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TAX LETTER

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RENTING OUT YOUR HOME – EFFECT ON PRINCIPAL RESIDENCE EXEMPTION

Most readers are likely aware of the principal residence exemption, which generally exempts all or a portion of the gain from the sale of your home from tax. Basically, if the home was your principal residence for all years in which you owned it (or all years but one), the gain on the sale of the home will not be taxable.

More particularly, the tax-exempt portion of the gain will equal:

> Gain x (1 + # years during which home is your principal residence / # years of ownership)

For this calculation, the home will be your principal residence for a year if you (or your spouse or child) "ordinarily inhabited" it in the year, generally meaning that you lived in the home for at least some period in the year. A cottage or other vacation home can qualify even if you lived there only for a couple of weeks. But only one home per family unit (you and your spouse and unmarried minor children) can qualify as your principal residence for any particular year.

There are provisions in the Income Tax Act that extend the principal residence exemption for years in which you do not live in the home. Basically, if you lived in the home and subsequently rent it out, the home can still qualify as your principal residence for up to 4 years during the rental period (as long as you do not claim another home as your principal residence for any of those 4 years).

This special treatment is elective – you must make an election with your tax return for the year in which you start renting it out. However, if you make this election, you cannot claim capital cost allowance (tax depreciation) on the home in a year during the rental period.

Example

You bought your house in 2003 and lived there until 2007, and then rented it out until 2013. You sold the house in 2013 and realized a gain of $110,000.

Your house was your principal residence from 2003 through 2007 (5 calendar years). If you make the election and designate the house as your principal residence for (the maximum) 4 of the 6 years during which you rented it out, under the above formula the exempt portion of your gain will be:

$110,000 x (1 + 5 + 4 / 11) = $100,000

(that is, 1 plus the number of years you lived there, plus no more than 4 years during which you rented it out, divided by the total number of years in which you owned the property, which was 11).

For the remaining $10,000 gain, one-half of that, or $5,000, will be a taxable capital gain included in your income.

Note that the 4-year period is waived (i.e. the home can qualify for your principal residence throughout the rental period) if:

- You moved out of your home because of a relocation of your employment or your spouse's employment;
- Your new place of residence is at least 40 kilometres closer to the new work location than your home; *and*
- You move back into the home during your employment or by the end of the year following the year in which your employment ends.

A corollary rule provides that where you first rented out the home and subsequently moved in, an election allows the home to qualify as your principal residence for up to 4 years during the previous rental period. This rule does not apply if you claimed capital cost allowance during the rental period. There is no extension to the 4-year period in these circumstances.

SPOUSAL AND CHILD SUPPORT PAYMENTS

As a general rule, spousal support payments made to a (separated or divorced) spouse or common-law partner are deductible in computing the payer's income, if they are required by a Court Order or a written agreement. The payments are included in the recipient's income. However, there are certain conditions that must be met, as summarized below.

On the other hand, child support payments are no longer deductible for the payer and are tax-free for the recipient (for court orders and agreements made or varied after April 1997).

Conditions for deduction / inclusion of spousal support payments

Generally, the payments will be deductible for the payer and taxable for the recipient if the payments are made on a "periodic basis" for the maintenance of the recipient, if the recipient has "discretion as to the use of the amount". As such, in most cases lump sum payments will not be deductible (or taxable), nor will payments over which the recipient does not have discretion over the use of the funds.

However, the periodic and discretion requirements are waived if the court order or agreement specifies as such and indicates that they are to be deductible and taxable (the order or agreement should specify the applicable provisions in the Income Tax Act – subsections 56.1(2) and 60.1(2)). In such case, payments on account of the recipient's rent, mortgage, housing costs, medical expenses, tuition costs, among others, will be deductible to the payer even if they are not made directly to the former spouse. These payments can be made in a lump sum. In the case of mortgage payments, this treatment is limited each year to 1/5 of the original principal amount of the mortgage loan.

Furthermore, the Canada Revenue Agency (CRA) states that lump sum payments can be deducted (and are taxable) in the following circumstances:

- the lump sum payment represents amounts payable periodically that were due after the date of the order or written agreement that had fallen into arrears, *or*
- the lump sum amount is paid pursuant to a court order and in conjunction with an existing obligation for periodic maintenance, where the payment represents the acceleration of future support that was payable on a periodic basis, for the sole purpose of securing the funds to the recipient.

Otherwise, a lump sum payment made to release the payer from making future or past support payments will generally not be deductible or taxable.

Another general condition is that the spousal support payments must be made after the relevant court order or written agreement is made. Payments made prior to that time are normally not deductible or taxable. However, if the court order or agreement specifies as such, payments made before the date of the order or agreement but in the same year or in the immediately preceding year will be deductible and taxable.

Rules distinguishing spousal and child support

If the court order or agreement provides for support for both the recipient spouse and a child, any amount that is not identified as being solely for the use of the recipient spouse is deemed to be child support. Effectively, this rule means that any amount that is not so identified will be non-deductible (non-taxable) child support. Therefore, proper drafting of the order or agreement is necessary to ensure that spousal payments are clearly identified as being for the support of the recipient spouse, if the parties want deductibility and taxability.

Furthermore, an ordering rule effectively provides that where both spousal and child support are payable under the order or agreement, the child support is deemed to be paid first. As such, if the full support payments owing are not made in the year, some of the spousal support will not be deductible or taxable.

Example of ordering rule

John and Mary are divorced. Under a court order made in 2011, Mary is obliged to pay John annual spousal support of $20,000 and annual child support of $30,000, for a total of $50,000. In 2012, Mary paid John only $45,000.

Of the total $45,000 payment, the amount of $15,000 ($45,000 – $30,000 child support payable) will be deductible for Mary and taxable for John in 2012. The $5,000 not paid in 2012 will be considered to be unpaid spousal support.

However, if Mary catches up and pays an extra $5,000 in 2013 (for a total payment of $55,000), she will be able to deduct a total of $25,000 in 2013 ($20,000 spousal support payable for 2013 plus the $5,000 catch up amount).

HIGHER TAX FOR PERSONAL SERVICES BUSINESS CORPORATION

If your Canadian-controlled private corporation (CCPC) carries on a "personal services business", the income from that business is **not** eligible for the small business deduction. That deduction, where applicable, effectively reduces the federal tax rate on the first $500,000 of active business income of a CCPC to 11%. (See the May Tax Letter for more details.)

Until recently, the income from a personal services business of a CCPC was subject to the general corporate tax rate, which in most provinces is about 25-30% (15% federal tax plus provincial corporate tax). However, under legislation passed on June 26, 2013 **but retroactive to corporate taxation years beginning after October 31, 2011,** the tax rate on such income is now the general corporate tax rate plus an **additional** 13%. The federal tax alone is 28%, plus provincial corporate tax that varies from 10% to 16% depending on the province (total 38%-44%).

Because of this higher tax rate, the payment of after-tax dividends from the corporation's personal services business income will result in excessive taxation. That is, although the individual shareholder will receive a dividend tax credit, such credit will effectively presume the general corporate tax rate of 15% rather than the actual 28% rate. As such, there will be a significant element of double taxation.

The double taxation can be avoided if the income is paid out as salary every year to the individual shareholder/employee of the corporation. In such case, the payment of the salary will be deductible for the corporation and taxed at the individual's regular marginal tax rates. However, the new rules effectively prevent the deferral of tax through retention of income in the corporation and the later payment of dividends (for reasons described in the preceding paragraph).

So what is a personal services business? In general terms, it is a business carried on by a CCPC where a "specified shareholder" of the CCPC (or a person related to the specified shareholder) provides services to a third party, and would be considered an

employee of the third party but for the existence of the CCPC (i.e. an "incorporated employee"). In determining whether the specified shareholder or related person would be considered an incorporated employee, the usual tests regarding employee vs. independent contractor are employed (these tests were outlined in our March 2013 Tax Letter)
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A "specified shareholder" includes a person who owns at least 10% of the shares of any class of the CCPC or a corporation related to the CCPC. For these purposes, the person is deemed to own any shares owned by a non-arm's length person. Therefore, for example, in determining whether you are a specified shareholder, you would be deemed to own the shares owned by your spouse, children, parents, and so on.

An exception to the definition of personal services business applies where the CCPC employs more than 5 full-time employees throughout the relevant year (this can include 5 full-time employees plus a part-time employee). In this case, the additional 13% tax will not apply.

DIVIDENDS FROM YOUR SMALL BUSINESS CORPORATION

As noted earlier, the first $500,000 of active business income earned by a Canadian-controlled private corporation (CCPC) is subject to a lower tax rate (the small business tax rate) than the general corporate tax rate. The federal small business tax rate is 11% while the general corporate rate is 15%. The provincial rates vary by province, and all provinces provide a lower rate for the CCPC active business income (1%-8% instead of 10%-16%, depending on the province).

Currently, dividends paid by a CCPC out of the low-rate active business income to an individual shareholder are grossed up by 25% of the dividend. The shareholder then gets a federal dividend tax credit (DTC) of 2/3 of the gross-up. The gross-up / DTC mechanism effectively provides a credit to the shareholder roughly equivalent to the corporate tax paid (in order to prevent double taxation of the business income earned in the corporation).

However, the federal gross-up and DTC amounts are changing, effective for dividends paid after 2013. The new gross-up will be 18% of the dividend, and the new DTC will be 13/18 of the gross-up. As illustrated in the example below, these changes will result in additional tax payable at the shareholder level.

Example

You are in the highest federal tax bracket of 29% in 2013 and will be in 2014. You are considering having the CCPC pay you a dividend of $100,000 out of its eligible active business income, either in 2013 or 2014 or both.

Payment of dividend in 2013:

You will include $125,000 in income. 29% x $125,000 = $36,250 tax, reduced by the DTC of (2/3 x $25,000), for total federal tax of $19,583.

Payment of dividend in 2014:

You will include $118,000 in income. 29% x $118,000 = $34,220 tax, reduced by DTC of (13/18 x $18,000), for total federal tax of $21,220.

(Of course, you will have provincial tax as well, which will vary in these examples depending on the province and your income bracket.)

Dividends that are paid out of the CCPC's business income in excess of the $500,000 active business income limit are not affected by these changes. These "eligible dividends", which also include most dividends paid by public corporations, continue to be grossed-up by 38% and the DTC is 6/11 of the gross up.

"EQUIVALENT-TO-SPOUSE" CREDIT

If you are unmarried, or married but separated from your spouse, you can claim the "equivalent to spouse" credit in respect of certain dependents as described below. The credit is referred to as "equivalent to spouse" because the amount is the same as the spousal credit that can be claimed by a married person. The credit is also called the "wholly dependent person" credit.

The credit is allowed if you support a person who lives with you in the year and who is:

- wholly dependent upon you for support;
- related to you; **and**
- either 1) your parent or grandparent; 2) under the age of 18; **or** 3) dependent upon you by reason of physical or mental infirmity.

If your dependant lived away from home while attending school, but ordinarily lived with you when not in school, the CRA considers that the dependant lived with you for the purposes of this amount.

The credit is typically claimed by single persons with a minor child, but as indicated above, the list of eligible dependants is actually broader.

Like the spousal credit, the equivalent to spouse credit can be claimed in respect of one dependant only. If the dependant is your child under 18, you can claim the child credit even if you also claim the equivalent to spouse credit.

For 2013, the federal equivalent to spouse credit equals 15% of ($11,038 minus dependant's income for the year). The provincial credits vary from province to province.

The $11,038 federal amount is increased by $2,040 if the person is 18 years of age or over and dependent upon you by reason of physical or mental infirmity (both figures are indexed to inflation).

For a child under 18, the additional 15% of $2,040 applies if the child, by reason of physical infirmity, is likely to be dependent upon you for a long and continuous period for "significantly more assistance" when compared to children of the same age. For such a child, the additional $2,040 amount is actually added to the child tax credit, rather than the equivalent to spouse credit, so it is not reduced by the child's income, if any.

The equivalent to spouse credit takes precedence over the "caregiver credit" (which generally applies in respect of parents or grandparents, or adult infirm dependants, living with you). However, if the caregiver credit in respect of that person would be greater than the equivalent to spouse credit, you are allowed to claim the additional amount as a "top-up" to the equivalent to spouse credit.

Furthermore, the equivalent to spouse credit does not prevent you from claiming the caregiver credit (or the similar infirm dependant credit) in respect of another dependent person.

PRESCRIBED INTEREST RATES

The CRA recently announced the prescribed annual interest rates that apply in the third quarter of 2013 to amounts owed to the CRA and to amounts the CRA owes to individuals and corporations. These rates are calculated each calendar quarter. The current rates are in effect from July 1, 2013 through September 30, 2013. (The same rates applied in the first two quarters of 2013 and throughout 2012 and 2011.)

- The interest rate charged on overdue income taxes, Canada Pension Plan contributions, and Employment Insurance premiums is 5%, compounded daily.
- The interest rate to be paid on late refunds paid by the CRA to corporations is 1%, compounded daily.
- The interest rate to be paid on other late refunds paid by the CRA 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

Spousal support taxable – recipient had discretion over use

As noted earlier in this Letter, in order for spousal support payments to be deductible for the payer and taxable for the recipient, the recipient must normally have discretion over the use of funds.

In the recent *Larivière* case, pursuant to a court-approved written agreement, the taxpayer's former husband was obligated to pay her $420 of weekly support. The agreement provided that the taxpayer was allowed to live in their former home, but that she was required to pay certain expenses relating to the home, including mortgage payments, insurance, taxes, and utilities. The support payments were calculated using an estimate of those expenses. As such, the taxpayer argued that she had no discretion over the use of the payments, because she was obligated to use the funds to pay the expenses. The CRA disagreed, and assessed her to include the support payments in her income.

On appeal to the Tax Court of Canada, the Court upheld the CRA assessment. According to the Court, although the amount of support payments was determined by reference to the home expenses, the payment of the support was not conditional upon the taxpayer paying the home expenses. As such, the Court ruled that she had discretion over the use of the funds, and so the payments were taxable to her.

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