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TAX LETTER

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TAXATION OF TRUSTS AND PROPOSED CHANGES
MOVING EXPENSES
NEW CHANGE OF CONTROL RULES FOR CORPORATIONS
TAXATION OF CORPORATE GROUPS
CHANGES TO DOLLAR LIMITS FOR TAX COURT PROCEDURES
GAINS AND LOSSES FROM PERSONAL-USE PROPERTY
AROUND THE COURTS

TAXATION OF TRUSTS AND PROPOSED CHANGES

For income tax purposes, there are two main types of trusts. A testamentary trust is generally one that is created on and arising as a consequence of death, such as a trust made under your will. It also includes your estate, which is considered a trust for tax purposes. On the other hand, an *inter vivos* trust is generally one that is created during your lifetime.

There are significant differences in the income tax treatment of testamentary trusts and *inter vivos* trusts.

First, a testamentary trust can have a taxation year that does not coincide with the calendar year. An off-calendar taxation year can defer the recognition of income distributed to the trust's beneficiaries, who report the income in their taxation year in which the trust taxation year ends. For example, suppose a testamentary trust has a taxation year ending on January 31. Its income in the taxation year from February 1, 2012 through January 31, 2013 that is distributed to its beneficiaries is included in the beneficiaries' income in their 2013 taxation year, even though most of the income may have been earned by the trust in the calendar 2012 year.

On the other hand, an *inter vivos* trust must have a taxation year that coincides with the calendar year, so there is no possibility of deferral. (Certain mutual fund trusts can have a December 15 year-end).

Second, a testamentary trust is not required to pay quarterly instalments of tax. An *inter vivos* trust may be required to make quarterly instalment payments, generally if its net tax for the taxation year and one of the two preceding years exceeds $3,000 ($1,800 federal tax for trusts resident in Quebec). (At present, however, the CRA does not assess any interest or penalty for an *inter vivos* trust that fails to make instalment payments.)

Lastly, and most significantly, a testamentary trust is subject to the same graduated tax rates that apply to other individuals. Thus, for example, in 2013 a testamentary trust is subject to 15% federal tax on its first $43,561 of taxable income, 22% on any excess up to $87,123, 26% on any excess up to $135,054 of taxable income, and 29% on its taxable income over that last figure. Provincial income taxes are additional, and vary by province.

However, an *inter vivos* trust is subject to a flat tax rate at the highest marginal federal rate of 29% on all of its taxable income, plus the rates applicable to the province of residence.

As a result, income splitting is easier and more beneficial with testamentary trusts. For example, say you are married with 3 children. Under your will, you could set up 4 trusts, one for your spouse and one for each of your children as beneficiaries. After your death, each trust could have the option of retaining its investment income or distributing it to its beneficiary. Since each trust and beneficiary would be subject to the graduated tax rates, this scenario would allow the splitting of investment income between 8 different taxpayers (the 4 trusts and the 4 beneficiaries).

Unfortunately, it looks like this type of tax planning will be curtailed. In the March 21, 2013 Federal Budget and then in a Consultation Paper dated June 3, 2013, the Department of Finance announced that it proposes to change the rules so that testamentary trusts will be subject to the federal flat tax rate of 29%, beginning in 2016. For estates, the top flat rate will kick in once 36-month have passed following the individual's death, if the estate has not been wound up by then. (Most estates are wound up and all the assets distributed to the beneficiaries within a couple of years after death.)

The top flat rate will also apply to "grandfathered" *inter vivos* trusts, which are certain *inter vivos* trusts set up before June 18, 1971 that currently get the low rates of tax.

The proposals will require testamentary trusts to make quarterly instalment payments. Also, the $40,000 income exemption that currently applies for alternative minimum tax (AMT) purposes for testamentary trusts will no longer apply starting in 2016.

Testamentary trusts will also be required to have taxation years that coincide with the calendar year, so that the deferral possibility described above will not be available.

Investment tax credits (ITCs) will not be allowed to be flowed out from testamentary trusts to its beneficiaries. Instead, the ITCs will have to be claimed by the trusts, which is the current rule for *inter vivos* trusts.

There will also be change to the status of testamentary trusts as "personal trusts". One of the benefits of having a personal trust is that the trust property can be rolled out on a tax-free basis to its beneficiaries. Currently, all testamentary trusts are personal trusts. Beginning in 2016, a testamentary trust will be a personal trust only if all beneficial interests in the trust were not acquired for consideration payable to the trust or to a contributor of property to the trust (the rule that currently applies to *inter vivos* trusts).

The above proposals are not yet law, and the Department of Finance has invited comments on them until December 2, 2013. So there is a chance that some of the proposed rules will be changed and perhaps relaxed. However, the Department seems determined to stop the type of income splitting described above, so any changes to the proposals will likely be minor.

MOVING EXPENSES

If you move to carry on new employment or a business in a new work location, you can deduct certain moving expenses incurred in the move. Generally, the deduction is allowed if your new home is at least 40 kilometres closer to the new work location than your old home was (to the new work location).

The deductible moving expenses include:

- Your travel costs for you and your family – for example, gas costs and the proportionate amount of oil, license, and insurance costs, and hotel and meal costs expended during the move;
- The cost of moving vans, or storage costs for your property;
- The cost of meals and lodging near your new or old residence for up to 15 days – if for example your new home is not ready to be inhabited;
- If you rented your former home, any lease cancellation costs;
- Selling costs (e.g. commissions and legal costs) incurred in selling your old home;
- If you sold your old home, your legal costs and land transfer tax incurred on the purchase of the new home (but not GST or HST);
- Interest, property taxes, insurance, and cost of heating and utilities for up to $5,000 incurred on your old home, during a period in which you are trying to sell it and you do no occupy it or rent it out; and
- The cost of revising legal documents to show your new address, replacing vehicle permits, and the cost of connecting or disconnecting utilities.

The expenses are deductible in the year of the move only to the extent of your income from the employment or business in the year in the new work location. However, excess expenses can be carried forward and deducted in any later year from the income in the new work location.

You should retain your receipts in order to prove your moving expenses. However, for vehicle travel costs or meal costs, the Canada Revenue Agency (CRA) allows a simplified method of claiming those expenses, in which cash receipts are not required. Instead of your actual gas or meal costs, the simplified method allows you to claim the CRA set amounts. For 2012, the set amounts were:

For meals: $17 per meal per person per day, to a maximum of $51 per person

For gas and other vehicle costs: the amount is set as a number of cents per kilometre incurred in the move and depends on the province in which the move began. For example, for moves beginning in Ontario, the rate was 55¢ / km, for Alberta it was 50¢, and for Quebec it was 57¢. The rates for all provinces are found on the CRA website at cra.gc.ca/travelcosts.

The 2013 rates will be available on the CRA website in early 2014 (well before the filing dates for 2013 tax returns).

If you receive a reimbursement from your employer for all of your eligible moving expenses, you will have no net deduction (technically you will have a full inclusion of the reimbursement that is offset by a deduction). However, if you receive only a partial reimbursement of eligible moving expenses, you should include the partial reimbursement in income and deduct all of your eligible expenses; such treatment will effectively provide you with a net deduction equal to your non-reimbursed expenses.

The CRA also permits a no-taxable "moving allowance" of up the $650.

NEW CHANGE OF CONTROL RULES FOR CORPORATIONS

Under existing law, various rules and restrictions apply when control of a corporation is acquired.

For example, upon the acquisition of control of a corporation, there is a deemed taxation year-end for the corporation. Furthermore, net capital losses incurred before the change in control cannot be carried forward beyond the change of control, and those incurred after the change in control cannot be carried back before the change of control. Capital properties with accrued losses are subject to a write-down of cost to fair market value upon an acquisition of control.

As of non-capital losses (e.g. business losses in excess of other income) incurred before the change in control, they can be carried forward beyond the change of control, but only to offset income from the same or similar business that had been carried on by the corporation before the change in control. Otherwise, the losses cannot be carried forward. A similar restriction applies if the corporation is to carry back non-capital losses incurred after the change in control to years before the change in control.

Restrictions also apply to the carry-forward or carry-back of investment tax credits, scientific research and development expenses, and various other amounts.

For the above purposes, “control” of a corporation normally means the ownership of shares with more than 50% of the votes required to elect the corporation’s board of directors.

In spite of the above restrictions, the Department of Finance has expressed concern about transactions that involved the acquisition of the majority of shares of a corporation (say 75%-90% of the value) without triggering an acquisition of control because the shares carried less than 50% of the votes. As a result, in the 2013 Federal Budget, new rules were announced to extend the application of the change in control restrictions.

The new rules will deem an acquisition of control of a corporation to occur for the above purposes when a person or group of persons acquires shares of the corporation that have more than 75% of the fair market value of all the shares of the corporation (without otherwise acquiring control of the corporation under existing law). However, the new rules will apply only if it is reasonable to conclude that one of the main reasons that control of the corporation was not otherwise acquired (i.e. more than 50% of votes were not acquired) was to avoid the above-noted restrictions.

The Department also stated: "related rules are also proposed to ensure that this anti-avoidance rule is not circumvented".

The new rules are not yet law. However, it is proposed that they will apply as of March 21, 2013. They will not apply to an event or transaction that occurs pursuant to a written obligation created before that day.

Draft legislation to implement these rules was released on September 13, 2013. These amendments will likely be enacted as part of the 2013 Budget second bill in December 2013.

TAXATION OF CORPORATE GROUPS

Unlike some countries, Canada does not allow related corporations to consolidate income or loss for income tax purposes or to otherwise transfer tax attributes between the corporations. (Workarounds exist that effectively allow losses to be transferred, but they require fairly complex transactions.)

A few years ago, the Department of Finance indicated that it would explore the issue of whether new rules for the taxation of corporate groups should be implemented – such as the introduction of a formal system of loss transfers or the consolidated reporting of income and loss.

The Department conducted extensive public consultations on the issue. Not surprisingly, businesses generally indicated that they were in favour of consolidated reporting. However, provincial governments were concerned that a new system of corporate group taxation could reduce their revenues (by the shifting of income and credits from one province to another) and that the implementation of a new system would involve significant upfront costs.

The Department announced in the March 21, 2013 federal Budget that its study on the taxation of corporate groups is complete and that there is no plan to move forward with a new system of group tax reporting. However, the Department indicated that "the Government will continue to work with provinces and territories regarding their concerns about the uncertainty of the cost associated with the current approach to loss utilization".

CHANGES TO DOLLARS LIMITS FOR TAX COURT PROCEDURES

Appeals to the Tax Court of Canada fall into two categories: the General Procedure and the Informal Procedure. The Informal Procedure is less costly, proceeds more quickly, involves fewer evidentiary rules and much less paperwork, and allows the taxpayer to use a representative other than a lawyer (although using a lawyer is obviously allowed).

However, the Informal Procedure can be used only within certain dollar thresholds. Until recently, the Informal Procedure could be used only if:

- the amount in issue of federal tax and penalties per year in dispute was $12,000 or less;
- in the case of a dispute of a determined loss, it was $24,000 or less per year; or
- the only matter under appeal was the amount of interest assessed under the Income Tax Act.

However, if the $12,000 or $24,000 monetary limit was exceeded, or it appeared to the Court that the limit would be exceeded, you could still proceed under the informal procedure by limiting the appeal to the $12,000 or $24,000 amount, whichever applied.

For GST/HST appeals, there was no limit on using the Informal Procedure.

The monetary limits were recently increased. The $12,000 amount is increased to $25,000, and the $24,000 amount is increased to $50,000. The new limits apply to notices of appeal filed with the Tax Court after June 26, 2013. However, for notices of appeal filed before that time, the previous limits continue to apply.

For GST/HST appeals, there is now a $50,000 limit to the amount in dispute for using the Informal Procedure.

GAINS AND LOSSES FROM PERSONAL-USE PROPERTY

Capital gains and losses from the disposition of personal-use property are treated somewhat differently than other capital gains and losses. Generally, personal-use property is property that is used primarily for your personal enjoyment or that of a related person.

One major difference is that capital losses from personal-use property are deemed to be nil and therefore are not recognized for income tax purposes. Thus, for example, if you sell your furniture or other personal property in a yard sale at a loss, it will be denied. There is an exception for "listed" personal property, the losses from which can be used to offset gains from other listed personal-use property.

Listed personal property is defined as the following:

- Paintings, drawings, prints, sculptures, and similar works of art;
- Rare folios, books, and manuscripts;
- Jewelry;
- Coins; and
- Stamps.

One-half of your net gains in a year from listed personal-use property (net of losses) are included in your income for the year. Your net gains for the year can also be reduced by losses from listed personal-use property in the preceding 7 years or following 3 years. In other words, listed personal-use losses can be carried back 3 years or forward 7 years, but only to offset gains from listed personal-use property (and not other personal-use property or other capital property).

For other personal-use property (not listed), one-half of your gains for the year will be included in income (subject to the $1,000 threshold described below). As noted, losses from other personal-use property are not recognized and cannot offset your personal-use property gains.

$1,000 cost and proceeds threshold

Additionally, for all types of personal-use property (listed or not), a special rule in the Income Tax Act provides that the cost of the property and the proceeds on its sale are deemed to be at least $1,000.

Example

In 2012, you sold one painting for $1,500. Your cost was $800.

You also sold another painting for $900. Your cost was $1,200.

For the first painting, your deemed cost will be $1,000, so you will have a $500 capital gain.

For the second painting, you deemed sales proceeds will be $1,000, so you will have a $200 loss.

Your net capital gain will be $300, one-half of which, or $150, will be included in your income as a "taxable capital gain".

AROUND THE COURTS

Spousal Support Payments Based on Employment Bonus Not Deductible

Spousal support payments are normally deductible for the payer, although there are certain conditions under the Income Tax Act that must be met. For example, in most cases the payment must be an allowance “payable on periodic basis”.

In the recent *Berty* decision, the taxpayer was required to pay support to his former spouse. The monthly payments were calculated and based on his regular salary. However, he was also required to pay his former spouse a lump sum equal to 50% of any employment bonus he would receive. The CRA disallowed the deduction of the latter amount on the grounds that it was not payable on a periodic basis.

On appeal to the Tax Court of Canada, the CRA’s position was upheld. The Court agreed that the regular monthly payments were periodic and therefore deductible, but it held that the bonus was not set or guaranteed and therefore could not be said to be payable on a periodic basis.

On a related point, the Tax Court held that the bonus payment was not deductible in any event, because the agreement between the parties indicated that it was payable to the spouse as “child and spousal support”. A specific rule in the Income Tax Act states that unless support is identified as being **solely** for the benefit of the recipient spouse, it is deemed to be child support, which is generally not deductible.

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