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TAX LETTER

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FEDERAL BUDGET HIGHLIGHTS

This year's Federal Budget was released on March 22, 2017 (the "Budget Day"). Although it was a relatively light budget, it contained some income tax measures. The income tax changes included the following:

Disability tax credit – under current rules, in order to claim this credit, an individual's physical or mental impairment must be certified by an eligible medical practitioner. The Budget expands the list of eligible medical practitioners to include nurse practitioners, applicable as of Budget Day.

Medical expense credit – under current rules, certain expenses incurred by an individual for the use of reproductive technologies for conceiving a child qualify for the credit, if the individual has an illness or condition such as the condition of medical infertility. The Budget provides that the credit will apply to such expenses even if the treatment is not required because of a medical condition (e.g. a single person or same-sex couple choosing artificial insemination to have a baby). The new provision applies to 2017 and subsequent years. However, the provision will also apply for an earlier year if the individual makes a request for a refund to the Canada Revenue Agency in respect of the earlier year within 10 calendar years after the end of the earlier year.

Family caregiver credit – as discussed in the April Tax Letter, there are three different credits that may apply if you support an eligible dependant – the spousal equivalent credit, the caregiver credit, and the infirm dependant credit. The Budget proposes to replace these credits with one consolidated Canada Caregiver Credit, effective for 2017 and subsequent years.

Tuition tax credit – the current rules allow a credit in respect of tuition paid to eligible educational institutions, which include most universities and colleges. The Budget extends the credit for tuition paid to such institutions for occupational skills courses that are **not** at the post-secondary level. The course must be taken for the purpose of providing an individual's skills, or improving an individual's skills, in an occupation. The individual must be 16 years of age or older before the end of the relevant tax year. This change applies to 2017 and subsequent years.

Public transit credit – this credit is being repealed, but will continue to apply in respect of transit passes used before July 1, 2017. For passes used from that point on, the credit is not allowed even if the pass was bought before Budget Day.

Home relocation loan – if you receive a loan from your employer with no interest or a rate of interest below the prescribed rate of interest under the Income Tax Act, you are required to include an imputed interest benefit in your employment income. However, if the loan is a "home relocation loan", the interest benefit on the first $25,000 of the principal amount of the loan is effectively exempt from tax. A home relocation loan generally means a loan used to buy a home when you move to a new work location and your new home is at least 40 kilometres closer to the new work location relative to your former home. Under the Budget, this exemption will be eliminated beginning in 2018.

Control of a corporation – control of a corporation for tax purposes includes *de jure* control (control in law) by a person, which generally means the ownership of more than 50% of the voting shares in the corporation. For certain purposes, it also includes *de facto* control (control in fact) by a person. For example, *de facto* control is relevant in determining whether Canadian-controlled private corporations are associated – if they are associated, they must share the small business deduction that applies to the first $500,000 of active business in a year. The Budget "clarifies" that the determination of *de facto* control by a person must take into consideration all factors that are relevant in the circumstances, and must not be limited to whether the person has a legally enforceable right or ability to effect a change in the board of directors of the corporation (a 2016 Federal Court of Appeal decision, *McGillivray Restaurant*, had held otherwise). This change applies to taxation years that begin on or after Budget Day.

Investment tax credit for child care spaces – an employer can currently earn an investment tax credit for costs associated with the creation of child care space for its employees. The credit is being repealed for costs incurred on or after Budget Day. However, the credit will still be available in respect of expenditures incurred before 2020 pursuant to a written agreement entered into before Budget Day.

Work in progress – certain taxpayers are required to include the value of work in progress ("WIP") in computing their income.

However, designated professionals (such as accountants, dentists, lawyers, Quebec notaries, doctors, veterinarians and chiropractors) may elect to exclude the value of WIP in computing their income. The exclusion of WIP effectively means that the income is deferred and reported in the year in which the professional's work is billed, even though expenses related to providing the work services are deductible in the year they are incurred. The Budget has eliminated this election for taxation years that begin after Budget Day (for individual professionals, the first such year will be calendar 2018). Under a transitional rule, for the first taxation year beginning after Budget Day, only 50% of the lesser of cost and fair market value of the WIP will be brought into income.

SECTION 85 TAX-FREE ROLLOVER TO CORPORATIONS

Overview

Section 85 of the Income Tax Act (the "Act") allows you to transfer property to a Canadian corporation without immediate tax consequences. The transfer is often called a "rollover", because it can take place at the cost of the property, thereby avoiding the immediate recognition of accrued gains.

The transfer is made by means of a "section 85 election", which is filed with your tax return and the corporation's tax return (see also "Time for election", below). The election allows a complete rollover (no immediate gain), or partial rollover (some immediate gain), depending on the "elected amount" on the transfer. The election is actually a joint election, in that it is made by you and the corporation. The election is made on Form T2057.

In order to qualify for the election, as consideration for the transfer of the property you must receive at least one share in the corporation. You may also receive non-share consideration – often called "boot" – but the boot may affect your elected amount in the manner discussed below.

Property that qualifies for the rollover includes capital property, and inventory other than real property.

Result of elected amount

The elected amount becomes your proceeds of disposition of the property transferred to the corporation. Therefore, for example, if you elect at your cost of the property, you will have a nil gain and nil income inclusion from selling the property to the corporation.

The elected amount also becomes the corporation's cost of the property.

Lastly, the elected amount, net of any boot taken back, becomes the cost of your shares received as consideration.

Limits on the elected amount

There are three general limits to the elected amount.

1) The elected amount cannot exceed the fair market value ("FMV") of the property;

2) The elected amount cannot be less than the lesser of the FMV of the property and its tax cost; and

3) Subject to the first limit above, the elected amount cannot be less than the FMV of any boot.

Example 1

You transfer real property (a capital property) to your corporation. Your cost of the property was $200,000 and its FMV at the time of the transfer is $500,000. As consideration for the transfer, you receive 100 common shares in the corporation.

Assuming you elect at $200,000, there will be no gain on the transfer. The corporation's cost of the property will be $200,000, and the cost of your 100 common shares will be $200,000.

Note that the rollover is essentially a deferral of tax rather than a complete exemption from tax, and can even create double tax down the road. If you subsequently sell your 100 common shares for more than your $200,000 original cost, you will have a capital gain at that point in time. Similarly, if the corporation sells the real property for more than $200,000, it will have a capital gain.

Example 2

Assume the same facts as in Example 1, except that the consideration you receive is 100 common shares in the corporation plus $220,000 cash (the cash is boot). In this case, you cannot elect at amount less than the $220,000 boot.

Assuming you elect at $220,000, you will have a $20,000 capital gain and half of that will be included in your income as a taxable capital gain. The corporation's cost of the property will be $220,000. The cost of your 100 common shares will be $220,000 minus the $200,000 boot, or $20,000.

Electing for partial or no rollover

In most cases, if possible, you would elect at your tax cost of the transferred property. As noted, this would allow a tax-free rollover on the transfer.

However, in some cases you may want to deliberately trigger some or all of the accrued gain in respect of the property by electing at an amount greater than your tax cost.

For example, you may have current or previous capital losses than could offset any triggered gain. By electing an amount greater than your tax cost of the property, the gain would not be taxable if it were offset by your losses; and the result is that the corporation's cost of the property and your cost of the shares taken back would be increased accordingly, leading to lower taxable capital gains somewhere down the road.

As another example, you may have transferred property that qualifies for the capital gains exemption – that is, qualified small business corporation shares or qualified farm or fishing property. Assuming you have a sufficient capital gains exemption available, you can elect to trigger a gain on the transfer of the property to the corporation, and again the greater elected amount means a greater cost of the property for the corporation and a greater cost of your shares taken back, leading to eventual lower taxable capital gains.

Unfortunately, you cannot trigger a loss on the transfer if you and the corporation are "affiliated". In such case, any loss will be a superficial loss and therefore denied. The concept of "affiliated persons" is quite complex, but as an example, you are affiliated with the

corporation if you or your spouse or common-law partner controls the corporation.

Time for election

The election must be filed by the earlier of your tax return due date and that of the corporation for the taxation year in which the transfer took place. Late filing within three years of that day is allowed, subject to a penalty. After the three years, you may be able to file late if the Canada Revenue Agency (CRA) is of the opinion that it would be "just and equitable" to allow the late filing. Again, a penalty will apply.

TAXATION ON DEATH

We all know the saying about death and taxes. Although both are certainties in life, your death will often result in additional tax payable for reasons discussed below.

Deemed disposition rules

When you die, you will have a deemed disposition of most of your capital properties at their FMV. For any given property, if the FMV is greater than your cost, you will have a capital gain, and half of that amount will be included in your income as a taxable capital gain ("TCG"). The person acquiring the property as a result of your death (for example, under your will or under intestacy laws) will have a deemed cost of the property equal to that FMV.

Conversely, if the property has an accrued loss, the deemed disposition will result in a capital loss. One-half of the loss will be an allowable capital loss ("ACL"). Normally, ACLs can offset only TCGs and no other forms of income. However, in the year of death and the immediately preceding year, ACLs can also offset other forms of income (technically, the amount of ACLs that can offset other sources is the ACLs net of any capital gains exemption that you have claimed).

There is an exception for property left to your spouse (all references to a spouse include common-law partner), or a qualifying trust under which your spouse is the beneficiary. In such case, the deemed disposition and acquisition take place at your tax cost of the property. In other words, it is a tax-free "rollover". However, your legal representative (such as your executor) can elect out of the rollover on a property-by-property basis. Electing out of the rollover means the property is subject to the deemed disposition at FMV. This may be beneficial if the property has an accrued loss, because the loss will be triggered. Alternatively, it can be beneficial if the property has an accrued gain that can be offset by your losses, as this will result in a higher cost for your spouse.

> *Example – electing out of rollover*
>
> You leave some real property to your spouse under your will. Your cost is $100,000 and the FMV of the property at the time of your death is $250,000. You have at least $75,000 in unused net capital losses from previous years.
>
> If your legal representative elects out of the rollover, you will have a deemed disposition at $250,000, resulting in a $150,000 gain and $75,000 TCG. The TCG can be offset by your $75,000 of net capital losses, resulting in no tax payable for you on your "terminal" return. The benefit is that your spouse's cost of the

property is $250,000, rather than the $100,000 that would apply if the rollover took place.

Deemed disposition for RRSPs and RRIFs

This can be one of the most significant items included in your income in the year of death. As a general rule, the FMV of your registered retirement savings plan (RRSP) at death is included in your income. If this rule applies, the beneficiary of the amount receives it tax-free.

An exception applies, generally where you leave the RRSP to your spouse (or common-law partner), or to a child or grandchild who was financially dependent upon your for support. For this purpose, the child or grandchild is deemed **not** to be financially dependent upon you if their income for the year preceding the year of death exceeded the basic personal credit amount (plus, if they are disabled, the disability credit amount), **unless** it is otherwise established that they were dependent upon you. Your spouse does not have to be financially dependent upon you.

Where the exception applies, you do not include the RRSP amount in your income. Instead, your spouse, child or grandchild includes in income the amount they receive from the RRSP. However, they may be eligible for an offsetting deduction. For example, if your unmatured RRSP was left to your spouse, she would include the amount received from the RRSP in her income, but she could use the amount to make a contribution to her own RRSP, or to acquire an annuity payable for life or up to 90 years of age, and get an offsetting deduction. Similar rules apply to an RRSP left to a child or grandchild who was dependent upon you by reason of mental or physical infirmity. If the child was not infirm, an offsetting deduction is allowed only if the child is under 18 years old and the amount is used to acquire an annuity payable up to an age not exceeding 18. In each such case, the contribution to their RRSP or acquisition of the annuity must take place in the same year in which they receive the assets or funds from your RRSP, or within 60 days after that year.

Similar deemed disposition rules (and exceptions to the rules) apply if your RRSP had been converted to a registered retirement income fund (RRIF) and you owned the RRIF at the time of your death.

Accrued amounts to date of death

Another rule provides that amounts payable periodically that have accrued to the time of your death are included in your income, even if they were not received by you. This category includes items such as interest accrued to the date of your death, and any salary or wages that accrued to the date of death. For example, if you are paid a monthly salary at the end of each month and you die half-way through a month, the half of that month's salary that accrued to your death would be included in your income.

Rights and things

The value of "rights and things" at your death may be included in your income. This category includes items such as declared but unpaid dividends on any shares you own, and any earned but unpaid employment income from a prior pay period. For example, if you died in the month of May and had not yet received your pay cheque for the month of April, the April salary would be a right or thing.

Although the rights and things are included in your income, your executor can elect to report them in a separate tax return rather than in your regular tax return for the year. The election must be made by the later of one year after your death and 90 days after the CRA sends a notice of assessment for the regular return. The main benefit to filing the separate return is that the rights or things are subject to a separate set of graduated tax rates, rather than being "stacked" on top of your other income in the regular return at your marginal rate of tax in the regular return. Another benefit is that you can double up on some of the personal tax credits and claim them in both returns – including the basic personal credit, the spousal credit, and the age credit.

However, if a right or thing is distributed to one of your beneficiaries within the time limit for filing the election, it is not included in your income in the regular return or separate return. Instead, it is included in the beneficiary's income when the right or thing is realized or disposed of.

AROUND THE COURTS

Surviving spouse not entitled to elect out of rollover on death

As discussed above, if you leave property to your spouse under your will, the property is subject to a tax-free rollover upon your death. However, your legal representative can elect out of the rollover, in which case the property is subject to deemed disposition at FMV and deemed acquisition by your spouse at FMV.

In the recent case of *Picard v. Lagotte*, a deceased left a rental property to her husband under her will. The husband wanted to elect out of the spousal rollover, hoping for an increased cost of the property at FMV and therefore a reduction in his future capital gains liability when he eventually sold the property. However, the deceased's legal representative opted for the tax-free rollover because it was in the best interests of the deceased and thus the beneficiaries of the remainder of the deceased's estate.

The deceased's husband sued the estate, claiming various damages including damages relating to his increased future tax liability because of the rollover. The Quebec Superior Court dismissed his claim, holding that it was clear law that the decision to take the rollover (or not) was that of the legal representative and not the husband.

* * *

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.