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PROPOSED AMENDMENTS TO DONATION RULES FOR ESTATES

Under recent changes to the charitable donation rules relating to death, an individual can claim a tax credit for a donation made under the individual's will or by the individual's estate in the year of death or the previous year. Alternatively, the estate can claim the credit in the year it actually makes the gift or in any earlier year of the estate. The changes took effect as of the beginning of 2016.

For these purposes, the estate must be a "graduated rate estate", generally meaning an estate during the first 36 months after death (certain other criteria apply).

Draft amendment released by the Department of Finance on January 15, 2016 will extend the 36-month period to 60 months after death for the purposes of the individual's credit in the year of death or the preceding year (the estate must still meet the other criteria for a graduated rate estate). This amendment, once enacted, will apply retroactively to the beginning of 2016.

However, the 60-month period will not apply for the purposes of the estate's credit in a preceding year of the estate. Only a graduated rate estate (first 36 months after death) will be able to claim the credit in a preceding year. However, the Department of Finance is being lobbied on this point, so a change may still be in the works.

A gift made by an estate beyond the 36-month period can still qualify for the estate's credit in the year of the gift, or can be carried forward 5 years to be used by the estate (assuming it is still in existence).

Also, under the regular donation rules, a gift made by the individual or the individual's spouse in any of the 5 years preceding death, to the extent they have not been used, can be claimed in the year of death.

THE DIVIDEND TAX CREDIT

GENERAL RULES

If you receive a taxable dividend from a Canadian corporation, you will normally be entitled to the dividend tax credit ("DTC") in respect of the dividend. The purpose of the DTC, along with the gross-up mechanism discussed below, is to provide you with a credit that reflects the income tax presumed to have been paid by the corporation on the income from which the dividend was paid.

In other words, because the dividend is paid out of the corporation's after-tax income, the DTC is meant to prevent double taxation.

There are two sets of DTC and gross-up rates, depending on the type of dividend. It will be either an "eligible dividend" or a non-eligible dividend.

In general terms, a non-eligible dividend is one received from a Canadian-controlled private corporation (CCPC) out of its business income that was subject to the small business corporate tax rate (applicable to first \$500,000 of active business income per year). This corporate rate is lower than the general corporate tax rate.

An eligible dividend is generally paid from a corporation whose income was subject to the general corporate tax rate rather than the small business rate. The corporation paying you the dividend must notify you whether it is an eligible dividend or not. This is done on the T5 slip; different boxes are used for eligible dividends and other dividends.

Because of the two different corporate tax rates, different DTCs are used to reflect the amount of tax paid by the corporation. As noted, the DTC mechanism is meant to alleviate the double tax that would otherwise be paid by you and the corporation combined.

AMOUNT OF DTC AND GROSS-UP

For eligible dividends, the federal gross-up amount is 38% of the dividend, and the DTC is 6/11 of the gross-up amount or 15.02% of the entire grossed-up dividend ($6/11 \times 0.38 / 1.38$).

For 2015 (on the return you may be filing now in April 2016), the federal gross-up for non-eligible dividends was 18% of the dividend. Due to reductions in the small business corporate tax rates over the next four years, the gross-up is 17% of the dividend for 2016 and 2017, 16% for 2018, and 15% for 2019. The corresponding DTC rates will be: 21/29 of the gross-up amount for 2016; 20/29 for 2017 and 2018; and 9/13 after 2018.

The provinces also have gross-up and DTC amounts for provincial tax purposes, which vary from province to province.

Owing to the gross-up / DTC mechanism, an individual can receive a significant amount of dividends without paying much or any tax, particularly in the case of eligible dividends.

Example with eligible dividend

John is 20 years old. In 2016, his only source of income is \$50,000 of eligible dividends from a family corporation.

John will report \$50,000 plus the 38% gross up in income, resulting in net income and taxable income of \$69,000 for 2016. On this amount, his initial federal tax will be \$9,933 after the basic personal tax credit.

The federal DTC will equal $6/11 \times \$19,000$, or \$10,363. Therefore, John's net federal income tax will be nil. Unfortunately, the excess DTC is not refundable. The amount of provincial tax will depend on the particular province, but will similarly be either nil or a fairly low amount.

TAXATION AND PARTNERSHIPS

COMPUTATION OF INCOME OR LOSS FOR PARTNER

A partnership is a relationship between persons (i.e., partners) carrying on business in common. A partnership is not a person under the *Income tax Act* and therefore does not pay tax. Instead, the income or loss of the partnership is computed on a notional basis, and each partner then includes their share of the income or loss of the partnership.

In general terms, the amount and character of the income or loss (e.g. business income, royalties, taxable capital gains) flows out to each partner. The partner's share of the income is normally determined under the applicable partnership agreement or other legal instrument that sets out the rights of the partners. Each partner then reports the income or loss on the partner's individual tax return for the year.

The partnership does not claim tax credits. Again, since the partners report the income on their tax returns, they simply claim the various credits that apply to them in the circumstances.

For certain credits, like charitable donations and political donations credits, and the investment tax credit in respect of the partnership's business, a notional calculation of the credit is made for the partnership and is then allocated to the partners according to their respective shares.

ADJUSTMENT TO ADJUSTED COST BASE OF INTEREST

Each partner's share of the partnership income is added to the adjusted cost base of the partner's interest in the partnership. This treatment ensures that, if the interest is sold and some or all of that income is retained in the partnership, any capital gain on the sale of the interest will not result in double taxation. That is, the addition to the cost base reflecting the income inclusion will reduce the subsequent capital gain accordingly.

Conversely, the partner's share of any loss of the partnership is deducted from the adjusted cost base of the interest in the partnership.

Since the partner's share of the partnership is included in income each year as it earned, cash withdrawals are not subject to further tax. However, the cash withdrawals reduce the adjusted cost base of the partner's interest.

Example

In 2015, John was a member of a partnership and his share of the income for the year was \$200,000. During the year, he withdrew \$150,000. On a net basis, \$50,000 would be added to his adjusted cost base of his interest at the end of 2015 (\$200,000 addition for the income inclusion, \$150,000 reduction for the cash withdrawal).

Note that John still has to pay income tax on \$200,000 of partnership income, even though only \$150,000 of that was paid out to him in the year.

PARTNERSHIP INFORMATION RETURN

Although a partnership is not a person or a taxpayer, in some cases a T5013 information return must be filed with the Canada Revenue Agency (CRA). The return will contain information such as the identity of the partners, the head office, the type of business, the partners' shares of the partnership income, and various related items.

The Income Tax Regulations require Canadian partnerships and partnerships that carry on business in Canada to file a partnership information return. A Canadian partnership is one in which all the partners are resident in Canada. However, the CRA has an administrative policy (cra.gc.ca/partnership) under which some of these partnerships are not required to file the information return.

The CRA requires a partnership to file the T5013 for a fiscal period if:

- at the end of the fiscal period, the partnership has an **absolute value** of revenues plus an absolute value of expenses of more than \$2 million, or has more than \$5 million in assets; **or**
- at any time during the fiscal period:
 - the partnership was part of a “tiered partnership”, e.g. where it was a partner in another partnership or vice versa;
 - the partnership had a corporation or a trust as a partner;
 - the partnership invested in flow-through shares of a principal-business corporation that incurred Canadian resource expenses and renounced those expenses to the partnership; **or**
 - the CRA requests that a return be filed.

Otherwise, a partnership is not normally required to file the T5013. For example, a partnership with only individuals as partners does not need to file the return unless the \$2 million or \$5 million thresholds above are exceeded. Furthermore, the CRA states that farm partnerships that are made up of only individual partners do not have to file a T5013 return for the 2015 fiscal year. The CRA has not yet indicated whether the farm partnership exception will continue to apply for 2016.

For the above purposes, the absolute value of a number is the value without regard to its positive or negative sign. Therefore, the \$2 million threshold revenue and expense threshold is determined by adding total worldwide expenses to total worldwide revenues.

LOW-INTEREST EMPLOYEE LOANS

If you receive a loan from employer “because of your office or employment” with no or low interest, an imputed interest rule in the Income Tax Act will generally apply to include an imputed interest benefit in your income. For these purposes, the loan will be deemed to be received by you because of your office or employment if it is reasonable to conclude that, but for your employment, either the terms of the loan would have been different or the loan would not have been received. (If you are, or are related to, a significant shareholder in the company, the CRA will normally say that the shareholder-benefit rules apply and these rules do not.)

During each year in which the loan remains outstanding, you will include in your income:

The prescribed rate of interest computed on the principal amount outstanding throughout the year

minus

The interest you pay on the loan within the year or by January 30 of the following year.

Therefore, if you pay at least the prescribed rate of interest, you will not be required to include an amount in income. The prescribed rate is set every quarter of every year and is based on 90-day government Treasury bill yields. It is currently 1% per annum and has been for almost all of the past seven years.

Furthermore, you do not include the benefit in your income if the loan carried an interest rate, at the time the loan was made, that was at least as much as an arm's length rate of interest that would have been charged by a creditor in the money-lending business.

SPECIAL RULE FOR HOME PURCHASE LOAN

If you use the loan to acquire a home, the deemed interest benefit is effectively "capped" at the rate in effect at the time of the loan. As such, if prescribed rates increase beyond that initial rate, the deemed benefit will not increase.

On the other hand, if prescribed rates decrease below the initial rate, the benefit will be reduced accordingly. (However, from 1% the rate has nowhere to go down, since it is always rounded up to the nearest 1%.)

The "cap" is re-set after five years, if the loan remains outstanding at that time.

FURTHER SPECIAL RULE FOR HOME RELOCATION LOAN

Another rule applies if you move and use the loan to acquire a home that is at least 40 kilometres closer to a new place of employment than your former home. Under this rule, you normally deduct the amount of the interest benefit on the first \$25,000 of the principal amount of the loan in computing your taxable income.

Basically, the rule means that you won't be taxed on the first \$25,000 of the loan.

REPLACEMENT PROPERTY RULES

GENERAL REQUIREMENTS

If you dispose of a capital property and acquire a replacement property within a set time period, you may be able to defer part or all of the capital gain that would otherwise be recognized on the disposition. Similarly, if the property is depreciable property, you can defer the recognition of any "recapture", which is an amount in excess of the undepreciated capital cost of the property.

The time period for the acquisition of the replacement property depends on the type of disposition:

For voluntary dispositions, you must normally acquire the replacement property within 12 months after the end of the taxation year in which the former property was disposed of;

For involuntary dispositions, the replacement period is 24 months after the year of the disposition. An involuntary disposition includes a destruction or expropriation of the former property where you receive compensation, such as insurance proceeds or expropriation compensation from a government).

In general terms, a replacement property qualifies under the deferral rule if it is reasonable to conclude that the property was acquired to replace the former property and it is put to a use that is the same or similar to the use of the former property. Certain other criteria may apply.

For voluntary dispositions, the former property and replacement property must be real property (land, buildings) used in a business. For involuntary dispositions, any capital property can qualify, other than a share of a corporation.

THE MECHANICS OF THE DEFERRAL

In general terms, if you use at least the amount of the proceeds of disposition from the former property to acquire the replacement property, there will be no capital gain from the former property. For every dollar of proceeds that you do not use to acquire the property, you will have a capital gain.

Any recapture on depreciable property will be deferred if you spend proceeds at least equal to the recapture amount on acquiring the replacement property.

The deferred gain will reduce your tax cost of the property. As a result, the gain may be realized when you ultimately dispose of the replacement property.

The deferral is elective. If you do not make the election in your tax return for the year in which the replacement property is acquired, there is no deferral, and the regular capital gains or recapture provisions will apply.

The election does not apply to capital losses.

Example of deferral

You bought a building that was destroyed by fire in 2015. It was used in your business. The adjusted cost base (ACB) of the building was \$200,000 and its undepreciated capital cost or UCC (basically, the amount of the cost not yet depreciated for tax purposes) was \$160,000.

You receive \$250,000 of insurance proceeds for the building and use that amount to acquire a new replacement building within the 24-month period described above.

Your initial capital gain for 2015 will be \$50,000 (\$250,000 insurance proceeds minus \$200,000 ACB of the building) and your initial recapture for 2015 will be \$40,000 (effectively, the difference between the ACB and UCC). You make the deferral election.

Results: Since you used the entire amount of the \$250,000 insurance proceeds to acquire the replacement property, the \$50,000 capital gain will be deferred and not recognized in 2015. Similarly, the \$40,000 will not be recognized in 2015. Instead, the ACB and UCC of the replacement property will be reduced to \$200,000 and \$160,000, respectively.

If, instead, you only used \$240,000 to acquire the replacement property, you could only defer \$40,000 of the capital gain, meaning that \$10,000 of the gain would be recognized in 2015, and you would include in income the taxable capital gain, being \$5,000. In this case, the ACB of the replacement property would be \$210,000.

AROUND THE COURTS

ANNUAL LUMP SUM SPOUSAL SUPPORT WAS DEDUCTIBLE

In order for spousal support payments to be deductible for the payer, the payments must normally be payable on a periodic basis (there are other requirements). A lump sum is often not deductible.

In the recent *Ken Blue* case, the taxpayer and his spouse agreed that the taxpayer would pay her \$1,000 per month of spousal support for five years. They subsequently agreed that the taxpayer could pay her a lump sum of \$12,000 at the end of each year in full satisfaction of the original amounts. The taxpayer attempted to deduct the \$12,000 payment in the year at issue. The CRA denied the deduction on the grounds that the \$12,000 annual lump sums were not periodic in nature but rather in the nature of a capital non-deductible lump sum.

On appeal to the Tax Court of Canada, the Court sided with the taxpayer and allowed the deduction. Even though each annual payment effectively released the taxpayer from paying the originally agreed-upon \$1,000 per month, the Court felt that, after examining the “true nature” of the payments, they were periodic in nature and otherwise fulfilled the criteria of deductible support payments.

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.

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