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TAX LETTER

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REDUCTION IN EI PREMIUMS FOR SMALL BUSINESSES
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REDUCTION IN EI PREMIUMS FOR SMALL BUSINESSES

The Federal government recently introduced a new "Small Business Job Credit", which will reduce the amount of employment insurance (EI) premiums for certain small businesses. The current EI premium rate (outside of Quebec) is 1.88% of insurance earnings (up to earnings of $48,600 in 2014).

The rate will be reduced to 1.6% of insurable earnings for 2015 and 2016. The reduction will apply to businesses that pay employer EI premiums not exceeding $15,000 in those years. (The federal rate for Quebec is lower because the province of Quebec also collects premiums under the Quebec Parental Insurance Plan.)

According to the Department of Finance, almost 90% of all EI premium-paying businesses in Canada will receive the credit. The Department also notes that "all employers and employees will benefit from a substantial reduction in the EI premium rate in 2017 when the new seven-year break-even rate-setting mechanism takes effect".

KIDDIE TAX

The so-called kiddie tax was introduced several years ago to combat certain income-

splitting transactions with minor children that were not caught by the income attribution rules.

The kiddie tax is not itself an attribution rule in the sense of attributing the income back to someone else. Instead, when the rule applies to "split income" of a minor child, the minor is subject to the highest marginal rate of tax on that income.

Furthermore, the only tax credits available in respect of this tax are the dividend tax credit and the foreign tax credit. As a result, the kiddie tax is just as onerous, if not more so, than the regular income attribution rules.

When does it apply?

As noted, the kiddie tax applies to the "split income" of an individual (minor) for a taxation year who is under the age of 18 at the end of the year.

Split income of a minor includes the following types of income:

- Dividends received from private corporations,
- Shareholder loans and benefits received from private corporations,
- Capital gains from the dispositions of shares in a private corporation to a non-arm's length person (the capital gains are deemed to be dividends and therefore caught by the above rule).

Split income also includes the minor's income earned through a trust or partnership from the provision of property or services to a business carried on by

- a person who is related to the minor,
- a corporation of which a person who is related to the minor is a "specified shareholder", or
- a professional corporation of which a person related to the minor is a shareholder.

A "specified shareholder" generally means a shareholder owning at least 10% of the shares of any class of the corporation. For these purposes, the shareholder is deemed to own any shares owned by a non-arm's length person (including the minor child).

This last type of split income effectively shut down tax splitting structures used by various law firms, accounting firms, and other firms that used trusts or partnerships to provide them with various administrative or management services with a mark-up or profit element. The profit or mark-up on the services – typically 10 or 15% – was effectively shifted to the trust or partnership of which minor children of the persons carrying on the business were members or beneficiaries. The minors would then include the amount in income, so that the structure would effectively shift some of the firm's income to the minor children. Interestingly, this structure may still work to shift income to spouses or other adults related to the persons carrying on the business, subject to the regular income attribution rules.

Effective for 2014 and subsequent years, the definition of split income was expanded somewhat. In general terms, it now also includes a minor's share of income earned through a trust or partnership from a business of, or the rental of property by, a particular partnership or trust, if a person who is related to the minor is actively engaged on a regular basis in the activities of the particular partnership or trust.

Split income that is subject to the kiddie tax is excluded from the minor’s income for regular income tax purposes, such that it is not taxed twice.

Exceptions

The kiddie tax does not apply if the minor was not resident in Canada during the relevant year, or if the minor’s parents were never resident in the year.

The kiddie tax does not apply to income from property or to capital gains from the disposition of property if the property was inherited from a deceased parent, or inherited from anyone else if the minor is enrolled full-time in a post-secondary institution or eligible for the disability tax credit. Thus, for example, if the minor inherits shares in a private corporation from such a person, dividends, shareholder benefits, or capital gains on dispositions to non-arm’s length person from the shares will **not** be subject to the kiddie tax.

The kiddie tax does not apply to dividends from or capital gains from the disposition of shares in public corporations or those earned through mutual funds.

Of note, capital gains of minor children are generally not subject to the kiddie tax (subject to the rule above regarding dispositions of private corporation shares to non-arm’s length persons) or the income attribution rules, so capital gains splitting with your minor children is generally allowed.

Parents’ joint and several liability

Although the kiddie tax is imposed on the minor child, a parent of the child will often be jointly and severally liable for the tax – meaning that if the child can’t pay the tax then the CRA will come after the parent to collect it.

Basically, the joint and several liability will apply if

- the parent carried on a business that purchased property or services, or was a specified shareholder of a corporation or a shareholder of a professional corporation that purchased property or services, from a business the income of which was subject to the kiddie tax for the minor; or
- the parent was a specified shareholder of a corporation or a shareholder of a professional corporation, dividends of which were subject to the kiddie tax for the minor.

As noted above, a specified shareholder of a corporation means a person who owns 10% or more of the shares of any class in the corporation, and the person is deemed to own any shares owned by a non-arm's length person. Thus, even if a parent does not own shares in a corporation, the parent will nonetheless be considered a specified shareholder of the corporation (and potentially subject to the joint and several liability) if the parent's child owns 10% or more of a class of shares in the corporation.

INVESTMENT TAX CREDIT

The Federal investment tax credit (ITC) program provides tax credits to taxpayers engaging in scientific research and development (SR&ED) as well as other types of activities as described below. There have been some significant changes to the ITC program and rates in recent years, as noted below.

If an ITC is not used for a taxation year, it can be carried forward or back. Credits earned in the 1998 and subsequent taxation years may be carried forward 20 years to offset tax payable in those years (for years before 1998, the carry-forward period is 10 years). ITCs may be carried back three years.

Alternatively, in some cases the ITC is refundable – meaning that it will be paid out to the taxpayer where there is no tax otherwise payable in the year (see "SR&ED" below).

The ITC rates and amounts include the following.

SR&ED

The credit is 15% of qualifying expenditures per year. The credit was previously 20% for taxation years ending before 2014. For certain Canadian-controlled private corporations (CCPCs), an enhanced rate of 35% applies on up to $3 million of qualifying expenditures. The enhanced rate for a CCPC is phased out if its taxable income exceeds $500,000 or its taxable capital exceeds $10 million.

There is a refundable ITC credit for SR&ED equal to 40% of the 15% credit amount; the refundable credit can be applied where your tax payable is already nil, such that you receive a refund for the year rather than having to carry the credit forward or back. This treatment can be a valuable alternative to carrying the credit forward or back, because it can result in current cash flow. For CCPCs, the entire 35% credit may be refundable, subject to the above phase-out limits.

Beginning with expenses incurred in 2014, the ITC for SR&ED applies only to "current" expenses and not capital expenses. Previously, the ITC could be claimed for many capital expenditures.

Qualified property for use in Atlantic Provinces and offshore regions

The credit for prescribed buildings or machinery and equipment used in these provinces (used primarily in farming, fishing, logging, mining, oil and gas, and manufacturing and processing) is 10% of the cost of the property. For property used in oil and gas and mining activities, the credit is reduced to 5% for property acquired in 2014 and 2015, and it will not be available for such property acquired after 2015 (subject to some grandfathering relief for agreements entered into before March 29, 2012).

Flow-through mining expenditures

For individuals, a 15% ITC is available for certain expenditures incurred by mining corporations and flowed through to individuals under flow-through agreements.

Pre-production mining expenditures for corporations

Certain corporations that incur pre-production **development** expenditures earn an ITC at the rate of 7% for 2014 and 4% for 2015. The ITC is eliminated for expenses incurred after 2015. (Before 2014, the rate was 10 %.)

The ITC for pre-production **mining exploration** used to apply at a rate of 10%, but was reduced to 5% for expenses incurred in 2013, and it has been be eliminated for expenses incurred after 2013.

Apprenticeship expenditures

An ITC is available for employers who hire apprentices in prescribed trades. The rate is 10% of eligible salaries paid to an eligible apprentice, up to a maximum credit of $2,000 per year per apprentice. The credit applies for the salaries paid for the first 24 months of employment.

Child care space amount

An ITC is available for employers who set up child care facilities for their employees. The ITC is equal to the lesser of $10,000 per **new** child care space created during the year and 25% of eligible child care space expenditures incurred during the year.

EMPLOYEE LOANS

If you receive a low or no-interest loan from your employer, you may be required to include an imputed interest benefit in income. Generally speaking, you will include a benefit equal to the prescribed rate of interest on the principal amount of the loan while it is outstanding, less any interest paid by you in the year or by January 30 of the following year. Therefore, if you pay at least the prescribed rate of interest on the loan, you will not include a benefit in income. If you are late in paying the interest by January 30 of the following year, you will be assessed the full amount of the benefit.

Caution: if you or a family member are a shareholder of the employer company, then the benefit is very likely to be taxed under the "shareholder benefit" rules, which are *much* more onerous than those described in this article. This discussion is about loans to regular employees who are not shareholders and have no family connection to the company's shareholders.

Example

> On January 1, Year X, Jack received a $100,000 interest-free loan from his employer. The prescribed rate of interest for the first two quarters of Year X was 1% and it was 2% for the last two quarters.
>
> Jack would include a benefit of $100,000 x 1% x ½ year (reflecting the first two quarters) plus $100,000 x 2% x ½ year (reflecting the last two quarters), for a total benefit of approximately $1,500. (It is approximate since we have pro-rated based on the half year rather than actual number of days in each quarter.)
>
> If Jack paid any interest on the loan in Year X or by January 30 of the following year, that payment would reduce the amount of the benefit.

You are not required to include the benefit in income if the loan carries an interest rate equal to a rate that would apply between arm's length parties at the time of the loan, on the assumption that the loan was not received by virtue of employment and it was made in an ordinary money-lending business.

The prescribed rate of interest is set quarterly under the regulations to the Income Tax Act. For each quarter of 2014, the prescribed rate is 1% (see "Prescribed Interest Rates", below).

Special rule for home purchase loans

If the loan is used to purchase a home in which you will reside, a special rule caps the

amount of the interest benefit. The cap or limit is the prescribed interest rate in effect at the time of the loan.

Thus, in the above example, if the loan was a home purchase loan, the benefit would be computed using the 1% rate in effect at the time of the loan, so Jack would include a benefit of 1% x $100,000, or $1,000. The cap or limit is re-set every 5 years (if the loan is outstanding for more than 5 years).

Note that if the prescribed rate during a quarter goes below the rate in effect in at the time of the loan, the benefit reflecting that quarter is computed using the lower rate. In other words, this special rule gives you upside protection from increases in the prescribed rate, but gives you downside access to decreases in the prescribed rate. (The rate is always a whole number, so it cannot go below the current 1%.)

Special rule for home relocation loans

If the loan is a home relocation loan, you are allowed a deduction in computing your taxable income, generally equal to the benefit that otherwise would apply on the first $25,000 of the loan. Basically, the deduction has the effect of eliminating the interest benefit on the first $25,000 of the loan principal for up to five years.

A home relocation loan is one used to acquire a new home upon a relocation of employment, where the new home is at least 40 kilometres closer to the new work location relative to the hold home.

PREPAID EXPENSES

Expenses incurred in the course of earning income from a business or property generally fall into two categories: current and capital expenses.

A current expense is an expense that does not provide significant future benefits or value of an enduring nature. The category includes expenses such as salaries paid to employees, utilities, rent, and repairs and maintenance. A current expense is normally deductible in full in the year in which it is incurred.

However, if an expense is a prepaid expense – meaning that you have paid the expense in respect of future taxation years – the expense is not deductible in the year it is incurred. Instead, it is deductible or amortized over the year(s) to which the expense relates.

For example, say you rent the building in which you carry on your business. If, in 2014, you decided to prepay rent for 2015 and 2016, the prepayments would be deductible in those future years rather than 2014.

Capital expenses are not subject to the prepayment rules. However, they can normally not be deducted currently but instead are claimed over time as capital cost allowance or under other specific rules in the Income Tax Act.

PRESCRIBED INTEREST RATES

The CRA recently announced the prescribed annual interest rates that will apply to amounts owed to the CRA and to amounts the CRA owes to individuals and corporations. These rates remain unchanged from the first three quarters of 2014 and are in effect from October 1, 2014 to December 31, 2014.

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

Expropriation award for land non-taxable

In the recent *Henco* case, the taxpayer corporation was a real estate developer that acquired land near Caledonia, Ontario for development and sub-division. However, due to protests and blockades by natives of the Six Nations group and their supporters who resisted the development of the land, and the reluctance of the Ontario Provincial Police (OPP) to remove the blockades, the taxpayer was unable to rezone and develop the property. The taxpayer acquired a court injunction demanding that the protesters leave and remove the blockades, but the OPP refused to enforce the injunction and the blockages continued. The taxpayer ultimately accepted $15.8 million from the Government of Ontario to dispose of all its right and interest in the property.

The CRA assessed the taxpayer on the grounds that the $15.8 million was consideration either for the taxpayer's interest in the property that was inventory, or for its business of property development, and that the amount was therefore fully taxable. The taxpayer appealed to the Tax Court of Canada, arguing that the amount was a capital receipt and therefore either only half-taxable or completely tax-free.

The Tax Court judge held in favour of the taxpayer and held that the entire $15.8 million receipt was non-taxable. The judge held that the amount received was not for the land or for the development business relating to the land, since each of those was essentially worthless due to the blockades and protests. The judge held that the "only conclusion that can be drawn is that Ontario paid Henco to go away and in doing so enable Ontario to get rid of the injunction, acquire control of the volatile situation and restore peace. The effect was to destroy Henco's business". As such, the receipt was a non-taxable capital receipt.

* * *

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.