of interest, thus, a $100,000 interest-free loan at a 1% prescribed interest rate throughout a taxation year, would mean only a $1,000 income inclusion for the year. However, if the prescribed rate goes up during the course of the loan, the benefit would increase accordingly.

In the case of a home purchase loan, if the prescribed rate goes up during a year, you will only include a benefit based on the lower rate that was in effect at the time the loan was made. Accordingly, a loan made now, with the current rate of 1%, would be subject to an effective 1% cap. At the end of the five years, if the loan remained outstanding, the new interest rate "cap" would be the prescribed interest rate at that time.

Avoiding income attribution

If you give or lend property to your spouse/common-law partner or your minor child, income attribution rules typically kick in and attribute any income from the property back to you (including taxable capital gains in the case of your spouse or common-law partner).

However, if you lend money at the prescribed rate of interest at the time of loan, the attribution rules will not apply as long as your spouse or child actually pays you the interest for each year by January 30th of the following year. Furthermore, even if the prescribed rate increases during the term of the loan, you can keep charging the original rate of interest and avoid attribution. Interestingly, there is no maximum term limit for this rule, so for example, even a 10 or 20-year loan made at the current rate of 1% would work to avoid attribution.

> *Example*
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> Assume you are in a much higher tax bracket than your spouse.
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> On January 1, 2018, you lent your spouse $500,000 and charged the current 1% prescribed rate of interest. The term of the loan is 10 years. Your spouse invests the amount and earns a 6% return each year, or $30,000 ($500,000 x 6%). She pays you the 1% interest per year, which is $5,000.
>
> Each year your spouse will include the $30,000 investment income and will be allowed a deduction for the interest paid to you, so your spouse will include the net amount of $25,000.
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> You will include the $5,000 of interest in your income, so you have effectively shifted $25,000 of income to your spouse.

> In addition, if your spouse further invests the $25,000 of investment income, any income earned on that amount ("secondary income") will not be subject to attribution and will be taxed to your spouse.

A similar exception to the income attribution rules applies where you sell property to your spouse or minor child in return for indebtedness, if the debt is at least equal to the fair market value of the property and carries the prescribed rate of interest at that time. However, in the case of a sale to your spouse, you must elect out of the tax-free "rollover" that normally applies to transfers of property between spouses. Therefore, for example, if the property has an accrued gain at the time of the sale, the capital gain will be triggered and the resulting taxable capital gain (1/2 of the gain) will be included in your income for the year of the sale. For this reason, it normally makes sense to transfer a property with little or no accrued gain.

Deferring tax instalments or tax balance for the year?

If you are late paying your tax instalments or tax balances, an additional 4% is added to the prescribed rate. The current rate for late taxes is 5%, compounded daily.

Therefore, deferring the payment of your tax instalments during the year, or payment of your tax balance for the year past the April 30th deadline of the following year, only makes sense if you can otherwise earn much more than 5% on the cash that would otherwise be used to pay the tax payments. You need to be able to earn much more because the interest you earn is taxable while the interest you pay on balances or instalments owing to the CRA is non-deductible. Thus, for example, if you're in a 50% tax bracket, you need to earn 10% on your money to compensate for having to pay 5% interest.

Furthermore, if your interest charges for late instalments exceed the greater of $1,000 and 25% of the interest that would be payable had you made no instalments, you will be assessed an extra penalty. So, deferring the payment of your instalments is typically not a good idea, unless you can otherwise earn a very healthy return on your investments.

US Tax reform

On December 22, 2017, the US passed its long-awaited tax reform. The reform has caused ripples in the international community with Australia already dropping its corporate tax rate from 30% to 25% in response. For US citizens or green card holders that are Canadian residents, there are a number of changes affected and will need to be looked at with respect to your individual facts.

The Bank of Canada said in its interest rate hike that US tax reform could have more implications to our economy than a failed NAFTA renewal.

Some of the key changes are:

1. A new one-time repatriation tax of foreign corporation earnings at 15.5% for cash and cash equivalents, or 8% on other assets at the higher of November 2, 2017 or December 31, 2017 balance sheet dates the higher of the two;

2. Dividend received deduction: Similar to Canada, the US will now fully exempt foreign dividends received from tax. In the past there was a 35% federal tax rate on this income which caused companies like Apple and Starbucks to park their money in foreign jurisdictions. It is estimated that there is in excess of $2 trillion parked off shore. This change will allow corporations to bring the money back to the US and re-invest the money in the US economy.

3. Sub Part F: In the past, Canadians residents could look to rely on a reducing the control ownership to fall out of these rules. The rules have been changed to eliminate this planning opportunity.

4. New Global Intangible Low-Tax Income (“GILTI”) providing for a new US tax on foreign intangible assets. This will cause US corporations with offshore IP to rethink this tactic as the tax rate will be lower being owned in the US.

5. Along with the U.S. transition tax, the GILTI tax is likely going to have widespread adverse implications for U.S. citizens living in Canada or Australia who own non-U.S. corporations, particularly those in the service industry due to typically lower tangible property requirements. For example, a U.S. citizen doctor residing in Canada who operates her practice through a Canadian professional corporation may be subject to full blown GILTI tax if the practice does not have tangible property. In that case, even though the professional corporation would have paid Canadian corporate income tax on its income, the doctor would also be required to include this corporate income on her U.S. personal income tax return with no deductions or foreign tax credits permitted. Canada, on the other hand, will not grant any foreign tax credit for the U.S. GILTI tax paid because it sees the source of income as Canadian, and Canada will tax the same income again when it is paid out to the doctor as a dividend leading to straight-out double taxation. In such cases, the better result may be to pay all corporate income out as a salary to the doctor.

6. Pass through entities are provided with a new reduction in taxable income of up to 20% based on various factors. This can result in approximately 9% reduction in the effective tax rate. Ultimately, this should not drastically affect Canadian residents as they typically received full foreign tax credit on the US tax to begin with prior to the change.

7. US partnership gains earned via effectively connected income: In the past there was a long dispute with the IRS with respect to whether the disposition of US partnership interest would be taxable in the US first. The IRS considered it to be active business income not a capital gain and would be treaty exempt. The tax changes have now

confirmed the IRS position for all effectively connected income to the US and that Canadians disposing of US LP interest will now be subject to US tax as ordinary income, where more often than not, it would be a capital gain for Canadian purposes. This change could cause the US taxes to be more than Canadian taxes depending on the numbers and marginal brackets in both countries.

8. Reduced US corporate tax rate from 35% to 21% and effective state rates averaging around 27% are now in line with Canada's general rate. US corporations will not have to be more cognisant of accumulated earnings tax that is not distributed to shareholders.

9. Amortization of assets: The new rules provide for generous deductions with respect to new equipment and assets purchased. There are also new proposed interest deductions in the US for corporations with gross receipts in excess of $25M.

10. New lower US personal tax brackets with the highest bracket being eliminated of personal exemptions and suspension of certain itemized deductions. There is also limited ability to claim state and local tax deductions above $10,000 USD annually.

11. No longer will alimony support payments be deductible or included in income for US purposes. This is at odds with Canada and could lead to double taxation.

12. Estate tax exemption increase from $5.49M to $11.18M USD for estates and deceased persons that passed away after Dec 31, 2017. This change will potentially allow US citizens living abroad with net worth under $12M to renounce citizenship without paying exit tax.

Change of control of corporation

There are various income tax restrictions when control of a corporation is acquired. Most of the restrictions are meant to prevent the shifting of losses or other tax attributes after an arm's length acquisition of the corporation ("loss trading", where someone buys a corporation and moves a profitable business into it, in order to benefit from its loss carryforwards).

The main rules and restrictions include:

- There is a deemed taxation year end for the corporation immediately before the acquisition of control, with a new deemed taxation year beginning immediately thereafter. This will typically result in a short taxation year.
- The short taxation year will mean tax returns need to be filed earlier, and certain deductions such as capital cost allowance (tax depreciation) will have to be pro-rated. It also counts as a year for purposes of any rules that allow balances, credits or losses to be carried forward for a fixed number of years.
- Net-capital losses cannot be carried back or forward beyond the acquisition of control.

- Capital losses accrued to the time of the acquisition of control are triggered and realized in the year ending immediately before that time. The cost bases of the loss properties are written down accordingly.
- As noted, the corporation's capital losses, including those triggered by the above rule, cannot be carried forward beyond the acquisition of the control. However, the corporation can elect to trigger part, or all, of the accrued gains on other property, which can be offset by the triggered losses. This will result in a stepped-up cost base of the accrued-gain properties.
- Non-capital losses (e.g. business and property losses) cannot be carried back or forward beyond the acquisition of control, except in the case of certain business losses. In general terms, the business losses can be carried back or forward if the *same or similar business* is carried on by the corporation with a reasonable expectation of profit, and then only to the extent of the income from that same or similar business.
- Investment tax credits cannot be carried forward or back, except, in general terms, to the extent of tax payable in respect of the same or similar business carried on with a reasonable expectation of profit.

When is there an acquisition of control?

General rule

The main rule provides that control of a corporation is acquired when a person or group of persons acquires more than 50% of the voting shares of corporation, where the person or group did not own more than 50% of the voting shares immediately before that time. (Thus, for example, if you already own 51% of the voting shares and now acquire another 10% of the voting shares, there is no acquisition of control.) This type of control is often called "de jure" control, or control as a matter of law, since the voting shares give you a legal right to elect the directors who will run the corporation.

There are some notable exceptions to the main rule. For example, if you acquire shares of a corporation from a person to whom you are related, there is normally no acquisition of control even if that acquisition puts you over the 50% vote threshold. Therefore, if your father owned 80% of the voting shares of a corporation and you acquired all of those shares, there would not be an acquisition of control. There is also an exception if you acquire shares in a corporation to which you are already related.

Similarly, where a person who controls a corporation dies, the acquisition of the deceased's voting shares by the estate of the deceased does not constitute an acquisition of control. Additionally, the distribution of the shares to a beneficiary who was related to the deceased does not result in an acquisition of control.

More than 75% rule

Another rule, which does not rely on the "de jure" concept of control, generally provides that there is an acquisition of control of a corporation when a person or group of persons acquires shares with a fair market value of more than 75% of the fair market value of all the shares in the corporation (regardless of votes).

The rule does not apply if the person or group already owned more than 75% of the shares based on fair market value (before the most recent acquisition of shares), or if the person or group otherwise has de jure control over the corporation.

Similar rules for trusts

Similar rules restrict or deny losses in the same manner as that described above for a trust that undergoes a "loss restriction event".

For a trust, a loss restriction event can occur when a person becomes a "majority-interest beneficiary", or a group of persons becomes a "majority-interest group of beneficiaries", of the trust. These terms generally refer to a beneficiary or group of beneficiaries where the interests in the trust of the beneficiary or group in either the income or capital of the trust are greater than 50% of all of such interests in the trusts.

There are various exceptions to the loss restriction event rules, which are similar to those that apply to acquisitions of control of a corporation. For example, there is no loss restriction event where a person acquires an interest in a trust from an affiliated person (e.g. a spouse).

Similarly, where a beneficiary dies, the acquisition of the deceased's interest in the trust by the estate of the deceased does not result in a loss restriction event. Where the interest in the trust is distributed to a beneficiary who was affiliated with the deceased, there is also no loss restriction event.

Loss carryovers

Non-capital losses

If you have a loss from a source such as a business or property, it will automatically offset income from another source in the same taxation year. However, your income cannot be negative. Therefore, your losses from sources in excess of your positive income from sources ("non-capital loss") cannot be used in that year.

However, such a non-capital loss can be carried back 3 years, or forward 20 years (for losses from 2006 and later years), to offset all other sources of income for those years.

Net capital losses

One-half of your capital losses are allowable capital losses (“ACLs”) and one-half of your capital gains are taxable capital gains (“TCGs”). Your ACLs for a taxation year offset your TCGs for the year, but you cannot have negative net TCGs. Any excess ACLs cannot be utilized against other sources of income for the year.

However, the excess ACLs, called “net capital losses”, can be carried back 3 years or forward indefinitely to offset TCGs in those other years. They cannot offset other sources of income. (However, upon death, the ACLs can offset other sources of income in the year of death or the immediately preceding year.)

Allowable business investment loss (“ABIL”)

An ABIL is a type of allowable capital loss that arises on the disposition (including certain “deemed” dispositions) of shares or debt in a small business corporation. Unlike regular ACLs, an ABIL can offset all sources of income and not just TCGs.

Unused ABILs in a year can be carried back 3 years and forward 10 years to offset all sources of income. ABILs carried forward beyond 10 years convert to regular ACLs and therefore can only offset TCGs.

Listed personal property losses

Most capital losses from personal property are deemed to be nil and are therefore not recognized for tax purposes.

However, if the loss is from the disposition of a listed personal property (“LPP”), it can offset gains from disposition of LPP in the same year. If there is a net gain, one-half is a TCG included in income. If there is a net loss, the excess loss can be carried back 3 years or forward 7 years to offset gains from LPP in those years (but not other properties).

LPP includes:

- Art work;
- Rare books, folios and manuscripts;
- Jewelry;
- Stamps; and
- Coins

Limited partnership losses

If you are a limited partner of a partnership, your share of the losses from the partnership for a year is limited to your "at-risk amount" in respect of your interest in the partnership. In general terms, the at-risk amount reflects your adjusted cost base of the interest (what you paid for the investment), reduced by certain amounts that you owe to the partnership or benefits or guarantees that you may be entitled to receive that are meant to reduce the impact of any losses from the partnership (i.e. it is meant to reflect only the money that you have "at risk").

The limited partnership losses in excess of your at-risk amount can be carried forward and used in future years, but again subject to your at-risk amounts in those future years. Limited partnership losses cannot be carried back.

Unearned income

If you carry on business and receive income in a year in respect of goods or services that will be delivered or rendered after the year, or income that is not otherwise earned in the year, you must nonetheless include the income in that year for tax purposes.

However, you are allowed an optional reserve to offset the inclusion in the year. The allowable reserve is basically the amount of income that is not earned in that year. The reserve is added back into income in the next year, and another reserve may be claimed to the extent of the income previously included that is still unearned. The process can continue until all of the income is earned, e.g. when all of the goods are delivered or the services are rendered.

> *Example*
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> In year 1, you receive $100,000 on account of goods to be delivered in years 2 and 3 – $50,000 of goods in each of those years.
>
> In year 1, you will include the $100,000 amount in your income, but can deduct the entire $100,000 reserve amount to offset that. In year 2, you will add back $100,000, but you can deduct $50,000 in respect of the year 3 goods, leaving a net inclusion of $50,000. In year 3, you will add back the remaining $50,000 into income.

The reserve is optional. For example, in year 2 you may decide not to claim a reserve such that the entire $100,000 would be included in income in year 2. This could make sense if you had losses that could offset the $100,000 inclusion, or if you knew that your marginal tax rate would be higher in year 3 than in year 2.

Prescribed automobile rates for 2018

The government recently announced the 2018 rates that will apply for the purposes of determining taxable automobile benefits for employees, and the maximum amounts of deductible automobile expenses.

The maximum tax-exempt car allowance deductible for employers for allowances paid to their employees for work purposes is increased by 1 cent from the 2017 amount to 55 cents per kilometre for the first 5,000 kilometres driven, and to 49 cents per kilometre for each additional kilometre driven during the year. For the Northwest Territories, Nunavut and Yukon, the maximum deductible tax-exempt allowance is 4 cents higher (59 cents per kilometre for the first 5,000 kilometres driven, and 53 cents per kilometre above that).

For deductions of car expenses, the maximum ceilings that have been in place for many years remain in place.

- For capital cost allowance (tax depreciation), the maximum cost is $30,000 plus applicable federal and provincial sales tax;
- For interest on a car loan, the maximum deduction is $300 per 30-day period; and
- For car lease costs, the maximum deduction is $800 plus applicable sales taxes per 30-day period, which can be reduced further if the manufacture's list price of the car exceeds a certain cost ceiling.

Prescribed interest rates

The Federal government recently released the prescribed interest rates that apply for the first quarter of 2018. These rates have remained constant for several years now, owing to the low interest rate environment. The rates are the same as the previous quarter.

Around the courts

Bookkeeping error meant no shareholder benefit

In the recent Chaplin case, the taxpayer was a 50% shareholder in a corporation (Triventa) Ms. Chaplin brought a legal action against the other 50% shareholder. She incurred significant legal fees in the dispute, including legal fees to document some of the corporate history that was necessary to determine the ownership of the corporation.

Four years after the lawsuit was started, the corporation Triventa recorded the legal fees as if it had actually paid them and added a corresponding amount to Ms. Chaplin shareholder loan account. Based largely on those corporate records, the CRA assessed the taxpayer, adding a shareholder benefit in her income.

Ms. Chaplin appealed to the Tax Court of Canada. One of her main arguments was that she paid the legal fees personally and that the corporation Triventa did not. Basically, she argued that the corporation's alleged payment of those fees, and therefore the credit to her shareholder loan account, were erroneously recorded.

The Tax Court agreed. Although the facts were quite complex, the Tax Court judge found no evidence that Triventa paid the fees. To the contrary, all of the relevant evidence showed that the taxpayer paid the fees. The judge concluded: "Based on all of the foregoing, I find that there was no loan made by Ms. Chaplin to Triventa to pay the Legal Expenses. The bookkeeping entry by which the purported loan was created was a complete fiction." Ms. Chaplin won the appeal.

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This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with us before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.