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TAX LETTER

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CAPITAL GAINS EXEMPTION AND PROPOSED CHANGES
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CAPITAL GAINS EXEMPTION AND PROPOSED CHANGES

The capital gains exemption allows Canadian resident individuals to earn tax-free capital gains when they sell qualified small business corporation ("QSBC") shares. The lifetime exemption limit as of 2017 is $835,716 of capital gains. The limit is indexed each year to account for inflation.

QSBC shares

Various conditions must be met in order for the shares to qualify for the exemption. Two of the main conditions are as follows:

First, at the time of the sale of the shares, the corporation must be a QSBC. In general terms, this is a Canadian-controlled private corporation ("CCPC"), where 90% or more of the assets of the corporation (based on fair market value) are assets used principally in an active business carried on primarily in Canada, shares or debt invested in other small business corporations, or a combination of such assets.

A CCPC is a Canadian resident private corporation that is not controlled by non-residents or public corporations.

Second, there is a 24-month holding period. Basically, throughout the 24 months before the sale, the shares must not have been owned by anyone but you or a person related to you. During those 24 months, more than 50% of the assets of the corporation must be assets used principally in an active business carried on primarily in Canada, shares or debt invested in other CCPCs, or a combination of such assets (other more specific criteria also apply).

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Effects of ABILs and CNILs

The taxable capital gains that qualify for the exemption in a particular year are reduced by two amounts: your allowable business investment loss ("ABIL") for the year or previous years, and your cumulative net investment loss ("CNIL") at the end of the year.

An ABIL is one-half of a "business investment loss", which is a capital loss that is incurred on the disposition of shares or debt in certain types of small business corporations (ABILs are deductible against all sources of income and not just taxable capital gains).

> **Example**
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> In 2016, you claimed a $40,000 ABIL. In 2017, you realize $120,000 of capital gains ($60,000 of taxable capital gains) on the disposition of QSBC shares. Only $20,000 of the taxable capital gains will qualify for the exemption.
>
> Suppose that in 2018 you had a further taxable capital gain of $100,000 from a disposition of QSBC shares. The amount that would qualify for the exemption would *not* be reduced by the 2016 ABIL, since the latter already reduced the amount you could claim in 2017.

Generally, your CNIL account includes your net investment losses for the year and previous years going back to 1988. Your net investment losses are basically your investment expenses in excess of your investment income.

Qualified farm or fishing property

There is an exemption for capital gains realized on the sale of qualified farm or fishing property. The current exemption covers $1 million of capital gains ($500,000 of taxable capital gains). The $1 million amount will be indexed for inflation once the indexation of the QSBC exemption amount reaches $1 million.

In general terms, qualified farm or fishing property includes property that is used in the course of carrying on a farming or fishing business in Canada, a share of a family farm or fishing corporation, and an interest in a family farm or fishing partnership. Various conditions must be met, including a general 24-month hold period test and a business activity test.

Proposed changes for 2018

As discussed in last month's Tax Letter, on July 18, 2017, the Federal government released draft legislation that, if enacted, will affect the taxation of small businesses and CCPCs in particular. The draft legislation proposes to make some significant changes to the capital gains exemption. The proposals are scheduled to take effect on January 1, 2018. (There has been significant pushback from the business community and it is possible the government will amend or abandon some of the proposed changes.)

The proposed changes include the following:

- Gains for children from dispositions before the year in which they turn 18 will no longer qualify for the exemption.
- Gains that accrued on the property up to the beginning of the year in which the child turns 18 will not qualify for the exemption.
- Gains that accrued while the property was owned by a trust and subsequently distributed to a beneficiary on a tax-free basis will generally not qualify for the exemption, except in the case of an "eligible

lifetime capital gains exemption (LCGE) trust" (see below).
- The only trusts that will be able to flow out the capital gains exemption in respect of taxable capital gains to beneficiaries will be LCGE trusts. These trusts include qualifying spousal and joint spousal trusts, alter ego trusts, and certain trusts that hold securities that are subject to an employee stock option agreement. All of these trusts are quite limited in how they can be used.

There are some transitional rules that will allow individuals to trigger gains on qualifying property in 2018 to take advantage of the current rules that apply before 2018.

EMPLOYEE LOANS (INCLUDING HOME RELOCATION LOANS)

If you receive an interest-free loan from your employer, or a loan at an interest rate lower than the prescribed rate of interest under the *Income Tax Regulations*, you are required to include a deemed interest benefit in your employment income.

In particular, you must include (and pay tax on) deemed interest on the amount of the loan outstanding during the year computed using the prescribed rate of interest that applies during the year. The prescribed rate is set quarterly, so it may change during the year (it hasn't moved from 1% in several years, but due recent Bank of Canada rate increases it may increase in 2018).

Deducted from the deemed interest amount is any interest that you actually pay to your employer on the loan. However, the interest must be paid in the year or by January 30 of the following year.

As a result, if you pay at least the prescribed rate of interest on the loan for each year, you will have no net inclusion.

Home purchase loan

If the loan is used to purchase a home to be inhabited by you or a person related to you, a special rule effectively "caps" the deemed interest benefit to the prescribed rate at the time of the loan. In other words, if the prescribed rate increases, the deemed benefit for the year will not increase. However, if the prescribed rate decreases, you will get the advantage of that lower rate.

> **Example**
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> You receive a $100,000 interest-free loan from your employer on January 1. At that time, the prescribed rate is 1%. It remains at 1% for the second quarter, but increases to 2% for the last two quarters of the year. You do not repay any of the principal during the year.
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> Your deemed benefit for the year will be capped at 1% of the amount of the loan, or $1,000.

If the loan remains outstanding for more than five years, the cap interest rate is re-set using the prescribed interest rate at the five-year anniversary mark. That cap will then apply for the next five years.

Home relocation loan

A "home relocation loan" is a loan used to buy a home that is at least 40 kilometres closer to a new work location than was your former home (to the new work location). For example, if your employer requires you to move from Toronto to Montreal and you use the loan to buy a new home in Montreal, the loan will be a home relocation loan.

Historically, there has been a rule that effectively exempts from tax the deemed interest benefit on the first $25,000 of the principal amount of the home relocation loan. However, this is the last year for this rule. The 2017 Budget eliminated this rule beginning in 2018.

However, the home purchase loan rules discussed above (the "cap") will continue to apply.

TAXATION OF DIVIDENDS

Canadian dividends

If you receive a taxable dividend from a corporation resident in Canada, you are subject to tax on the dividend at a preferential rate of tax. The effective rate of tax will be less than your regular marginal rate of tax. For example, dividends will be subject to less personal tax than investment income such as interest or rental income.

(If proposals released on July 18, 2017 are implemented, many dividends from private corporations will be taxed at a much higher rate, in situations where the person receiving the dividend is not involved in running the business.)

The tax preference results from the application of the dividend tax credit. This credit, along with a "gross-up mechanism", provides you with a credit for the estimated corporate income tax already paid on the income that provides the dividend.

For these purposes, there are two different sets of dividend tax credits and gross-up amounts, depending on the type of dividend.
An "eligible dividend" is generally a dividend paid out of a corporation's income that is subject to regular corporate tax rates (typically 25% − 30%, varying by province).

A non-eligible dividend is generally a dividend paid out of a corporation's income that was eligible for the small business deduction on the first $500,000 of active business income of a CCPC, and thus subject to lower corporate tax rate (the small business rate is around 13% − 15%, varying by province).

You do not make the determination as to the type of dividend. The corporation paying you the dividend must indicate whether it is "eligible" or not.

For an eligible dividend, the dividend is grossed-up by 38% − in other words, for every $100 of dividend you receive, you report income of $138 on your tax return. The federal dividend tax credit is the 6/11ths of the gross-up amount. The amount of the provincial credit depends on the province, but in rough terms, you get a credit for something close to the gross-up.

A non-eligible dividend is grossed-up by 17%. The federal dividend tax credit is 21/29 of the gross-up amount. Again, the amount of the provincial credit depends on the province.
As noted, the purpose of the credit and gross-up mechanism is to provide the individual shareholder with a credit for the corporate tax already paid (or presumed to have been paid), thereby avoiding double taxation. The net result should amount to the "integration" (more or less) between the personal and corporate tax. This means that the total amount tax paid by the individual and the corporation should generally equal the amount of tax that would have been paid, had the underlying business income been earned directly by the individual.

Example – business income through corporation

Assume that you are in a 50% marginal tax bracket (combined federal and provincial) and that your corporation's general tax rate is 27% (also combined federal and provincial).

Your corporation earns $138 of business income that is not eligible for the small business deduction. Using the 27% tax rate, it will pay about $38 in tax, leaving $100 that can be paid to you as a dividend.

The dividend is paid to you as an eligible dividend. You will include $100 plus the 38% gross-up, for a total inclusion of $138 (which, you will notice, is the same as the corporation's original income was). At a 50% personal tax rate, this would result in $69 of personal tax.

However, your dividend tax credit will reduce your tax payable. As noted, the federal credit is 6/11 of the $38 gross-up amount. Assume that the provincial credit is 5/11 of the gross-up. Your total credit will equal $38, which will reduce your personal tax from $69 to $31.
Combined with the $38 in corporate tax paid, the total tax will be $69, which is 50% of the $138 of business income earned by the corporation. So "integration" has worked: you and the corporation have paid the same $69 in tax that you would have paid if you had earned the $138 directly.

Deferral makes the difference

Looking at the above numbers, you might wonder whether there is a tax advantage to running a business through a corporation. In many cases, there is. The initial corporate tax rate (whether the regular rate or the small business rate) is usually lower than the individual shareholder's rate of tax. As a result, if some or all of the corporate income is reinvested in the corporation's business, the shareholder level of tax will be deferred, leading to a distinct tax advantage that increases the longer the period of deferral. (The July 18, 2017 proposals, if implemented, will impose a prohibitive tax rate on the corporation's investment income, so that you will in the end be worse off leaving money in the corporation.)

Dividends from foreign corporations

If you receive a dividend from a corporation resident in another country, there is no dividend tax credit and no gross-up. You simply pay tax on the entire dividend at your marginal rate of tax.

However, if the other country levies a withholding tax on the dividend, you will normally receive a foreign tax credit in Canada to alleviate the potential double taxation. In general terms, the foreign tax credit leaves you paying a net of the higher of the two countries' rates.

Example

You receive a dividend equal to C$100 from a corporation in the United States. You pay C$15 of United States withholding tax, which is withheld so that you actually receive only $85.

You include the $100 amount in your Canadian tax return and initially compute your Canadian tax payable on that amount. That tax is then reduced by your foreign tax credit, which in this simple example will equal the C$15 tax paid to the U.S.

TRANSFERS OF PROPERTY TO TRUSTS

If you set up a trust and transfer property to the trust, there is normally a deemed disposition of the property for proceeds equal to its fair market value. For example, if there is an accrued gain on the transfer, you will realize a capital gain, half of which will be included in your income. If the transfer is cash, you won't have to worry about this issue (except possibly in the case of foreign currency).

For certain types of trusts, you can transfer property to the trust on a tax-free "rollover" basis. Effectively, you have a deemed disposition at your tax cost of the property, which results in no tax. The trust is deemed to acquire the property at your tax cost.

The trusts that qualify for the rollover include the following:

- A spousal or common-law partner trust. This is a trust under which your spouse or common-law partner is a beneficiary and is entitled to all of the income of the trust and no one else can receive capital of the trust during your spouse's lifetime. After your spouse's death, other beneficiaries may receive income or capital out of the trust.
- A joint spousal or common-law partner trust. This is similar to the trust described above, except both you and your spouse are beneficiaries. Both or either of you must be entitled to the trust income while you or your spouse are alive, and no one else may receive the capital until both of you have died.
- An *alter ego* trust. This is a trust under which you are the beneficiary during your lifetime, under which you are entitled to all of the income and no one else may receive the capital of the trust while you are alive.

The tax-free rollover is automatic. However, you can elect out of the rollover on a property-by-property basis, in which case the regular rule applies (deemed disposition at fair market value). If the trust is an *inter-vivos* (made during your lifetime) any loss on the election out of the rollover will typically be denied under the superficial loss rules.

In the case of a *testamentary* spousal or common-law partner trust (one arising upon your death, such as under your will), essentially the same rules apply. There is an automatic rollover, although your executor can elect out of the rollover. If the election out of the rollover gives rise to a loss, the superficial loss rule will not apply in such case, and the loss will be allowed.

AROUND THE COURTS

Legal fees to defend criminal charges not deductible employment expense

In the recent *Geick* case, the taxpayer was a police officer who was charged with several criminal offences. He hired a lawyer to defend him and incurred legal fees in contesting the charges, some of which were subsequently withdrawn. He was suspended from employment pending the outcome of the charges, but with pay, so he continued to collect his salary.

The taxpayer attempted to deduct the legal fees in computing his employment income, under Income Tax Act paragraph 8(1)b), which permits legal fees paid to "collect or establish a right to" employment income. He argued that any criminal conviction would have resulted in the loss of his employment

and his employment income. As such, he argued that the legal fees were deductible because they protected his right to employment income.
The CRA denied the deduction, taking the position that the legal fees were paid solely to defend criminal charges.

The Tax Court of Canada agreed with the CRA and dismissed the taxpayer's appeal. The Court held that even if it could be said that legal fees were incurred to "preserve" the taxpayer's employment, which did not constitute an effort to "collect" or "establish" a right to collect an amount of employment income owed.

The Court made a similar finding in response to the taxpayer's argument that the legal fees were incurred to preserve the pension he would receive upon retirement as a police officer (so that they would qualify under a different provision of the Act paragraph 60(o.1).

As a result, none of the legal fees were deductible.

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