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Tax Newsletter

Topics for discussion:

- Revised position on the ITCs claimed by orthodontists
- Allowable business investment losses
- Deemed disposition of property upon death
- Significance of "associated corporations"
- Do you always need to file a tax return?
- Around the courts

Revised position on the ITCs claimed on orthodontists

In a recent ruling, *Dr. Brian Hurd Dentistry Professional Corporation* (Applicant) *vs. Her Majesty the Queen* (Respondent), the Tax Court of Canada disallowed input tax credits (ITCs) claimed by an orthodontist on the grounds that the Applicant provided a single supply of an exempt orthodontic treatment.

The Applicant claimed ITCs consistent with the CRA's administrative policy, *RITS 56527-Eligibility by an Orthodontist for Input Tax Credits*. Per the 2004 administrative policy, dentists and orthodontists may claim ITCs where multiple supplies are made and wherein the supply of an orthodontic appliance is identified separately from the orthodontic treatment on the invoice. If identified separately, the ITCs would be calculated using an estimated 35% of sales. For instance, an orthodontist that makes multiple supplies consisting of consultative and diagnostic health services and zero-rated supply of an orthodontic appliance. The taxpayer would be able to claim ITCs where the consideration for the zero-rated supply is shown separately from the consideration from the exempt supply of health services.

In this case, Judge Campbell determined that the Applicant had not sufficiently segregated the supply of zero-rated orthodontic appliances from exempt services. The Applicant's appeal was dismissed and ITCs in the amount of $22,440 were denied because the Applicant was making a single supply of exempt services; thus, there were no commercial activities to support the claim of ITCs. The Judge commented in his ruling that the administrative policy was not binding, and he believed it to be incorrect and misleading to taxpayers.

Going forward, dentists and orthodontists may not be eligible to claim ITCs if multiple supplies are made because it may be considered a single supply, especially if multiple supplies are not segregated for billing purposes. There is an uncertainty because it is not clear if this would be a change in position or an outlier of a case precedent. Ergo, orthodontists ought to be cautious when claiming the ITCs, and to the extent possible, clearly distinguish its supplies separately in invoices to patients. It is also expected that Revenu Quebec would treat the ITC claims in a similar manner.

Allowable business investment losses

An allowable business investment loss ("ABIL") is a special form of allowable capital loss ("ACL"), which is half of a capital loss. However, unlike an ACL, which can normally only be deducted against taxable capital gains, an ABIL can be deducted from all sources of income such as income from employment, business, or property.

> *Example*
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> This year, you have a $60,000 capital gain and thus a $30,000 taxable capital gain, along with $60,000 of employment income. You also have a $50,000 ABIL.
>
> The first $30,000 of the ABIL reduces the taxable capital gain to zero, while the excess $20,000 ABIL reduces your other income to $40,000. As a result, you are left with $40,000 of net income.
>
> If the $50,000 amount has been a regular ACL, it could reduce your taxable capital gain to zero, but you would still be left with $60,000 of employment income and net income. The unused $20,000 of the ACL could not be used this year, although it could be carried back 3 years or forward indefinitely to offset taxable capital gains in those years.

If your ABILS are not fully used in the year, they can be carried forward up to 10 years to offset all other sources of income in those years. If there are any ABILs remaining after that time, they revert to being regular ACLS and can be carried forward indefinitely, but only to offset taxable capital gains, not other sources of income.

So what is an ABIL?

First, it is one-half of a business investment loss. So what is a business investment loss?

A business investment loss is a capital loss that occurs on a disposition of certain types of property in certain circumstances. There are two types of dispositions that can generate a business investment loss.

Scenario one:

A business investment loss occurs when you dispose of property to an arm's length person at a loss, where the property is:

1. a share of a "small business corporation", or
2. a debt owing to you by a Canadian-controlled private corporation (CCPC) that is
   a) a small business corporation,
   b) bankrupt and was a small business corporation at the time it last became bankrupt, or
   c) a corporation that was insolvent and that was a small business corporation when it was subject to a statutory winding-up order.

In general terms, a CCPC is a Canadian-resident private corporation that is not controlled by non-residents or public corporations. For example, if you are a Canadian resident and you control your private corporation, it will be a CCPC. Control normally means owing more than 50% of the voting shares of the corporation.

A small business corporation must be a CCPC, but it also must meet the following requirements:

"All or substantially all" of the fair market value of the assets of the CCPC must be attributable to any combination of:

1. assets used principally in an active business carried on primarily in Canada by the CCPC or a related corporation, or
2. shares or debt in small business corporations that are connected with the CCPC ("connected" generally means that the CCPC owns at least 10% of the shares of the other corporation or corporations).

An arm's length person includes a person that is not related to you (in income tax terms). For example, a related person will include most of your close family members, a corporation that you control, and a corporation that you control together with your family members.

The Canada Revenue Agency ("CRA") takes the view that "all or substantially all" means 90% or more.

Scenario two:

A business investment loss can also occur on a "deemed disposition" of one of the above properties. A deemed disposition of the property occurs at the end of a taxation year where:

1. If the property is a debt owed to you by the corporation, the debt became a bad debt during the year. Basically, a bad debt is one that is uncollectable, based on the facts; or
2. If the property is a share in the corporation,
   a) the corporation became bankrupt during the year,
   b) the corporation was under a winding-up order made in the year, or
   c) at the end of the year, the corporation was insolvent, it did not carry on a business, the fair market value of the share was nil, and it was reasonable to conclude that the corporation would be dissolved or wound up.

In the case of a deemed disposition, you must make an election for the taxation year in your tax return for the year.

ABIL reduced by claimed capital gains exemption

The capital gains exemption allows you to earn tax-free capital gains on dispositions of certain types of property, namely qualified small corporation shares, and qualified farm or fishing property.

The lifetime exemption for qualified small corporation shares is $848,252 in 2018, and the amount is indexed annually to inflation. Since capital gains are only one-half taxed, this currently amounts to $424,126 of taxable capital gains. For qualified farm or fishing property, the exemption is $1 million of capital gains, or $500,000 of taxable capital gains.

A special rule in the Income Tax Act provides that your business investment loss in a taxation year is reduced by the amount of the capital gains that you sheltered in previous years under the capital gains exemption, if any.

> *Example*
>
> In 2015, you claimed the capital gains exemption on $40,000 of capital gains, or $20,000 of taxable capital gains. In 2018, you incurred a $70,000 business investment loss.
>
> Your business investment loss will be reduced to $30,000 ($70,000 business investment loss minus $40,000 capital gains exempted in 2015). One-half of that amount, or $15,000, will qualify as an ABIL which can offset any sources of your income in 2018.

> The remaining $40,000 of your loss will then be a regular capital loss, and half of that, or $20,000, will be an ACL that can offset only your taxable capital gains.

Conversely, if you claimed an ABIL in a previous year, it can serve to reduce the amount of the capital gains exemption you can claim in the current year.

Deemed disposition of property upon death

Capital gains or losses on property are normally triggered only when there is a “disposition” of the property (i.e., you sell it). In other words, accrued but unrealized gains are not taxed unless and until there is a disposition.

As a result, you can own property for years with large accrued gains, and not pay any tax until you sell the property.

General deemed disposition rule

However, ultimately the tax rules will catch up to you. The Income Tax Act provides that when you die, you are deemed to have disposed of your capital properties immediately before your death, for proceeds equal to their fair market value. As a result, your accrued capital gains will be triggered (as well as any accrued capital losses). Similar rules apply to land inventory and certain resource properties that you own at the time of your death.

The person acquiring the property as a consequence of your death acquires the property at a cost equal to that same fair market value.

> *Example*
>
> John dies on July 1, 2018. He owned mutual funds with a total cost of $200,000 and fair market value of $600,000 at the time of his death. He leaves the funds to his son under his will.
>
> John will have a deemed disposition for proceeds of $600,000, resulting in a $400,000 capital gain, and half of that, or $200,000, will be a taxable capital gain included in his income on his 2018 terminal return. John’s son will acquire the funds at a cost of $600,000 for tax purposes.

Exception for spouses etc.

An exception to the above rule applies where you leave property to your spouse (or common-law partner), or a qualifying spousal trust. In such case, there is an automatic rollover, meaning that you will have a deemed disposition of the property for proceeds equal to your cost, thus leading to no gain or loss. Your spouse will pick up a cost of the property, for tax purposes, equal

to your cost.

However, the executor of your estate can elect out of the rollover on a property-by-property basis. Where this election is made, the property is subject to the regular deemed disposition at fair market value rule.

(Similar rules apply to farm or fishing property left to children or grandchildren – the subject of a future Tax Letter.)

You might wonder – why make the election out of the rollover, since the rollover results in no gain and no tax? Well, there are a few possible reasons. First, if the property has an accrued loss (fair market value less than your cost), the election can trigger the loss, which can be used in the year of your death (and more on this point below). Second, even if the property has an accrued gain, you might have unutilized losses that could fully offset the gain, so that your estate will pay no tax. Meanwhile, your spouse will pick up a higher tax cost in the property (i.e., the fair market value). Third, if the property qualifies for the capital gains exemption and you have some exemption remaining, the gain can be offset by the exemption, meaning no tax for you, but again a higher tax cost for your spouse.

As noted above, the rollover also applies if the property is left to qualifying spousal trust, rather than directly to your spouse. In general terms, a qualifying spousal trust is a trust under which your spouse is entitled to all of the trust income during her lifetime, no one else may obtain the income or capital of the trust during her lifetime, and the property vests in the trust within 36 months of your death.

Allowable capital losses when you die

As noted earlier, your allowable capital losses (ACLs) can normally offset only your taxable capital gains, not any other sources of income.

However, this rule is relaxed upon your death. Basically, any ACLs in the year of death, as well as those carried forward from previous years (called "net capital losses") can offset taxable capital gains *and other sources of income* – both in the year of death and in the year preceding death. The ACLs subject to this rule include any that arise because of the deemed disposition upon death as described above.

There is one *caveat*. The amount of an ACL that can offset other sources of income will normally be reduced to the extent that you have claimed the capital gains exemption. However, such an ACL will remain available to offset taxable capital gains, including those arising due to the deemed disposition on death.

Significance of “associated corporations”

There are various income tax rules that apply when two or more corporations are “associated” with each other. Unfortunately, the rules tend to be detrimental rather than beneficial, and the associated corporation rules must always be considered when dealing with closely-held corporate structures.

For example, associated corporations face the following restrictions or limitations:

- Most significantly, if two or more Canadian-controlled private corporations (CCPCs) are associated, they must share the small business deduction (SBD) that applies to the first $500,000 of active business income in a year. The SBD reduces corporate tax rates on business income to around 12-15%, depending on the province, compared to the regular corporate rates that range from around 25-31%.

- For example, if two associated corporations each earn $400,000 of active business income, they can claim the SBD only on $500,000 of income between them, and not $400,000 of business income for each one. If, for instance, one corporation claimed the SBD for all $400,000 of its business income, the other can claim it for only $100,000 of its business income, leaving $300,000 of business income subject to the regular (high) corporate tax rates.

- In the 2018 Federal Budget, the government introduced restrictions on the amount of passive investment income that CCPCs can earn without adverse tax consequences (see our May 2018 Tax Letter for details). Essentially, a CCPC may earn up to $50,000 of passive investment income per year without affecting the SBD. However, above that level every dollar of additional investment income in a year reduces the limit of business income that qualifies for the SBD on a 5:1 basis ($5 business income for each excess $1 investment income). If CCPCs are associated, the rule applies to $50,000 of investment income earned by *all* the associated corporations. For example, if two associated corporations each earn $26,000 of investment income, they will be over the $50,000 limit and therefore subject to the SBD reduction, so their maximum business income eligible for the SBD will be $490,000 instead of $500,000 ($10,000 reduction, due to being $2,000 over the $50,000 threshold).

- CCPCs can earn refundable investment tax credits of up to 35% of expenditures on scientific research and experimental development. However, the credit is phased out if the combined taxable income of the CCPC and any associated corporations exceeds $500,000, or if the combined “taxable capital” of the CCPC and any associated corporations exceeds $10 million.

Meaning of “associated corporation”

The definition is quite complex. However, the following is a general description of the main situations under which corporations are associated.

- Corporation A and Corporation B are associated if:
- Corporation A controls Corporation B, or vice versa.
- The same person or group of persons controls both Corporation A and Corporation B.
- Corporation A is controlled by one person (A) and corporation B is controlled by a person (B) that is related to person A; plus, either A owns at least 25% of the shares of any class of Corporation B, or B owns at least 25% of the shares of any class of Corporation A.

For these purposes, “control” of a corporation includes the regular legal meaning, which says that a person or group controls a corporation if the person of group owns more than 50% of the voting shares in the corporation. However, for the purposes of the associated-corporation rules (and not for most other tax purposes), the concept of "control" is expanded.

For example:

- You are deemed to control a corporation if you own shares in the corporation whose *fair market value* (even without votes) is more than 50% of all of the shares in the corporation;
- *De facto* control is considered "control" for these rules; and even having "direct or indirect influence that, if exercised, would result in control in fact of the corporation" is sufficient in many cases.
- In determining whether you control a corporation, any shares owned by your children under the age of 18 are deemed to be owned by you. For example, if you owned most of the voting shares of one corporation and your minor child owned most of the voting shares of another corporation, you are deemed to control both corporations and they will be associated. However, this rule does not apply “if it can reasonably be considered that your child manages the business and affairs of his or her corporation "without a significant degree of influence” by you.

Do you always need to file a tax return?

Of course, the simple answer is no. Normally, you do not have to file a tax return for the year if you have no income tax payable for the year. (Note that having no tax payable *at year-end* because of source withholdings does not get you out of a filing obligation. For this purpose, "tax payable" includes amounts you have already paid or that were withheld from payments to you.)

However, even if you have no tax payable, you may need to file a return for the year. For example, you must file a return if you have a taxable capital gain in the year or dispose of capital property in the year. You must file if the CRA sends you a demand to file a return. You must file a return if you have withdrawn money from your registered retirement savings plan ("RRSP") under the Home Buyers' plan or Lifelong Learning Plan and have an outstanding balance payable in respect of the repayment of those amounts to your RRSP.

Furthermore, even if you are not required to file a tax return, in many cases it is beneficial to do so. For example, if you are entitled to a tax refund for the year, you need to file a return. This could occur where tax was withheld from your salary or wages, but you did not end up owing tax for the year, meaning that the withheld tax will be refunded to you. It could also occur where you paid some tax instalments for the year, but you ended up having no tax payable for the year.

You should also file if you wish to claim a refundable tax credit. You may want to claim the GST/HST Credit that applies to low-income individuals or families. You may want to receive the Canada Child Benefit. In these circumstances, even though you are not required to file a tax return, you obviously should.

Around the courts

Car allowances based on estimated travel taxable

The Income Tax Act provides that a car allowance paid to an employee is not taxable if it is reasonable. If it unreasonable, it is taxable.

A further rule provides that a car allowance is deemed to be unreasonable, and therefore taxable, if the allowance is **not** based solely on the number of kilometers driven in the course of employment.

In the recent *Positano* case, the taxpayers were brothers employed in a family snow-plowing business. One of their duties was to do "snow runs", under which they would drive to streets and neighborhoods to determine whether snow plowing would be needed. The brothers were paid a car allowance for the snow runs, which were based on estimated travel and average travel distances throughout the year. The CRA held that the allowances were taxable because they were not based solely on the number of kilometers driven in the course of employment.

The taxpayers appealed to the Tax Court of Canada, but the Court upheld the CRA assessment saying that an estimate is not good enough. As a result, the allowances paid to the taxpayers were taxable. Therefore, we continue to stress the need for detailed logs of automobile travel for business use of automobiles.

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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.