



TAX LETTER

November 2011

**NEW FAMILY CAREGIVER TAX CREDIT
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**NEW FAMILY CAREGIVER
TAX CREDIT**

In the 2011 Federal Budget, the government introduced a new "family caregiver" tax credit, which will apply starting in 2012. The new credit is a maximum of 15% of \$2,000 (\$300), and can apply where the existing dependent tax credits are claimed.

In particular, the new credit can be claimed for an individual for whom you are claiming the spousal credit, the equivalent-to-spouse credit, the child credit, the (regular) caregiver credit, or the infirm dependent credit.

Each credit except for the child credit is reduced when the dependent's income reaches a certain threshold (for the spousal and equivalent to spouse credit, it starts to be

reduced if they have any income). The thresholds at which the credits are completely phased out will be increased by the \$2,000 additional amount.

In order to claim the credit for a dependant who is 18 or older at the end of the year, the person must be dependent upon you by reason of mental or physical infirmity.

In the case of a dependent child who is under 18 at the end of the year (where you are claiming the child credit or the equivalent-to-spouse credit), the credit applies only if the child is, by reason of mental or physical infirmity, likely to be, for a long and continuous period of indefinite duration, dependent on others for significantly more assistance in attending to the child's personal

needs when compared to children of the same age.

Only one family caregiver tax credit can be claimed in respect of each infirm dependant. However, if you are eligible to claim the dependant credits described above for more than one person, the new credit may be claimed for each such person, assuming they meet the infirmity conditions described above.

The \$2,000 amount on which the credit is based will be indexed to inflation beginning in 2013.

TAXATION OF TRUSTS AND BENEFICIARIES

General rules

Income earned by a trust and retained in the trust (that is, not paid out to a beneficiary of the trust in the year the income is earned) is taxed to the trust. The trust is considered an individual for income tax purposes and a T3 tax return must be filed if tax is payable by the trust. The return is due within 90 days after the year end of the trust (this is usually March 31, but note that in a leap year such as 2012, it will be March 30).

In terms of how the trust is taxed, there are two basic types of trusts. Estates and other “testamentary trusts”, generally meaning trusts arising as a consequence of death, are taxed at the same graduated tax rates as apply to natural persons (human beings). On the other hand, “inter-vivos” trusts, generally including all other trusts such as mutual fund trusts and most family trusts, are taxed at a flat rate of tax on all of their income. The flat rate is the highest marginal rate of tax applicable to individuals (29% federal tax rate, the provincial tax varies by province).

Testamentary trusts are therefore taxed favourably relative to inter-vivos trusts; other tax advantages of testamentary trusts are discussed in the next section of this letter (“Estates and Testamentary Trusts”).

If the income of a trust is paid or payable to a beneficiary in the year it is earned, it is deducted in computing the trust’s income and included in the beneficiary’s income. For certain types of trust income, such as interest, rent, or business income paid or payable to the beneficiary, the amount is simply included in the beneficiary’s income as income from the beneficiary’s interest in the trust.

However, certain types of income of a Canadian resident trust (including a mutual fund trust) can retain their character when paid out to the trust’s beneficiaries (or unit holders). The most significant of these types of income are dividends and taxable capital gains.

“Flow-through” of dividends and taxable capital gains

Taxable dividends received by a trust from a Canadian resident corporation and paid out to a beneficiary can be designated by the trust as taxable dividends received by the beneficiary. As such, the character of the income as dividends “flows through” to the beneficiary. Furthermore, the type of dividend also flows through to the beneficiary.

For example, if the dividend is an “eligible dividend”, it will remain as such to the beneficiary, who will include it along with the regular 41% “gross-up” (for 2011) and will be eligible for the dividend tax credit applicable to eligible dividends. An eligible

dividend is generally one received from a public corporation out of its business income or from a Canadian-controlled private corporation (CCPC) out of its business income in excess of the \$500,000 small business income threshold. (See the discussion later in the Letter regarding the small business deduction available to CCPCs.)

If the dividend is a non-eligible dividend, such as a dividend paid by a CCPC out of its small business income, it will remain as a non-eligible dividend to the beneficiary, who will include it along with the 25% gross-up for such dividends. The beneficiary will be eligible for the applicable dividend tax credit.

Taxable capital gains of a trust can also be flowed out to a beneficiary, and thus treated as taxable capital gains in the beneficiary's hands. Also, the non-taxable half of the capital gains can be paid out tax-free to the beneficiary (one-half of capital gains are taxable capital gains and the other half is not taxed).

If the taxable capital gains flowed through to the beneficiary result from dispositions of property that qualify for the lifetime \$750,000 capital gains exemption (namely, qualified small business corporation shares, qualified farm property, or qualified fishing property), the amounts will be eligible for the exemption in the hands of the beneficiary.

The above flow-through rules do not normally apply to non-resident beneficiaries. Income paid to a non-resident is simply treated as income from the beneficiary's interest in the trust, and is subject to flat withholding tax of 25% (although sometimes reduced by tax treaty). One exception applies to taxable capital gains of a mutual fund trust,

which can retain their character as taxable capital gains for the non-resident beneficiaries.

When income can be paid out tax-free to a beneficiary

A special rule in the Income Tax Act allows a trust to designate and pay out its income to a beneficiary without claiming a deduction, with the result that it is not included in the beneficiary's income. The beneficiary will therefore receive the amount free of tax, although the trust will include the amount in its income.

The designation will be useful if the trust has loss carry-forwards available from other years. That is, the loss carry-forwards can offset the trust's income inclusion, and, as noted, the beneficiary will pay no tax on the income received.

The designation may also be useful if the trust is in a lower tax bracket than the beneficiary (e.g. if the trust is a testamentary trust), which will result in less tax payable on the income.

ESTATES AND TESTAMENTARY TRUSTS

As noted above, estates and other testamentary trusts, generally meaning trusts arising as a consequence of your death (with certain other requirements), are taxed at the same graduated tax rates as apply to natural persons. Thus, for example, in 2011 a testamentary trust is subject to the lowest federal tax rate of 15% on its income up to \$41,544. This contrasts with an inter-vivos trust, which is subject to a federal flat tax rate of 29% on the same amount of income. (Provincial taxes vary and depend on the

residence of the trust, which in turn may depend on where the trust is managed.)

A testamentary trust can have a taxation year ending at any time, as long as it does not exceed 12 months. Having an off-calendar taxation year can result in some tax deferral if the income is paid out to a beneficiary, because the beneficiary includes it in the beneficiary's taxation year in which the trust's taxation year ends.

For example, if a testamentary trust has a taxation year ending on January 31, the trust's income from February 1, 2011 to January 31, 2012 that was paid to a beneficiary would be included in the beneficiary's 2012 income. In other words, even though most of the income may have been earned by the trust during 2011, it is not included in the beneficiary's income until 2012.

Since a testamentary trust is taxed at graduated tax rates, there are income-splitting opportunities through the use of multiple testamentary trusts for various beneficiaries. Because each trust will be taxed separately at the graduated rates, there is the opportunity to have more income subject to low tax rates, relative to having all the income taxed in one trust. Furthermore, each trust can allocate income to its beneficiary (or beneficiaries), which leads to further income splitting.

For example, say you have three children and plan to leave them some property under your will. You could set up three testamentary trusts with each child being a beneficiary of one of the trusts. The income earned in each of the trusts would be subject to tax at the graduated rates, so the total income would be effectively split three ways.

Furthermore, any income from a trust that was paid to the children during the year would be included in their income and deducted from the trust's income. Therefore, the total income could be split six ways – some income taxed to each of the trusts and some income taxed in the hands of children.

If you plan to set up multiple testamentary trusts in your will, you should ensure that each trust has a different beneficiary or group of beneficiaries that is entitled to the income of the trust. Otherwise, if multiple trusts are structured so that the income accrues to the same beneficiary or the same group of beneficiaries, the CRA can treat all of the trusts as one trust. Obviously, this would largely defeat the objective of income splitting, since all of the trusts' income would be treated as if it had been received by one trust only.

Note that the income attribution rules do not apply after your death, so that they are not a concern in the above scenario.

Trust planning is complex, and there are many legal and tax issues which need to be planned properly with professional advice. This discussion only scratches the surface.

SUPERFICIAL LOSSES

The superficial loss rules in the Income Tax Act are meant to prevent you from claiming a capital loss on the disposition of property when you (or an affiliated person) acquire the same or identical property within a set period of time as described below. Basically, the government doesn't want you to claim a loss for tax purposes when you haven't "really" disposed of the property.

The superficial loss rules can apply when:

- You dispose of a property at a loss; and
- You or an “affiliated person” (described below) acquires the property or an identical property within the period that begins 30 days before the disposition and ends 30 days after the disposition, and owns the property at the end of that period.

When the rules apply, your loss on the disposition is denied. Instead, the amount of the loss is added to the cost of the property acquired (or reacquired) by you or the affiliated person.

For these purposes, an affiliated person includes your spouse or common-law partner, a corporation that you control, and a partnership of which you are a majority-interest partner, among others.

Example

You sell 1,000 common shares in X Corp at a total loss of \$10,000, or a loss of \$10 per share. Two days later, your spouse buys 1,000 common shares in X Corp at a cost of \$15 each, and she continues to own them at the end of the 30-day period.

Your capital loss of \$10 per share is denied. However, your spouse’s cost of each share is increased by \$10, to \$25 per share. Effectively, your accrued loss on the shares is transferred to your spouse. For example, if she later sells them for \$15 per share, there will be a loss of \$10 per share.

An affiliated person does **not** include your child, so the superficial loss rules will not apply if your child acquires the property within the time period described above.

The rules do not apply if you wait for more than 30 days after the disposition to reacquire the property. Thus, if you sell shares at a loss and reacquire the same shares 31 days later, your loss will not be denied.

Note also that the above rules apply to individuals. Similar but not identical rules apply where the disposition is made by a corporation, partnership, or trust.

SMALL BUSINESS DEDUCTION FOR ACTIVE BUSINESS INCOME OF CCPC

A corporation that qualifies as a Canadian-controlled private corporation (CCPC) is eligible for the small business deduction on the first \$500,000 of its income from an active business carried on in Canada during a taxation year. The “deduction” is actually a tax credit, in that it reduces the tax rate for the year. The small business deduction results in a federal tax rate of 11% on the income. This compares to the federal rate of 16.5% (for 2011) on other business income not eligible for the small business deduction.

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 15.5% (rather than 28%) on the first \$500,000 of active business income.

In general terms, a CCPC is defined as 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 major stock exchanges in the world are designated).

The term “active business” carried on by a corporation is 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”. As a result, income from either of these businesses does not qualify for the small business deduction, even if it is otherwise considered a business. (Income from property is also not active business income.)

For these purposes, a specified investment business 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, or royalties), **unless** either a) the CCPC employs in the business throughout the year more than five 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 five 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 (e.g. an employee 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, 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 person receiving the services. 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 relevant year, or, obviously, six or more full-time employees throughout the year.

AROUND THE COURTS

Full deduction allowed for catering and meal expenses

If you incur meal or entertainment expenses in the course of earning income from a business, your deduction for the expenses is normally limited to 50% of the expenses. The 50% expense limitation is ostensibly in place because meals and entertainment provide at least some personal pleasure and therefore are not normally wholly for business purposes.

One exception, where the 50% limitation does **not** apply, is where the expenses are incurred “for food, beverages or entertainment

provided for, or in expectation of, compensation in the ordinary course of a business carried on by that person of providing the food, beverages or entertainment for compensation”.

In the recent *Pink Elephant* case, the issue was whether this exception applied to the taxpayer, who was in the business of providing educational technology courses. The courses were typically offered at hotels, and the taxpayer hired a caterer to provide breakfast and lunch to the participants in the course. The invoices issued to the participants indicated only the total costs of the course, and did not separately bill or identify the costs of the meals.

The CRA limited the taxpayer’s meal deductions to 50%, arguing the exception did not apply to the taxpayer.

On appeal, the Tax Court of Canada allowed the taxpayer's deductions in full. The Court found that the ordinary course of business of the taxpayer included the provision of educational courses, and that the provision of those courses included providing breakfast and lunch to the participants. As such, the food was provided for compensation in the ordinary course of the taxpayer’s business, so the exception applied and the 50% limitation did not apply.

The CRA had also argued that, since the taxpayer’s invoices did not separately identify the amount that the participants were paying for the meals, the meals were not provided for compensation. The Court rejected this argument, holding that a reasonable allocation of the costs paid for the courses could be made for the meals notwithstanding that they were not separately identified; as such, the meals were provided for compensation.

Gain upon redemption of non-interest-bearing debt was interest

In the recent *Goulet* case, the taxpayer had acquired various debt instruments issued by corporations without any stipulated interest. Instead of paying stipulated interest, the instruments were issued at a discount to face value.

Upon redemption of the debt instruments at face value, which were above the price paid by the taxpayer because of the discount, the taxpayer claimed that the excess amounts were capital gains because the debt instruments were capital property. As such, the taxpayer reported one-half of the amounts as taxable capital gains.

Upon appeal to the Tax Court, and further to the Federal Court of Appeal, it was held that the applicable provisions and regulations of the Income Tax Act provide that discounts of this sort are treated as interest. As a result, the redemption amounts in excess of the purchase price (i.e. the discounts) were fully included as interest income.

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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.