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Tax Letter

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TOPICS	
INCOME ATTRIBUTION RULES	1
UNUSED LOSSES – CARRY THEM BACK OR FORWARD	3
OVERVIEW OF TAX FILING AND PAYMENT DATES	4
CAMPGROUND BUSINESSES AND THE SMALL BUSINESS DEDUCTION	5
AROUND THE COURTS	5
QUEBEC FILING EXTENSION	6

INCOME ATTRIBUTION RULES

Canada employs a progressive or graduated income tax system, under which higher levels of income attract higher tax rates relative to lower levels of income. At the Federal level, there are currently five tax brackets, the lowest being 15% and the highest being 33%. Depending on the province, the combined Federal and Provincial tax rates can range from about 20% to about 54%.

As a result, income-splitting amongst family members can save tax, particularly where there is a high income earner and one or more low income earners. For example, if my marginal tax rate is 53% and my spouse's or child's marginal tax rate is 20%, we are obviously better off on the whole if I can shift some income to them. Furthermore, we might be able to multiply some tax credits, such as the basic personal tax credit.

The government is not keen about income splitting, at least in most cases. The Income Tax Act contains income attribution rules, which, when they apply, shut down the beneficial tax effects of income splitting. Fortunately, there are some exceptions, which allow certain forms of income splitting.

The attribution rules

There are two main income attribution rules.

The first rule applies if you lend or transfer property, which includes cash, to your spouse or common-law partner. If they earn income from the property (such as dividends, interest or rent), or taxable capital gains from selling the property, the income will be attributed to you and included in your income. Exceptions are discussed below.

This rule can apply even if you lend or transfer property to them *before* becoming married or common-law. In such case, the rule can start once you are married or common-law, but not before that time.

The first attribution rule ceases to apply when you become divorced or are no longer common-law partners. If you are

separate but still married, the rule relating to income from property does not apply, although the rule relating to capital gains ceases to apply only if you and your spouse or partner make a joint election in your tax return.

The second rule applies if you lend or transfer property to a child under the age of 18 with whom you do not deal at arm's length (e.g. your child or grandchild), including a niece or nephew. This rule applies only to income from property such as interest, dividends and rent, and does not apply to capital gains. Therefore, splitting capital gains with your child is legitimate. For example, you could buy public common shares or equity mutual funds for your child, and subsequent capital gains would be taxed to them rather than you. (Of course, you don't know for sure that the shares will go up in value!)

The second rule ceases to apply in the year during which the child turns 18 years, regardless of the birth date. For example, if your child turns 18 on December 31 of this year, there is no attribution throughout this year.

Both rules can continue to apply for income from "substituted property". For example, if you give cash to your spouse and she buys shares, then sells the shares and buy bonds, income from the bonds can still be attributed to you. The "substituted property" rule can continue regardless of the number of sales and purchases of new property.

Example

I give some shares to my spouse. She receives dividends on the shares, and subsequently sells the shares, realizing a taxable capital gain. She uses the proceeds to buy mutual funds and receives interest and dividends from the funds.

Result: All of the income from the shares and mutual funds, including the taxable capital gain, will be included in my income.

Exceptions

In addition to the exceptions noted above, there are other exceptions that apply to both attribution rules.

One major exception applies where you lend money to your spouse or child and charge interest at the "prescribed rate" under the Income Tax Regulations in effect at the time of the loan. (You will have to include the interest in your income, but they can deduct it from the investment income they earn by investing the money.) The prescribed rate is based on 90-day Federal treasury bill rates and is set each quarter. The current rate is 2%. The only catch is that they must actually pay you the interest each year or by January 30 of the following year. If they miss any year's interest payment by even a day, the exception ceases to apply. Interestingly, the exception can apply regardless of the term of the loan. So you could lend your spouse money with a repayment date of 10 or 20 years later, and still qualify for the exception.

Another exception applies if you sell property to your family member for fair market value proceeds. If the sale is to your spouse or common-law partner, you must elect out of the spousal tax-free "rollover" that normally applies on such sales, and if the consideration they give you includes debt, you must charge the prescribed rate of interest as discussed above.

The attribution rules do not apply if you (the transferor or lender) are not resident in Canada. They similarly do not apply after your death.

The rules do not apply to business income. Therefore, you can give cash to your spouse or child to be used in their business, and the business income will not be attributed to you.

The rules do not apply to income from reinvested income. For example, if you transfer bonds to your spouse and he or she uses the interest from the bonds to purchase other investments, the income

from the other investments will not be subject to attribution.

The rules obviously do not apply if the transferred property or money does not generate income. Therefore, as an example, you could give your spouse or child cash for personal expenses or to pay their personal income tax, thereby freeing up their own cash to make investments. The income from the investments will not be attributed to you.

The rules do not apply if the income is subject to the "tax on split income" (TOSI) in the hands of your spouse or child. The downside is that your spouse or child will be subject to the highest marginal rate of tax on such income. TOSI can apply to items such as dividends from private corporations, and passive income from partnerships or trusts that provide services to your business or corporation. TOSI was discussed in our January 2018 Tax Letter, and will be reviewed again in a future Letter.

UNUSED LOSSES – CARRY THEM BACK OR FORWARD

There are various types of losses that you cannot use for tax purposes in your return for a given year. Fortunately, the losses are normally not "lost" forever, and can be carried back or forward and used in other years.

Non-capital loss

A business loss is called a "non-capital loss". In general terms, you will have a non-capital loss in a year when your losses from all sources exceed your positive income from all sources for the year (capital losses are dealt with separately as discussed under the next heading). For example, if you have $80,000 of investment income and a $90,000 business loss, your net income for the year will be zero, and the excess $10,000 will be a non-capital loss that cannot be used in the year.

Non-capital losses can be carried forward up to 20 years or back 3 years to offset all sources of income in those years. If you are carrying back a loss, a special form is used to adjust the previous year's return. The carried-over loss is deducted on your return after calculating "net income" for the year, when computing "taxable income" (on which tax applies).

An ordering rule provides that earlier years' non-capital losses are used before later years' non-capital losses. However, there is no ordering rule in terms of the year that you carry the loss forward or back to. For example, say you have a non-capital loss in each of years 1 and 2. You want to carry a loss forward. You must carry forward the year 1 loss before the year 2 loss, but you could carry it forward to year 4 rather than year 3 (as just one option).

Net capital loss

You will have a net capital loss in a year if your allowable capital losses for the year exceed your taxable capital gains for the year. Allowable capital losses are one-half of capital losses; taxable capital gains are one-half of capital gains.

The net capital loss cannot be used in that year, even if you have other sources of income. (An exception applies in the year of death, when net capital losses can offset other sources of income in that year or the preceding year.)

Net capital losses can be carried back 3 years or forward *indefinitely* to other years. However, they can only offset taxable capital gains in those other years. (In other words, capital losses cannot be used against employment, business or investment income.)

An ordering rule also applies to net capital losses, similar to the rule discussed above for non-capital losses.

Allowable business investment loss ("ABIL")

An ABIL is one-half of a "business investment loss", which is a special kind of capital loss. In very general terms, you

may have a business investment loss if you realize a capital loss on a disposition of shares or debt in a private corporation engaged in active business (various conditions apply).

Unlike allowable capital losses, an ABIL can offset both taxable capital gains and other sources of income in a year. Excess unused ABILs can be carried back 3 years or forward 10 years to offset all sources of income in those years. After the 10th forward year, any unused ABILs become regular net capital losses, and from that point on can only offset taxable capital gains.

Limited partnership losses

In general terms, a limited partner can deduct its share of losses from a limited partnership only to the extent of the partner's "at-risk amount" in respect of the partnership. Although the concept of the at-risk amount is quite complex, you could think of it as the "hard" cost or amount that you have invested in the limited partnership – the amount that is not subject to any kind of guarantee or benefit that might reduce your financial exposure in terms of what you have invested. (The technical definition is found in subsection 96(2.2) of the Income Tax Act, and other factors can come into play.)

Any excess limited partnership loss can be carried forward indefinitely, but only to the extent of your at-risk amount in future years. (Your income from the partnership for a year generally adds to the at-risk amount.)

Personal-use property loss

Most capital losses from selling personal-use property are simply not deductible for income tax purposes. However, losses from listed personal property ("LPP") are deductible from gains from LPP in a year. If there are excess LPP losses, they can be carried back 3 years or forward 7, but only to offset gains from LPP in those years.

LPP includes artwork, rare books and manuscripts, jewelry, stamps, and coins.

OVERVIEW OF TAX FILING AND PAYMENT DATES

Most readers are likely aware of their tax-filing due date for a taxation year. For the majority of individuals it is April 30 of the following year. If April 30 falls on a weekend, it is the following business day.

However, if either you or your spouse (or common-law partner) carry on business in the year, your tax-filing date is June 15. The downside is that any tax still owing for the year is due by April 30! If you owe tax and pay it on the filing date of June 15, you will be charged 45 days of interest (currently the interest rate is 6% compounded daily, so this will cost you about 0.7%).

The filing due date for corporations is 6 months after the end of the taxation year. The taxation year is the corporation's fiscal period, which does not have to be the calendar year. However, if the corporation owes taxes for the year, the balance is due 2 months after the end of the taxation year, and a late payment will be subject to interest. If the corporation is a Canadian-controlled private corporation that meets certain conditions, including that its taxable income for the preceding year did not exceed $500,000, the balance due date is extended to 3 months after the end of the year.

For a trust, the filing due date is 90 days after the end of the taxation year, and the balance due date is the same day. The taxation year of a trust is the calendar year, although a graduated rate estate can have an off-calendar taxation year. In general terms, a graduated rate estate is a deceased's estate for up to 36 months after the death.

CAMPGROUND BUSINESSES AND THE SMALL BUSINESS DEDUCTION

The small business deduction applies to the first $500,000 of active business income earned by a Canadian-controlled private corporation (CCPC), and results in a combined Federal and Provincial tax rate of about 9%-14%, depending on the province. On the other hand, income from property is subject to a combined rate of about 50%-54%, again depending on the province (some of this is refundable tax that is recovered once dividends are paid out).

Active business income of a CCPC does **not** include a "specified investment business" ("SIB"), which is a business the principal purpose of which is to derive income from property – including rental income – unless the CCPC employs more than five full-time employees throughout the relevant year. In other words, income from a SIB is taxed the same as income from property.

Campground and mobile home park operators have lobbied the government to allow their businesses to qualify for the small business deduction in those cases where they do not employ more than five full-time employees throughout the year. Due to the seasonal nature of the camping and mobile home parks in Canada, this rule affects many such businesses because they cannot employ more than five employees throughout the year. However, the Department of Finance announced in the 2016 Federal Budget that it had reviewed these rules carefully, and no changes will be made.

The CRA has held that generally, the business of a campground involves the renting of property and providing basic services typical to such a rental operation. As such, the principal purpose of the business is to earn rental income from real property and the corporation is not eligible for the small business deduction, unless it employs more than five full-time employees in that business throughout the year.

However, if a corporation carrying on a campground business does not employ more than five full-time employees throughout the year but does provide "significant additional services that are integral to the success of its business operations", the CRA states that it may consider the corporation eligible for the small business deduction. Some of the additional services typical to this industry include coin-operated laundry, swimming pool/lifeguard, playground, garbage disposal, and retailing food and supplies. Providing services such as these may change the principal purpose of the business from property rental to providing services. Generally speaking, the more services provided, and the greater the importance of the additional services to the financial success of the business, the greater the likelihood that the corporation may be eligible for the small business deduction.

Unfortunately, the CRA position leaves some campgrounds and mobile home parks in limbo, as the eligibility requirements depend on the level of services provided. One case, where the campground business was found not to be eligible for the small business deduction, is discussed in the next article.

AROUND THE COURTS

Campground business not entitled to small business deduction

In the recent *1717398 Ontario Inc.* (*Lost Forest Park)* case, the taxpayer corporation operated a campground and facility for campers and recreational vehicle (RVs). In the taxation years in question, the corporation attempted to claim the small business deduction (see above) on the grounds that it carried on a business and that earning rental income was not the principal purpose of the business. (The corporation did not employ more than 5 full-time employees throughout the year, so the exception described above did not apply.)

The CRA denied the small business deduction on the grounds that earning rental income was the principal purpose of

the taxpayer's business. On appeal to the Tax Court of Canada, the Court considered the taxpayer's arguments regarding other services it supplied, such as storage facilities, picnic tables and fireplace sites, a swimming pool, a laundry room, and certain athletic facilities. However, the Court concluded that "the services and amenities offered by the Appellant were not sufficient to reach the tipping point" whereby the provision of the services outweighed the rental of the property. Therefore, the Court agreed with the CRA that the principal purpose of the business was to earn rental income, and the small business deduction was disallowed.

"Signing bonus" was a capital gain, not ordinary income

In the 2018 *Ritchie* case, Ritchie owned some farm property on which a pipeline company planned to construct part of a pipeline project. Ritchie agreed to allow the pipeline to be installed on his property, in exchange for a payment of $254,870 that was identified as a "signing bonus" in the agreement with the company.

Ritchie reported the payment as a capital gain and thus included half of the payment in his income as a taxable capital gain. The CRA reassessed him, taking the position that the payment was business income (fully included in income). One of the CRA's arguments was that the payment was received in the course of Ritchie's income-earning activity of farming and did not relate to the disposition of capital property.

On appeal, the Tax Court of Canada held that the farming business was carried on by Ritchie's corporation and not by him personally. As a result, it could not be said that Ritchie received the "signing bonus" in the course of earning income from a farming business, since the corporation rather than he carried on the farming business. The Court held the amount was paid in respect of Ritchie's disposition of a capital property, being an interest in his land, so it was a capital receipt and gave rise to a capital gain. Thus, his appeal was allowed and the CRA's reassessment was overturned.

QUEBEC FILING EXTENSION

As discussed in the September Tax Letter (under "Bare trusts and nominee agreements"), the Quebec government introduced a rule in May 2019 requiring a nominee agreement signed after May 19, 2019 to be disclosed to Revenu Québec in an information return within 90 days of signing, with a penalty for non-compliance. However, on August 22, 2019 Revenu Québec extended the date for filing the information return to the later of the following dates:

- the 90th day following the conclusion of the nominee agreement; or
- the 90th day following the day the bill introducing the new measures receives assent.

At the time of writing, the bill had not been introduced and therefore has not received assent.

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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.