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# Beyond Numbers

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## ASSOCIATED CORPORATIONS

The “associated corporation” rules in the Income Tax Act are relevant mainly for the purposes of limiting certain income tax preferences or benefits that apply to private corporations.

The most significant limitation relates to the small business deduction that applies to active business income of a Canadian-controlled private corporation (CCPC). The small business deduction results in the first \$500,000 of a CCPC’s active business income being subject to a much lower rate of tax than applies to other corporations or other income. As a result of the deduction, the lower federal rate of tax is 11% and, depending on the province, the combined federal and provincial rate ranges from about 14% to 19%. The federal small business rate is being lowered further, to 10.5 % in 2016, 10% in 2017, 9.5% in 2018, and 9% in 2019.

In contrast, for business income above the \$500,000 limit and for other corporations, the regular federal rate is 15% and the combined federal and provincial rates range from about 26% to 31%.

The associated corporation rules prevent you from incorporating two or more CCPCs and benefiting from the lower tax rate for more than \$500,000 of active business income. For example, in the absence of the rules, you could own 3 corporations that each earned \$500,000 or more of active business income. Your corporations would therefore benefit from the lower rate on up to \$1.5 million of business income. However, the associated corporation rules prevent this result and allow the lower rate only for a maximum of \$500,000 of business income, either for one corporation or to be shared by the corporations. You can designate the amounts that qualify for

each corporation, and if you do not, the Canada Revenue Agency (CRA) can designate the amounts for each corporation.

Associated corporations include the following:

- A corporation and another corporation that controls it;

- Two or more corporations controlled by the same person or group of persons;

- Two corporations if one is controlled by one person and the other is controlled by another person who is related to the first person, where either person owns at least 25% of the shares of any class of each corporation; and

- Two corporations if each is controlled by a related group of persons, where each of the persons in one related group is related to all of the persons in the other group, if a person in either group owns at least 25% of the shares of any class in each corporation.

For these purposes, “control” includes the ownership of shares with more than 50% of the corporate votes. It also includes *de facto* control or control “in fact”, such as where someone has influence that could result in the person controlling the corporation as a matter of fact.

Furthermore, there are various deeming rules that provide that a corporation will be deemed to be controlled by a person for the purposes of the associated-corporation rules. For example, there is deemed control by a person if the person owns shares of the corporation having a value of more than 50% of the value of all the shares of the corporation (with or without votes), or common shares of the corporation having a value of more than 50% of the value of all of the common shares of the corporation (with or without votes).

The rules do not normally prevent you and family members from each owning a CCPC and each claiming the small business deduction in respect of the first \$500,000 of active business income. For example, if you control one CCPC and your spouse controls another CCPC, the two CCPCs will **not** automatically be associated, unless one of you owns 25% or more of the shares of a class of the other spouse's CCPC. However, if "one of the main reasons for the separate existence" of the corporations is to save tax, the CRA can deem them to be associated.

Furthermore, for the purposes of the associated-corporation rules, you are deemed to own any shares of a corporation owned by any child of yours who is under age 18. Thus, for example, if you control one CCPC and your 16-year-old controls another CCPC, the two corporations will be associated and will be required to share the small business deduction. However, this deeming rule does not apply where it can reasonably be considered that your child manages the business and affairs of the corporation and does so "without a significant degree" of your influence.

Note that the associated corporation rules differ from the related and non-arm's length rules and therefore require a separate examination of the rules.

## DEATH AND INCOME TAXES

We all know the old saying about these two sure things in life. And one sure thing, death, can result in additional income tax, due to the "deemed disposition" rule that applies on death.

### DEEMED DISPOSITION RULE

Basically, the rule provides that on your death, you are deemed to have sold each capital property you own for its current fair market value. This is deemed to happen an instant before your death, so the resulting tax is triggered in your final return, not in your estate, although your estate is liable for the tax. (An exception applies for spouses, as discussed below.)

The person who acquires the property as a result of your death acquires the property at a cost equal to the same value at which you are deemed to have sold it. Similar rules apply to land inventory and resource properties owned at death.

For capital properties, the deemed disposition rule can result in either capital gains or capital losses being recognized in the deceased's year of death. As per the normal rule for capital gains, half of capital

gains are included in income as taxable capital gains and half of capital losses are allowable capital losses. For depreciable property, the rule can also result in recapture of previously claimed capital cost allowance (tax depreciation), or a terminal loss.

To the extent your taxable capital gains from the deemed disposition exceed your allowable capital losses, the excess net taxable capital gains will be included in your income for the year of death. It will be added to any of your "regular" income that you earned or realized during the year before your death, such as from employment.

If your allowable capital losses exceed your taxable capital gains from the deemed disposition, the excess will reduce any taxable capital gains that may have been realized during the year from "actual" dispositions. Furthermore, if there are still allowable capital losses remaining (net capital losses), they can serve to offset **other** sources of income in the year of death or in the immediately preceding year (e.g. employment, business or property income). This is an exception to the general rule under which allowable capital losses can only offset taxable capital gains. However, the allowable capital losses that can offset other sources of income are reduced to the extent you claimed the capital gains exemption in any year (e.g. for gains from selling small business corporation shares).

### Example

John died in 2014 and had a \$20,000 net capital loss (\$40,000 capital loss), triggered by the deemed disposition rule. In 2014 he also had \$30,000 of business income and no other income. In 2013, he had \$4,000 of net taxable capital gains. In 2012, he claimed a capital gains deduction of \$5,000 and has not otherwise claimed the capital gains exemption.

Of the net capital loss of \$20,000, \$4,000 can be carried back to 2013 to fully offset the \$4,000 of taxable capital gains in that year, retroactively reducing John's net taxable capital gains in that year to zero. Of the remaining \$16,000, \$11,000 can be used to reduce his income in 2014 (i.e. \$16,000 minus the \$5,000 capital gains deduction claimed in 2012).

Alternatively, the 2014 net capital loss does not have to be carried back. In this case, \$15,000 (\$20,000 net capital loss minus \$5,000 previous capital gains deduction) could be used to offset income in 2014.

A similar rule allows unused net capital losses from years before death to offset all sources of income in the year of death or the preceding year, again after offsetting any remaining taxable capital gains of those years and after accounting for any capital gains exemption claimed in any year.

### **ROLLOVER FOR SPOUSES AND COMMON-LAW PARTNERS**

If you leave property to your spouse (or common-law partner), a different rule applies. It provides that you are deemed to have disposed of the property at its tax cost and your spouse takes over the same tax cost. As a result, no income or gain is triggered by the deemed disposition. This is called a tax-free “rollover”.

However, your legal representative (e.g., executor or estate trustee) can elect out of the rollover on a property-by property basis. When this election is made, the property is subject to a deemed disposition at fair market value as discussed above. The election can be beneficial if the property has an accrued capital loss, since the loss will be triggered and can offset any taxable capital gains and possibly other sources of income as described above. It can also be beneficial to trigger a gain on a property, if the gain can be offset by losses that you have. That is, you won’t pay tax on the gain, while your spouse will inherit a bumped-up cost equal to the fair market value of the property. Lastly, the election can be useful if it triggers a capital gain from small business corporation shares, or farm or fishing property, that are eligible for the capital gains exemption, to the extent you have a remaining exemption, and if so they will not be subject to tax.

In addition to the spousal rollover, there is a rollover that applies if qualifying farm or fishing property is left to your child, grandchild, or great-grandchild (including step-children, spouses of children, etc.).

### **DEEMED ACCRUAL RULE**

Another rule provides that any amount payable periodically but not yet paid, such as interest, rent, or employment income, is included in your income to the extent that it accrued up to the time of your death. For example, assume you are paid a monthly salary that is paid on the last day of each month. If you die half-way through a month, the salary that accrued to that point in time will be included in your income in the year of death.

### **“RIGHTS OR THINGS”**

Rights or things are generally amounts receivable by you at the time of death that have not otherwise been included in your income. Rights and things include

items such as declared dividends not yet paid, and receivable (declared) employment bonuses or other remuneration not yet paid for previous pay periods.

If your legal representative makes an election, the rights and things can be included in a *separate* tax return, treated as if they were received by a separate person. The benefit of this election is that this income is subject to the graduated tax rates otherwise applicable to individuals. Thus, the rights or things in the separate return will start being taxed at the lowest marginal rate of tax (increasing under the graduated rate schedule), rather than being “stacked” on top of your other income in the year of death, which is likely in a higher tax bracket. Furthermore, some personal tax credits can be claimed in both your regular return and the separate rights and things return, further reducing your tax bill on death.

### **ESTATE LOSSES**

If your estate realizes capital losses in its first taxation year in excess of capital gains, the excess allowable capital losses can be carried back to your final taxation year and used in that year. However, they cannot be carried back to offset gains or income in earlier years.

## **SALE OF BUILDING WITH TERMINAL LOSS AND LAND WITH GAIN**

If you own a building that is a rental property or used in your business, a special rule in the Income Tax Act can apply when you sell the building along with the land on which the building is located (of course, in most cases, you will sell both building and land).

The rule applies if you realize a *capital gain* on the sale of the land and a *terminal loss* on the sale of the building. Only half of the capital gain is included in income. In contrast, the entire amount of a terminal loss is normally deductible in full. In general terms, a terminal loss on the sale of a building occurs when you sell the building for proceeds that are less than the undepreciated capital cost (UCC) of the building – normally meaning that the building was previously over-depreciated for income tax purposes relative to its actual value.

Obviously, the government is not enamoured with the idea that the gain on the land will only be half-taxed while the loss on the building could be deducted in full, especially since you can choose in your sale agreement how much of the sale price to allocate

to the building and how much to the land. Accordingly, the rule applies to *re-allocate* your proceeds of disposition from the land to the building to offset the terminal loss on the building, but only to the extent of your gain from the land.

### Example

You own land that cost you \$200,000 and a building with an original cost of \$100,000 and a UCC of \$80,000. You sell both for \$310,000, and your sale agreement allocates \$240,000 to the land and \$70,000 to the building. You might even be able to demonstrate that this allocation is fair and correct, based on an expert valuation.

In the absence of the special rule, you would have a capital gain of \$40,000 on the land (\$240,000 – \$200,000) resulting in a taxable capital gain of \$20,000; and a terminal loss of \$10,000 on the building (the \$70,000 proceeds for the building being \$10,000 lower than the \$80,000 UCC). Subtracting the \$10,000 terminal loss from the \$20,000 taxable capital gain, your net income from the sale would (absent the special rule) be only \$10,000.

The rule reallocates \$10,000 of the land proceeds to the building, so you have no terminal loss. The capital gain on the building is reduced to \$30,000 and taxable capital gain is reduced to \$15,000. Thus, your net income from the sale is \$15,000 rather than \$10,000.

## RESERVES FOR RECEIVABLES

If you sell capital property, or you sell inventory in the course of your business, and part or all of the sale price is due after year-end, you may be able to claim a *reserve* to defer recognizing some of the resulting capital gain or profit.

### CAPITAL GAINS RESERVE

This reserve can apply where you sell property and realize a capital gain. The maximum reserve you can claim in one year is limited to the lower of the following amounts:

1. The portion of the gain equal to  $\text{gain} \times (\text{proceeds due after year} / \text{total proceeds})$  (i.e., you allocate the gain proportionately to the percentage of the sale price you have not yet received); and
2. In year of sale  $\frac{4}{5}$  of the gain, in the next year  $\frac{3}{5}$  of the gain, in the next year  $\frac{2}{5}$  of the gain, in the next year  $\frac{1}{5}$  of the gain, and in the 4<sup>th</sup> year

following the year of sale, nil. (In other words, you must recognize at least 20% of the gain every year, even if more than that percentage of the sale price has not been received.)

Because of the second limitation, the gain cannot be spread out more than 5 years including the year of sale.

Whatever you claim in one year is added back into your capital gains in the next year, and the calculation for the reserve is performed again in that year (if any).

### Example

In year 1 you sell some land and realize a capital gain of \$100,000. You receive  $\frac{1}{3}$  of the proceeds up front, while  $\frac{1}{3}$  of the proceeds are due in each of year 2 and 3.

In year 1, you can deduct a maximum reserve equal to the lesser of: 1)  $\$100,000 \times \frac{2}{3} = \$66,667$  (two-thirds of the gain, since two-thirds of the sale price is still owing), and 2)  $\$100,000 \times \frac{4}{5} = \$80,000$  (four-fifths of the gain). So the most you can claim is \$66,667. Assuming you claim the reserve, you have a net gain in year 1 of \$33,333 and a taxable capital gain of half of that or \$16,667.

In year 2, you add back \$66,667 as a gain, but can claim another reserve of \$33,333 in that year, resulting in another \$33,334 capital gain and a \$16,667 taxable capital gain. In year 3 there is no further reserve, so you will include the remaining \$16,667 taxable capital gain in that year.

The reserve is optional. You can claim the maximum, none of it, or any amount in between.

### INVENTORY RESERVE

Inventory sold at a profit in a year is eligible for a reserve of up to the portion of the profit from the sale equal to:  $\text{profit} \times (\text{proceeds due after year} / \text{total proceeds})$ .

The reserve can normally only be claimed for a maximum of 3 years including the year of sale (more specifically, only in a year that ends 36 months or less after the date of sale). Furthermore, unless the inventory is real estate, you can claim a reserve only if part or all of the proceeds are due at least two years after the date of sale. The reserve is optional. Again, any reserve claimed is included back into income the next year, and a new reserve can be claimed if it still qualifies.

## PRESCRIBED INTEREST RATES

The prescribed interest rates that apply for the current calendar quarter are as follows:

- The interest rate charged on overdue taxes, CPP contributions, and EI premiums is 5%, compounded daily.
- The interest rate paid on late refunds paid by the CRA to corporations (after 30 days) is 1%, compounded daily.
- The interest rate paid on late refunds paid by the CRA 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

### ABIL ON LOAN MADE TO 'ALTER EGO' OF CORPORATION NOT ALLOWED

An allowable business investment loss (ABIL) is deductible against all forms of income, as opposed to other allowable capital losses, which are normally deductible only against taxable capital gains. In very general terms, an ABIL includes a loan made by a taxpayer to a Canadian-controlled private corporation (CCPC) that has become an uncollectible debt (certain other criteria apply).

In the recent *Barnwell* case, the taxpayer lent money to an individual (Austin) to be invested in a travel book business. The business was actually carried

on by a corporation owned by Austin. Apparently, the taxpayer believed the loans, although provided to Austin, were made 'in favour' of the corporation. Eventually, the business venture collapsed and part of the loans made by the taxpayer became bad debts. The taxpayer claimed an ABIL, arguing that the loans had been made to the individual as an agent or 'alter ego' of the corporation, so that they were really made to the corporation rather than Austin. The CRA disagreed and disallowed the ABIL claim.

On appeal, the Tax Court of Canada judge sided with the CRA. The judge sympathized with the taxpayer and believed that the loans were intended to help fund the corporation's business. But the fact of the matter was that the taxpayer made out the cheques (for the loans) to Austin personally, and not to the corporation, and evidence was insufficient to show that Austin was acting as agent of the corporation when he accepted the cheques.

The taxpayer has appealed the decision to the Federal Court of Appeal. However, given the Tax Court's findings of fact, it is very unlikely the Court of Appeal will reach a different decision.

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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.*

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