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TAX LETTER

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SUPERFICIAL LOSSES
TAXATION OF TRUSTS
TAXATION ON DEATH: "DEEMED DISPOSITION RULES"
TRANSFER AND CARRYFORWARD OF TUITION AND EDUCATION CREDITS
CHILD TAX BENEFITS AND UCCB: INVEST WITHOUT ATTRIBUTION
AROUND THE COURTS

SUPERFICIAL LOSSES

The superficial loss rules under the Income Tax Act apply where taxpayers sell property at a loss and then purchase or repurchase the same or identical property within a specified period of time. More particularly, the rules apply where:

- A taxpayer (whether an individual or a corporation) disposes of property at a loss;
- The taxpayer or an "affiliated person" (described below) acquires the same property or an identical property in the period that begins 30 days before the disposition and ends 30 days after the disposition; and
- That taxpayer still owns the property or identical property at the end of the period.

Results for individuals

When the superficial rules apply to a taxpayer who is an individual, the taxpayer's loss on the sale of the property is denied and deemed to be nil. However, the loss is not necessarily lost forever, because it is added to the cost of the newly acquired property or identical property. As a result, that property effectively inherits the accrued loss, which will either be realized at a later time and/or serve to reduce a gain at a later time.

Example

On December 1, 2013, Jake sold 1,000 common shares in XCorp at a loss of $10,000. On December 20, 2013, in a different brokerage account, he bought 1,000 common shares in XCorp for $30 each, for a total cost of $30,000. He sold the 1,000 shares on March 1, 2014 for $42,000.

As a result of the superficial loss rules, Jake's $10,000 capital loss is denied and deemed to be nil. However, the $10,000 denied loss is added to the total cost of his 1,000 shares acquired on December 20, 2013, which becomes $40,000. Therefore, on the sale of the shares in March 2014, his capital gain is $2,000 rather than $12,000. One-half of the $2,000 gain, or $1,000, is included in his income as a taxable capital gain.

As discussed above, the rules can apply where either you or an "affiliated person" acquires or re-acquires the new property or identical property within the specified period of time. For these purposes, an affiliated person includes your spouse or common-law partner, a corporation that you control, a partnership in which you are a majority-interest partner, among others.

Interestingly, an affiliated person does not include your child or other relative, so that the rules do not apply if you sell property at a loss to such individuals.

Results for taxpayers other than individuals

For taxpayers other than individuals, such as corporations and trusts, the superficial loss rules work a bit differently. The rules still apply in the same circumstances, i.e. a corporation sells a property at a loss, it or an affiliated person acquires the same property or identical property within the 30-day before and 30-day after period described earlier, and the corporation or the affiliated person continues to own the property at the end of the period.

As with the rules for individuals, the loss is denied.

However, the loss is not added to the cost of the acquired or re-acquired property. Instead, in general terms, the loss is subsequently allowed to the corporation when the property is sold to a non-affiliated person, as long as the corporation or affiliated persons do not own the property or identical property for a period of at least 30 days.

TAXATION OF TRUSTS

Although trusts are not persons or individuals for most legal purposes, they are considered to be both "persons" and "individuals" for income tax purposes. As a result, a trust is generally required to report income, file a tax return (T3), pay income tax on its taxable income, and so on.

Inter-vivos trusts – meaning trusts that are set up during one's lifetime – are subject to a flat tax at the highest marginal rate (29% federal rate plus the applicable provincial rate) on every dollar of taxable income. Testamentary trusts – generally, trusts made under your will or otherwise upon your death – are subject to the same graduated tax rates as natural individuals. (However, as noted in our April 2014 Tax Letter, it is proposed that most testamentary trusts will be subject to the same highest flat tax as *inter-vivos* trusts, beginning in 2016. This proposal is included in the 2014 Budget first bill which is currently before Parliament and will almost certainly be enacted in June.)

For most purposes, trusts compute their income in the same manner as other individuals. However, any income of the trust (including taxable capital gains) for a taxation year that is paid out or made payable to a beneficiary of the trust is deducted from the trust's income and included instead in the beneficiary's income. As such, unlike corporations where there are two levels of tax (corporate **and** shareholder), for trusts there is normally only one level of tax – trust **or** beneficiary. Of course, where the beneficiary is an individual, the beneficiary will have access to low rates of tax on lower amounts of taxable income.

Generally, the beneficiary's income from the trust is considered income from property, since it comes from the beneficiary's interest in the trust. However, in some cases, the trust can designate income that is paid or payable to a beneficiary so that it retains its character in the beneficiary's hands.

For example, if the trust pays out taxable capital gains to the beneficiary, it can designate that they retain their character for the beneficiary. While the taxable capital gains (half of actual capital gains) are still taxable, this designation can be useful if the beneficiary has net capital loss carryforwards or current-year allowable capital losses available, which can be used only against taxable capital gains. The designation is also useful if the taxable capital gains resulted from the sale of property eligible for the lifetime capital gains exemption – for example, qualified small business corporation shares. The flow-out of these taxable capital gains to the beneficiary can then be offset by the beneficiary's available capital gains exemption.

Similarly, a trust receiving taxable dividends from a Canadian corporation can pay those out to a beneficiary and designate that they remain taxable dividends in the hands of the beneficiary. If the beneficiary is an individual, the beneficiary can use the gross-up and dividend tax credit mechanism to pay tax at lower dividend rates than ordinary trust income. If the beneficiary is a Canadian corporation, it can deduct the dividend in computing its taxable income.

The designations are made on the T3 slip which the trust provides to the individual by March 31 to report the individual's taxable income from the trust in the previous year.

As noted, trust income must normally be "paid" or "payable" in order to be deducted for the trust and included for the beneficiary. However, there are two circumstances under which the trust gets a deduction for its income that is **not** paid or payable to a beneficiary and thus retained in the trust:

- The first situation involves "preferred beneficiaries", who are generally severely disabled beneficiaries of the trust and who are either the settlor of the trust, the settlor's spouse or common-law partner, or a child, grandchild or great-grandchild of one of them. The trust and the preferred beneficiary can jointly elect in a taxation year that some or all of the beneficiary's share of the (*unpaid*) trust income for the year is included in the beneficiary's income and deducted from the trust's income. The deducted portion is thus not taxed in the trust. This election can be beneficial where the beneficiary's marginal tax rate is lower than that of the trust, which will typically be the case for *inter-vivos* trusts.

- The second situation involves trusts for beneficiaries who are under 21 years of age. In this scenario, if the beneficiary's right to trust income in a year is "vested" in the beneficiary, even though it is not paid out or made "payable" to the beneficiary in the year, it will be included in the beneficiary's income and deducted from the trust's income. The right must vest unconditionally, or with the sole condition being that the beneficiary must survive to an age not exceeding 40. Again, this rule can be beneficial if the beneficiary's tax rate is lower than the trust's, because it will allow more after-tax income and capital to accumulate in the trust.

Conversely, a trust can pay its income to a beneficiary in a taxation year and elect that such income, to the extent the trust does not claim a deduction, is **not** included in the beneficiary's income. This election (found in subsections 104(13.1) or (13.2) of the Act) is often useful where the trust has loss carry-forwards available, which can be used to offset the income of the trust that is not deducted. (Losses of the trust cannot be allocated to the beneficiaries of the trust.) That income can then flow out to the beneficiary tax-free.

Example

A trust has an unused loss carryforward of $50,000 from 2012. In 2014, it has $60,000 of income, which it pays out to its beneficiary.

For 2014, the trust chooses not to deduct $50,000 of the $60,000 paid out to the beneficiary, so the $50,000 remains income of the trust. It then elects that this $50,000 amount is not included in the beneficiary's income.

The result for 2014: The trust can carry forward its unused $50,000 loss to offset the $50,000 income, resulting in no tax for the trust. The beneficiary receives $60,000, but is taxed only on $10,000 of that amount.

Lastly, it should be noted that most personal trusts have "deemed disposition" dates, at which all their capital property is deemed to be disposed of for fair market value proceeds. The deemed disposition can lead to tax being paid on any accrued resulting gains. For many trusts, the deemed disposition occurs every 21 years (some special kinds of trust are excluded from this rule). For certain spousal trusts, the first deemed disposition date is the death of the spouse and then every 21 years. One way to avoid the deemed disposition is to transfer out the property of the trust to a capital beneficiary before the deemed disposition date. In most cases, the transfer can take place on a tax-free "rollover" basis.

TAXATION ON DEATH: "DEEMED DISPOSITION RULES"

Death and taxes – it is often said that they are the only things that are certain in this world. Furthermore, in most countries, including Canada, death often leads to more taxes.

Many countries have an inheritance tax, estate tax or succession tax. Canada does not (most provinces impose probate fees or "estate administration taxes", but they never exceed 1.5% of the estate). However, our income tax system contains certain "deemed

disposition” rules that effectively tax accrued gains at the time of one’s death.

Basically, when you die, you are deemed to have sold all your capital properties (and certain other properties like land inventory) for fair market value (FMV) proceeds, at the instant before death. The person who acquires or inherits the property as a consequence of your death will have a cost in the property equal to that FMV.

As a result, if the FMV of the property exceeds your cost of the property, you will realize a capital gain and half of that will be a taxable capital gain reported on your "terminal" return for the year of your death, with the resulting tax payable by your estate. If the FMV is less than the cost, you will have a capital loss.

If the capital losses in your terminal return exceed the capital gains, one-half of the excess is a net capital loss. Net capital losses can normally be deducted only against taxable capital gains. However, in the year of death and the preceding year, they serve to offset taxable capital gains and all other sources of income.

If the property is left to your spouse or common-law partner (or a qualifying spousal or common-law partner trust), the property is deemed to be disposed of at its tax cost rather than its FMV. As a result, there will be no gain or loss and no tax payable by you on the deemed disposition. Your spouse will inherit the same tax cost in the property. This scenario is often referred to as a tax-free spousal rollover.

However, the estate trustee, executor or administrator of your estate can elect out of the spousal rollover on a property-by-property basis. If they elect out of the rollover, the property is subject to the regular deemed disposition rule at FMV proceeds. This election could be useful in the following circumstances:

- The property has an accrued loss, so that the loss will be triggered in the year of death and can reduce tax on capital gains otherwise payable on your terminal return;

- The property has an accrued gain, but the gain can be offset by other capital losses on the terminal return. The spouse (or spouse trust) will inherit the property at a stepped-up cost equal to FMV; or

- The property has an accrued gain that can be offset by your capital gains exemption, if any. This exemption allows up to $800,000 of capital gains (more after 2014) to be realized tax-free on dispositions of qualified small business corporation shares, and certain qualified farm or fishing property. The spouse will then inherit the property at a stepped-up cost at FMV.

Lastly, if your estate realizes capital losses in its first taxation year in excess of capital gains, the excess losses can be carried back to your final taxation year and used on your terminal return. These capital losses can serve to offset any capital gains in the year of death, including those arising under the deemed disposition at FMV rule.

TRANSFER AND CARRYFORWARD OF TUITION AND EDUCATION CREDITS

A student attending a qualifying educational institution can claim the federal tuition

credit, which is calculated as 15% (the lowest marginal tax rate) multiplied by the eligible tuition fees paid in a year to the institution.

For these purposes, a qualifying education institution includes most universities, colleges, other educational institutions providing courses at a post-secondary school level, and a trade institution certified by the Minister of Employment and Social Development to be an institution providing courses that furnish a person with skills for, or improve a person's skills in, an occupation.

In addition, full-time students can claim the federal education and textbook credit, which is 15% of ($465 times the number of months of enrolment in the year). For part-time students, the education and textbook credit is 15% of ($140 times the number of months of enrolment in the year).

However, a part-time student eligible for the disability tax credit, or a part-time student who has a mental or physical impairment certified to be such that the student cannot reasonably be expected to enroll full-time, qualifies for the full-time education and textbook amounts rather than the part-time amounts.

The educational institution should provide the student with the Form T2202A "Tuition, Education and Textbook Amounts Certificate". Each province has its own tuition and education credits, whose rates and amounts vary by province.

The tuition, education and textbook (TET) credits are applied to the student's tax remaining after accounting for most personal credits and certain other credits. If the TET credits bring the tax down to zero, any remaining TET credits can be carried forward indefinitely to be used by the student in future years. (However, if the student has substantial dividend income, the dividend tax credit effectively operates to wipe out the TET credits in many cases.)

Example

In 2013, Mary had TET credits of $1,400. She required $200 of the credits to bring her tax down to zero on her 2013 return. She can claim $200 of the credits to bring her tax down to zero, and carry forward the remaining $1,200 to 2014. If they can't be used on her 2014 return, they can be carried forward again.

Note that if Mary chose not to claim the $200 TET credits in 2013, she could not carry that $200 amount forward.

Alternatively, instead of carrying forward unused TET credits, a student can transfer them to the student's spouse or common-law partner. If the student is single, or the student's spouse does not claim a personal tax credit in respect of the student, the student can transfer the unused TET credits to her parent or grandparent. In either case, the maximum federal TET credits that can be transferred per year is 15% of $5,000, or $750, less the current year's TET credits required to bring the student's tax down to zero. Any remaining TET credits can be carried forward.

Example

In 2013, Mary had TET credits of $1,400. She required $200 of the credits to bring her 2013 tax down to zero. She is single. She can transfer up to $550 of the TET credits ($750 − $200) to any parent or grandparent. Assuming she does make the

transfer, she can carry forward the remaining $650 of TET credits ($1,400 – $200 – $550).

Note that TET credits that are carried forward to a future year can be claimed only by the student. That is, the TET credits cannot be transferred once they have been carried forward.

In Ontario, the amount that can be transferred to a spouse or parent or grandparent is a maximum of 5.05% of $6,686 for 2014 (rather than the applicable percentage of $5,000, the amount that applies for Federal and most provinces' purposes).

CHILD TAX BENEFITS AND UCCB: INVEST WITHOUT ATTRIBUTION

The income attribution rules normally apply if a parent gives or lends income-earning property to his or her child under 18. For example, if you purchase some bonds in your child's name, the interest income will be attributed back to you and included in your income.

There are various exceptions to the attribution rules. Two simple exceptions apply where a parent receives the Canada Child Tax Benefit (CCTB) or the universal child care benefit (UCCB) in respect of a child and invests the amount for the child. In these cases, the income attribution rules will not apply, so the income will be taxed to the minor child rather than the parent.

The CCTB is a refundable tax credit available to certain low-income individuals and families, and the amount depends on the family's net income. The UCCB is a $100 per month amount payable to a parent for every child under the age of 6, and is paid regardless of the parent's or family's income.

AROUND THE COURTS

Legal fees of shareholder to contest bankruptcy of corporation not deductible

Legal fees are normally deductible if they are incurred for the purpose of earning income from a business or property. In the recent *Lacroix* case, the taxpayer was a major shareholder of a corporation who incurred legal fees in contesting the corporation's assignment into bankruptcy, as well as contesting his assessment as a director for the corporation's unremitted GST.

The CRA rejected the taxpayer's position, who had argued that the fees were incurred for the purpose of earning income from property based on future dividends, and the CRA's assessment was upheld by the Tax Court of Canada. The Tax Court judge held that, at the time that the legal fees were incurred by the taxpayer, he did not have a source of income because the corporation was bankrupt and therefore incapable of earning income. In any event, the judge held that the legal fees were capital expenses and therefore not deductible, because they were incurred for the purpose of preserving a capital asset, namely, the bankrupt corporation.

Furthermore, while legal fees to contest an income tax assessment (including a director liability assessment) are deductible under the Income Tax Act, the same was not the case for legal fees to contest a GST assessment. Thus, these fees were also not deductible

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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.