October 2020

Tax Newsletter

Topics for discussion:

- Taxable COVID-19 benefits
- Acquisition of control of corporation or trust
- “Zero coupon” debt instruments
- Employee loans
- Tax loss? You need a source of income
- Around the courts

Taxable COVID-19 benefits

In response to the COVID-19 pandemic, the federal government has provided various benefits and tax measures, including the Canada Emergency Response Benefit (“CERB”), the Canada Emergency Student Benefit (“CESB”), the Canada Recovery Benefit (“CRB”), the Canada Recovery Sickness Benefit (“CRSB”), and the Canada Recovery Caregiving Benefit (“CRCB”). If you received any of these benefits you must include the amount in income. You will receive a T4A slip indicating the amount you must report on your tax return.

CERB

The CERB was provided to certain employed and self-employed individuals who were unable to work because of the pandemic. If you qualified, you received $2,000 for each four-week segment of the eligibility period. There were seven eligibility periods, for a total of 28 weeks, starting on March 15 and ending on September 26, 2020.

In general terms, you qualified for the CERB if you fell into the following criteria:

- You were resident in Canada and were at least 15 years old;
- You stopped working because of the COVID-19 situation or were eligible for Employment Insurance regular or sickness benefits or exhausted your Employment Insurance regular benefits between December 29, 2019 and October 3, 2020;
- You had employment income, self-employment income, or a combination of both (including non-eligible dividends), of at least $5,000 in 2019 or in the 12 months prior to the date of your application; **and**
- You did not quit your job.

(Certain other conditions applied.)

If you received the CERB, it is fully included in your income for 2020.

CESB

The CESB was available to post-secondary students, and post-secondary and high school graduates who were unable to find employment because of the COVID-19 situation. It was available only if the students did not qualify for the CERB or Employment Insurance.

From May to the end of August 2020, the CESB was $1,250 per four-week period, and increased to $2,000 for certain disabled individuals and those with dependants. If you received it, it is fully included in your 2020 income.

If you have to repay some of the CESB (say, if it turned out you did not qualify at some point in time), any repayment made by the end of 2020 will reduce your amount taxable for 2020.

CRB

If you qualify, the CRB pays you up to $900 per 2-week period for up to 13 periods. The actual benefit is $1,000 per 2-week period and $100 of tax is withheld from the payment for a net amount of $900. It is available to certain employees and self-employed individuals who are not eligible for Employment Insurance and that have experienced a 50% reduction in their average weekly income compared to the previous year (or other comparable period) due to COVID-19.

If you make more than $38,000 in a year, this benefit must be repaid at a rate of $0.50 for every dollar of income over $38,000. The repayment will be calculated on your tax return.

It applies as of September 27, 2020 and is in effect for one year.

CRSB

If you qualify, the CRSB pays you $450 per week for up to two weeks, if you are sick or have to self-isolate for reasons related to COVID-19 and are unable to work at least 50% of your scheduled work week. The actual benefit is $500 per week and $50 of tax is withheld from the payment for a net amount of $450.

It applies as of September 27, 2020 and is in effect for one year.

CRCB

If you qualify, the CRCB pays you $450 per week for up to 26 weeks, if you are unable to work for at least 50% of a working week because you have to attend to:

- a child under age 12 because of the closure of a school or daycare;
- a family member with a disability or a dependent because their day program or care facility was closed;
- a child, a family member with a disability, or a dependent who was not attending school, daycare, or another care facility under the advice of a medical professional.

The actual benefit is $500 per week and $50 of tax is withheld for a net payment of $450.

It applies as of September 27, 2020 and is in effect for one year.

You can read more about these programs here:

https://www.canada.ca/en/services/benefits/covid19-emergency-benefits.html

Acquisition of control of corporation or trust

There are various tax restrictions that apply when "control" of a corporation or trust is acquired. Some of the major restrictions are:

- Net capital losses cannot be carried forward to years after the acquisition of control or back to years before the acquisition. This is a major exception to the regular rule that normally allows a three-year carry-back and indefinite carry-forward of net capital losses.

- Non-capital losses (e.g. business losses) can be carried forward or back, but only to the extent of income generated by the business that generated the losses, or a similar business (this is a very general summary of a complex rule).

- Investment tax credits (e.g. for scientific and experimental research) are restricted unless the same or a similar business is carried on, along the same lines.

- There is a deemed taxation year-end immediately before the acquisition of control, and a new taxation year begins immediate after the acquisition. This will typically result in at least one short "stub" taxation year ending upon the acquisition of control. The short stub year will accelerate the tax-filing date for the tax return for that short year and will require the pro-ration of certain deductions like capital cost allowance (tax depreciation).

- All capital properties with accrued losses are written down to fair market value, resulting in capital losses in the taxation year ending upon the acquisition. As noted above, these losses cannot be carried forward to years beyond the acquisition of control. However, the corporation or trust can elect to trigger any accrued capital gains in the taxation year ending upon the acquisition, to the extent of the capital losses in that year, including those resulting from the write-down rule described above. The capital gains can be offset by those capital losses, and result in an increased adjusted cost base of the gain properties. The following is an example of the application of this rule:

  Example

  Corporation Xco used the calendar year as its taxation year. In 2020, there was an acquisition of control of Xco. At that time, it owned the following capital properties:

  Property 1: $100,000 adjusted cost base; $60,000 fair market value

  Property 2: $100,000 adjusted cost base; $130,000 fair market value

  Xco will have a deemed year-end immediately before the acquisition of control, resulting in a short 2020 taxation year (that is, from January 1, 2020 to the acquisition of control). It will have a deemed new taxation year, and from that point on it can choose to maintain a calendar year end (in which case it will have another short taxation year ending on December 31, 2020) or have a new off-calendar taxation year end that would generally be 12 months after the acquisition control.

  In the short 2020 taxation year ending at the acquisition of control, Property 1 will be written down to $60,000, resulting in a $40,000 capital loss and $20,000 allowable capital loss. Xco can elect to trigger the accrued capital gain on Property 2, resulting in a $30,000 capital gain and $15,000 taxable capital gain, which can be offset by the allowable capital loss. The adjusted cost base of Property 2 will be bumped up to $130,000.

Acquisition of control of corporation

So when does an “acquisition of control” of a corporation occur?

It occurs when a person or group of persons acquires sufficient shares of the corporation to have more than 50% of the votes. However, it does not occur if the person or group already owned shares giving them more than 50% of the votes. For example, if I own 52% of the voting shares and then buy more shares to get up to 62% of the voting shares, there is no acquisition of control. Another exception to this rule generally applies where a person acquires shares from a related person. For example, if I own 45% of the voting shares of a corporation and I buy another 10% of the shares from my spouse, there is no acquisition of control.

An acquisition of control also occurs where a person acquires more than 75% of the shares of the corporation calculated by fair market value, regardless of the number of voting shares. As above, there are some exceptions. For example, if you acquire more than 75% of the shares of the corporation that you already controlled, or acquire the shares from a related person, there is no acquisition of control.

Acquisition of control of trust

An acquisition of control of a trust occurs when a person becomes a “majority-interest beneficiary” of the trust, or a group of persons becomes a “majority-interest group of beneficiaries” of the trust. (The acquisition of control is technically called a “loss restriction event”.) Generally speaking, this means acquiring more than 50% of the income interests or capital interests in the trust based on their fair market value. As with the corporate rules, there are exceptions. For example, if you are already a majority-interest beneficiary and acquire a larger interest in the trust, there is no acquisition of control. Also, if you acquire an interest from an “affiliated person” (similar to but not quite the same as “related person”), there is no acquisition of control.

“Zero coupon” debt instruments

If you own a debt instrument like a bond, term deposit, or even a bank account, you often receive interest at least once a year. Normally, you just report the interest on your tax return in the year that you receive it. However, there are some debt instruments that do not pay interest annually. For example, you might purchase a zero-coupon bond or term deposit that pays all the interest upon maturity.

In these cases, you must report the interest income annually on an accrual basis. The general rule is that you report the accrued interest income in a taxation year that accrues to each “anniversary date” that ends in the taxation year. Each anniversary date is basically 12 months from the date of the issue and each 12-month period after that. Due to the 12-month rule, there typically will be a deferral of tax, as illustrated in the example.

Example

On July 1, 2020, you invested in a 3-year term deposit that matures on June 30, 2023. All of the interest is payable on maturity.

The first anniversary date is June 30, 2021, so you report that 12 months of accrued interest on your 2021 tax return. You do not report any interest in 2020 because there is no anniversary date in 2020. As a result, there is some deferral because you do not pay tax in 2020 on the interest that accrued to the end of calendar 2020.

For the 12 months of interest that accrues to June 30, 2022, you report that in your 2022 tax return. For the remaining interest that accrues to June 30, 2023, you report that in your 2023 return.

Employee loans

There are various employment benefits that are taxable for employees. One such benefit occurs where an employee receives a no or low-interest loan from their employer, or more particularly, a loan with interest lower than the “prescribed rate” under the Income Tax Act.

The general rule provides that if you receive a loan from your employer, you will have a taxable benefit equal to the prescribed rate of interest on the principal amount of the loan, minus any interest you actually pay on the loan in the year or within 30 days after the year. (Right now, the prescribed rate is just 1%.)

The interest calculations are rounded off without compounding.

Example

I receive a $100,000 loan from my employer on January 1, Year 1 at 1% interest. The prescribed rate of interest for the first six months of Year 1 is 2% and it is 3% for the last six months. I pay the 1% interest on the loan by January 30, Year 2.

For the first six months of Year 1, I will have a taxable benefit of (2%-1%) x $100,000 x ½ (for half of the year), or $500. For the last six months, the taxable benefit will be (3%-1%) x $100,000 x 1/2 or $1,000.

I will have a total taxable benefit of $1,500 included in my income in Year 1.

Home purchase loans

A special rule applies if you use the loan to acquire a home in which you will live (it does not apply if you use the loan to buy an investment property that you rent out).

Basically, the maximum taxable benefit will be based on the lower of the prescribed rate of interest at the time of the loan and the prescribed rate that applies during the relevant year (some modifications may apply).

> *Example*
>
> Assume the same facts as the above example, except that the $100,000 loan was used to acquire your home.
>
> Since it is a home purchase loan, your taxable benefit is based on the 2% prescribed rate as of January 1, Year 1, and is not increased for the last six months.
>
> Therefore, your taxable benefit for Year 1 will be (2%-1%) x $100,000, or $1,000.

The original home purchase loan rule applies for the first five years of the loan. After the fifth year, the prescribed rate of interest at that time becomes the new limit that applies for years 6 through 10.

> *Example*
>
> Assume the same facts as above, except the prescribed rate of interest on January 1, Year 6, is 3% but increases to 4% for the last six months of the year. You pay the 1% interest on the loan for Year 6 on time.
>
> The benefit will equal (3%-1%) x $100,000, or $2,000.

Tax loss? You need a source of income

If you have a loss from a business or a rental property in a taxation year, you can use the loss to offset other sources of income in the year.

For example, if I have $50,000 of employment income but also carry on a side business with a loss of $30,000, my income for tax purposes will be $20,000.

The “catch” is that the loss must be from a “source”.

If the loss is apparently from a business or property, the issue is not always straightforward because of the source issue.

At one time, the CRA and the courts took the position that you could have a loss from a business or property source only if you had a reasonable expectation of profit ("REOP"). If you did not have an REOP you did not have a source and your loss could not be used for tax purposes.

Fortunately, the Supreme Court of Canada clarified the source rules in the landmark Stewart case, back in 2002.

According to the Supreme Court, the source rules are as follows:

> First, if your activity is "clearly commercial", basically meaning that it is a business or investment activity with no personal element, then any loss from the activity will be recognized for income tax purposes.
>
> However, if your activity has some personal element to it, the source issue becomes more complicated. In such case, the courts must look at the following factors to determine whether you have a source and therefore whether your loss will be recognized for tax purposes:
>
> "(1) the profit and loss experience in past years; (2) the taxpayer's training; (3) the taxpayer's intended course of action; and (4) the capability of the venture to show a profit…it is not necessary for the purposes of this appeal to expand on this list of factors. As such, we decline to do so; however, we would…caution that this list is not intended to be exhaustive, and that the factors will differ with the nature and extent of the undertaking. We would also emphasize that although the reasonable expectation of profit is a factor to be considered at this stage, it is not the only factor, nor is it conclusive. The overall assessment to be made is whether or not the taxpayer is carrying on the activity in a commercial manner."

In other words, where your activity has a personal element and a commercial element, it will be a question of fact as to whether it is a "source" such that a loss from the activity will be recognized for income tax purposes.

Around the courts

Line of credit replaced other loan – is the interest deductible

Interest expense on a loan or debt is deductible for income tax purposes if the loan is used for the purpose of earning income from a business or property.

In addition, there is a rule that states that if you take out a new loan to repay a previous loan that was used to earn income from a business or property, interest on the new loan is deductible. The recent case of Wesley Brown dealt with these issues. There were a few contentious points. One of the main issues involved the taxpayer taking out personal loans from family members with no interest, to help him purchase an investment property. Subsequently, he used his line of credits to pay off the personal loans.

The personal loans to the taxpayer were at no interest, so there was no interest expense deduction he could claim. However, since he repaid some of those personal loans with his line of credits, which did require him to pay interest, the interest expense on the line of credits was deductible in computing his income.

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