



TAX LETTER

May 2010

ACTIVE BUSINESS INCOME OF CCPC CONSOLIDATED REPORTING ON THE HORIZON? TAXATION OF BENEFICIARIES OF TRUSTS TRANSFER OF PROPERTY TO YOUR RRSP TAX CREDITS FOR STUDENTS KIDDIE TAX ON PRIVATE COMPANY DIVIDENDS BC AND ONTARIO: HST COMING YOUR WAY AROUND THE COURTS

ACTIVE BUSINESS INCOME OF CCPC

A corporation that qualifies as a Canadian-controlled private corporation (CCPC) is eligible for the small business deduction in respect of the tax on the first \$500,000 of its income from an “active business” carried on in Canada during a taxation year. The small business deduction results in a federal tax rate of 11% on the active business income.

The provinces provide similar small business deductions, and the amount varies depending on the province. For example, in Ontario the small business deduction leads to a combined federal and provincial rate of 16.5% on the first \$500,000 of active

business income, and the rate is scheduled to decrease to 15.5% effective July 1, 2010.

A CCPC is, in general terms, a private corporation resident in Canada that is not controlled, directly or indirectly, by non-residents or public corporations or a combination of the two. A corporation cannot be a CCPC if any of its shares are listed on a designated stock exchange. Most of the world’s major stock exchanges are designated for these purposes.

The term “active business” is essentially defined in negative terms under the Income Tax Act, as any business carried on by the corporation **other** than a “specified investment business” or a “personal services business”. Thus, income

from either of the latter types of business does not qualify for the small business deduction and is be taxed at the corporate tax rate that otherwise applies to the income.

A specified investment business of a CCPC in a taxation year means a business the principal purpose of which is to derive income from property (e.g. interest, dividends, rent from real property, and royalties), **unless** either a) the CCPC employs in the business throughout the year more than 5 full-time employees, or b) a corporation associated with the CCPC provides, in the course of carrying on an active business, managerial, administrative, financial, maintenance or other similar services to the CCPC, and the CCPC could reasonably be expected to require more than 5 full-time employees if those services had not been provided to it.

A personal services business of a CCPC in a taxation year means a business of providing services where an individual who performs the services on behalf of the CCPC (typically an employee or shareholder of the CCPC) or any person related to the individual is a “specified shareholder” of the CCPC, and the individual would reasonably be regarded as an employee of the person to whom the services were provided (the ostensible employer), but for the existence of the CCPC. Put more simply, this means that in the absence of the CCPC, there would be an employer-employee relationship between the individual providing the services and the ostensible employer. A personal services business does **not** include a situation where, in the absence of the CCPC, the individual would be viewed as a self-employed individual carrying on a business. For the above purposes, a specified shareholder is generally one who owns at least 10% of the shares of any class of the CCPC. Similar to

the exception above, a personal services business does not include a business that employs throughout the year more than five full-time employees.

For the above purposes, the “more than five full-time employees” exception can apply if the CCPC employs five full-time employees and at least one part-time employee throughout the year. The Canada Revenue Agency (CRA) previously took the position that the exception applied only if the CCPC employed at least six full-time employees, but changed that position after losing a court case on this issue.

CONSOLIDATED REPORTING ON THE HORIZON?

Under the Canadian income tax system, a related corporate group cannot file consolidated tax returns. Each corporation in the group must file its own return and compute its income separate from other corporations in the group. This means that, among other things, losses of one corporation cannot be used directly to reduce income of a related corporation.

As we reported in last month’s Tax Letter, in the 2010 federal budget the government announced that it would explore the introduction of a formal system of transferring losses within a related corporate group or a consolidated reporting system. Since then, both the Ontario and Quebec provincial governments indicated in their 2010 budgets that they would explore possible changes in this regard.

One significant challenge to such a system is the allocation of tax losses between provinces. For example, if a corporation operating in Ontario had a profit that could be offset by a loss of a corporation operating in Quebec,

the consolidation of tax reporting could lead to no tax payable, with the province of Ontario losing tax revenues relative to the current system. It is therefore expected that the federal government will consult with the provincial governments as well as various tax experts before implementing such a system. The federal budget and the provincial budgets indicated no firm timelines in this regard, so we will have to wait and watch for developments. In the meantime, the CRA does accept many schemes that are designed to transfer losses within a corporate group and often issues advance rulings approving such schemes.

TAXATION OF BENEFICIARIES OF TRUSTS

When income of a trust is paid to a beneficiary of the trust, the amount paid is normally deducted in computing the trust's income and is included in the beneficiary's income. This general rule applies to personal trusts, as well as commercial or investment trusts such as mutual funds.

For certain types of trust income, such as interest, rent, or business income paid to a beneficiary, the amount is simply included in the beneficiary's income as income from the beneficiary's interest in a trust. However, there are certain types of trust income that retain their character and therefore "flow through" to the beneficiaries as the same type of income. The most significant types of flowed-through income are dividends and capital gains.

Dividends

A Canadian resident trust that receives a taxable dividend from a Canadian resident corporation can pay out the amount to a beneficiary and "designate" it as a taxable dividend to the

beneficiary. Once the designation is made, the type of dividend (eligible or non-eligible) also flows through to the beneficiary. Thus, if the dividend is an "eligible dividend" (as are most dividends from public corporations), the beneficiary will include the dividend plus the 44% "gross-up" in income, and will be eligible for the enhanced dividend tax credit applicable to eligible dividends. (The gross-up was decreased from 45% to 44% for the 2010 year.)

If the taxable dividend is a non-eligible dividend, the beneficiary will include the dividend plus the 25% gross-up for such dividends and the beneficiary will be eligible for the applicable dividend tax credit. A non-eligible dividend includes a dividend paid by a CCPC out of its first \$500,000 of active business income that is eligible for the small business deduction.

Note that the flow-through of the gross-up and credit mechanism only applies to Canadian resident individual beneficiaries.

If a trust receives a non-taxable dividend, that status can also be flowed out to the beneficiary. A non-taxable dividend is generally a "capital dividend", which can be paid by Canadian private corporations out of their "capital dividend account". That account includes certain tax-free items such as the non-taxable half of capital gains realized by the corporation.

The trust must designate and report the type of dividend on its T3 slip issued to the beneficiary.

Capital gains

One-half of a trust's net capital gains (generally its taxable capital gains in excess of its allowable capital losses) can also be paid and flowed out to a beneficiary as

taxable capital gains. That flow-through status allows the beneficiary to use any allowable capital losses or loss carryovers from other years to offset the taxable capital gains. (That is, allowable capital losses can normally be deducted only against taxable capital gains, and not other forms of income.)

Additionally, if a trust realizes a taxable capital gain from the disposition of property that qualifies for the lifetime \$375,000 taxable capital gains exemption (qualified small business corporation shares, qualified farm property, or qualified fishing property), the amount will remain eligible for the exemption when paid out to the beneficiary.

As above, the trust will designate and indicate the taxable capital gains on the T3 slip issued to the beneficiary.

As a general rule, income of a trust paid to a non-resident beneficiary is simply treated as income from the interest in the trust and subject to 25% withholding tax (or less, such as 15% under the Canada-US tax treaty). The major exception to this general rule involves taxable capital gains of a mutual fund trust, which retain their character as taxable capital gains for the non-resident beneficiaries.

Tax-free amounts for beneficiaries where trust claims no deduction

Although income of a trust can flow out to the beneficiaries as just discussed, losses of a trust cannot. Therefore, any losses in the trust can be used only by the trust.

In this regard, a special mechanism under the Income Tax Act allows a trust to use its loss carry-forwards from previous years to effectively provide tax-free income to its

beneficiaries. Basically, if the trust has income in one (current) year, it can pay out the income to its beneficiaries without taking a deduction at the trust level, meaning that the income is reported by the trust. The trust can then make a designation in respect of the beneficiary, which results in the income paid out to the beneficiary not being included in the beneficiary's income. The trust can then use any loss carry-forwards from previous years to offset the income inclusion at the trust level in the current year. Note that if the trust is **not** a personal trust, the amount designated to the beneficiary will reduce the adjusted cost base of the beneficiary's interest in the trust, which may increase a subsequent capital gain if the beneficiary sells the interest."

TRANSFER OF PROPERTY TO YOUR RRSP

Most of us transfer cash into our RRSPs. However, certain RRSPs, generally self-directed plans, allow you to transfer property directly into the RRSP (assuming the property qualifies under the RRSP rules).

Thus, for example, if you own shares in a corporation, you can transfer the shares to your RRSP and claim a deduction equal to the fair market value of the shares at the time of the transfer.

However, the transfer of shares constitutes a disposition at fair market value for capital gains purposes, so the transfer may trigger tax. As a result, it usually makes sense to transfer property with little or no accrued gain.

Unfortunately, if you transfer shares with an accrued loss to your RRSP, the loss is denied, although you still get a RRSP deduction equal to the fair market value of the shares.

If you sell the shares at a loss on the market and contribute the cash proceeds to your RRSP, you of course get the deduction for the contribution. However, if your RRSP buys the same shares on the market within 30 days of your sale, your loss will be denied as a "superficial loss". So you should wait at least 31 days for your RRSP to buy the shares.

TAX CREDITS FOR STUDENTS

Students attending a post-secondary institution are eligible for various education-related credits.

For full-time students, the federal education credit is \$60 (15% of \$400) for each month during which the student was enrolled at a university or college. For these purposes, full-time study generally means a program of at least 3 consecutive weeks with at least 10 hours of courses or study per week. (The school should indicate this status on Form T2202.) Full-time study at certain trade schools, certified by the government as furnishing students with skills for an occupation, also qualifies.

For part-time students, the federal education credit is \$18 (15% of \$120) for each month of attendance, although students eligible for the disability tax credit or whose infirmity has been certified as preventing them from studying full-time get the higher amount of \$60 per month of part-time study.

Students attending a university outside Canada can qualify for the education credit, generally if the course is at least 13 consecutive weeks in duration and the course leads to a degree.

Students are also eligible for the tuition credit, which equals 15% of eligible tuition

fees, assuming they exceed \$100. For this purpose, eligible tuition fees include admission fees, academic fees, charges for the use of library or laboratory facilities, examination fees, application fees, and fees for ancillary services such as athletic and health services. The amount of an ancillary fee is limited to \$250 if the fee does not have to be paid by all students. Fees that do **not** qualify as eligible tuition fees include those paid to a student association, a charge for property to be acquired by students, and room and board and transportation.

Provinces offer similar education and tuition credits, and the amounts vary from province to province.

Students entitled to the education credit can claim the federal textbook credit, which is \$10 per month of full-time study and \$3 per month of part-time study. Part-time students who are eligible for the disability tax credit or whose infirmity has been certified as preventing them from studying full-time can claim the higher amount of \$10 per month.

If students cannot use the education, tuition and textbook credits because they have insufficient tax payable, they can normally transfer them to their spouse or common-law partner. If the student is not married or living common-law, or is not claimed as a dependant by his or her spouse or common-law partner, the student can transfer the credits to his or her parent or grandparent. In either case, the maximum federal amount that can be transferred is \$750 of credits (15% of \$5,000) per year.

Alternatively, students can carry forward the credits and claim them in a future year when they have enough tax payable to use the credits. Credits that are carried forward in this

way **cannot** be transferred to a spouse, common-law partner or parent or grandparent.

Lastly, for students paying off government loans or debt made under the Canada Student Loans Act, the Canada Student Financial Assistance Act, or similar provincial law, a credit of 15% of the interest paid on such debt in a year may be claimed. If the credit cannot be used in one year, it can be carried forward up to 5 years. This credit **cannot** be transferred to a spouse, common-law partner, parent or grandparent.

KIDDIE TAX ON PRIVATE COMPANY DIVIDENDS

Several years ago, the Department of Finance introduced the so-called kiddie tax in order to combat certain income-splitting arrangements that it felt were abusive from a tax policy perspective. The kiddie tax applies to the “split income” of a child for any year in which the child is under 17 years of age. The kiddie tax is a flat tax at the **highest** marginal rate of tax otherwise applicable to individuals (29% federal rate; the provincial rate depends on the province of residence). Furthermore, the only tax credits that can be claimed in respect of the kiddie tax are the dividend tax credit and the foreign tax credit, if applicable.

Split income includes, among other things, taxable dividends and shareholder benefits received from most private corporations, or more particularly, from a corporation whose shares are **not** listed on a designated stock exchange or a mutual fund trust.

Even in the case of private company dividends, there are a couple of exceptions where the kiddie tax does not apply. It does not apply where the shares were inherited upon the death of the child’s parent, or inherited from anyone else if the child is enrolled full-time in a qualifying post-secondary institution or qualifies for the disability tax credit.

Lastly, note that if the kiddie tax does not apply, the income attribution rules under the Income Tax Act may apply. For example, if you give or lend money to your minor child (under 18) and he or she uses it to buy shares in a company listed on the TSE, or mutual funds, any dividends received by your child will be attributed to you and included in your regular income until the year in which the child turns 18. However, any capital gains realized by the child will not be attributed to you.

BC AND ONTARIO: HST COMING YOUR WAY

Just a reminder to folks living or doing business in British Columbia and Ontario, the provincial retail sales tax in these provinces is being eliminated and replaced with the Harmonized Sales Tax (HST), beginning July 1, 2010. The HST, which includes the federal GST component (5%) and the provincial sales tax component, will be at the rate of 12% for B.C. and 13% for Ontario. Note that businesses currently registered for GST purposes will be automatically registered for HST purposes in these provinces.

This change will actually affect many businesses throughout Canada, not just in Ontario and BC. Our June issue will include a detailed article on the new HST rules.

AROUND THE COURTS

“Donations” made to charity were not gifts

As most readers know, donations made to a registered charity qualify for the donations tax credit.

In the recent *Coleman* case, a registered charity (NFCL) provided financial assistance in the form of bursaries and scholarships to students who attended certain Christian colleges or universities in Canada. Basically, each student was entitled to a bursary of 80% of the amount of donations the student solicited for the NFCL, and a scholarship of 10% to 20% of the amount of those donations. The total bursary and scholarship amounts were capped at a “maximum eligible amount”, which reflected all tuition, housing, books and other related expenses, net of any scholarships or bursaries that the student received from other sources.

Therefore, for example, if the student solicited donations equal to 125% of the maximum eligible amount, he would receive a bursary equal to the entire maximum eligible amount (i.e. 80% of 125% = 100%), meaning that the bursary would cover all of the student’s education costs.

Although there was a minimum grade requirement for the entering term, the student did not have to repay any bursary or scholarship already received if he or she failed to maintain the grade. However, the student might not be eligible for a bursary or scholarship for the next term.

The issue in the *Coleman* case was whether donations made by a parent of a student, which were solicited by the student, were donations made to NFCL and therefore

eligible for the donations tax credit. The CRA argued that they were not, basically on the grounds that the parent’s “donation” was made with the view and expectation that the student would receive total bursaries and scholarships reflecting 90-100% of those donations. Therefore, according to the CRA, the “donation” was not really a gift, and therefore not eligible for the credit.

Upon the taxpayers’ appeal, the Tax Court of Canada agreed with the CRA and denied the tax credit. The Court determined that there was a clear link and correlation between the donation made by the parent and the bursary and scholarship received by the student, such that the donation was not really a gift. Therefore, the taxpayers did not qualify for the donation credit.

Note that under draft rules, which when enacted will be effective for donations made after December 20, 2002, the donation in such a case would not be disqualified solely on the grounds that the donor received back an “advantage”, as long as the advantage did not exceed 80% of the donation. Under the draft rules, the donation would still qualify for the credit, although the amount of the donation for these purposes would be reduced by the amount of the advantage. Therefore, for example, if the donation was \$10,000 and the value of the advantage was \$8,000, the amount of \$2,000 could qualify for the credit.

* * *

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.