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TAX LETTER

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PRESCRIBED AUTOMOBILE AMOUNTS FOR 2013

CCA, interest on car loans, and leasing expense limits

If you carry on a business, you are allowed to deduct car expenses incurred in the course of your business. Similarly, certain employees can deduct their car expenses incurred in the course of employment (note that driving from home to work and back is personal driving, not employment driving).

For 2013, the monetary limits for capital cost allowance (CCA) in respect of a car that you own, interest expense incurred on borrowed money used to buy a car, or leasing costs in respect of a car that you lease, remain unchanged. (CCA is depreciation that you are allowed to claim for income tax purposes.) For cars purchased or car leases entered into after 2000 and through 2013, the limits are:

- The maximum cost of your car on which CCA can be claimed is $30,000 plus applicable federal and provincial sales taxes;
- The maximum allowable interest deduction for car loans is $300 per 30-day period in the year; and
- The general limit on deductible leasing costs is $800 per 30-day period in the year plus applicable federal and provincial sales tax. However, the deductible lease payments can be reduced further, generally if the manufacturer's list price of your car exceeds the capital cost ceiling.

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Tax-free car allowances

If you use your car for employment purposes, you can receive a tax-free allowance in respect of the employment use of the car if the allowance is reasonable. From the employer's perspective, if certain monetary limits are not exceeded, the entire allowance should be deductible.

For 2013, the monetary limits are increased by 1 cent over last year's amounts to 54 cents for the first 5,000 kilometres driven in the course of employment and 48 cents for each additional kilometre driven. For Yukon, the Northwest Territories and Nunavut, the allowance limits are also increased by 1 cent to 58 cents for the first 5,000 kilometres driven and 52 cents for each additional kilometre driven.

Employee car benefits

If your employer provides you with a car and pays any of your personal operating costs, you are required to include an operating expense benefit in income. (See our January letter regarding GST/HST to be remitted in respect of the benefit.) For 2013, the prescribed rate used to determine this benefit is increased by 1 cent over last year's amount to 27 cents per kilometre. For employees who are employed principally in selling or leasing automobiles, the prescribed rate is also increased by 1 cent to 22 cents per kilometre.

The benefit is not included in your income if you repay the expenses in full to your employer in the year or by February 15 of the following year. If you repay only a portion of the expenses, the benefit is simply reduced by the amount of the repayment.

SUPERFICIAL LOSSES

If you sell property such as shares or other securities at a loss and then reacquire the same or identical property, you may be subject to the "superficial loss" rules under the Income Tax Act. If so, the loss will be denied.

In particular, you will have a superficial loss if you dispose of a property at a loss and

- you or an "affiliated person" acquire the same or identical property in the period that begins 30 days before the disposition and ends 30 days after the disposition, and

- you or an affiliated person own the property or identical property at the end of that period.

For these purposes, an affiliated person includes your spouse or common-law partner and a corporation that you control (among others). It does not include your children, so losses can be triggered by sales to your children without worrying about the superficial loss rules.

Although the loss will be denied when the rules apply, the loss will in turn be added to the cost of the property, so it may effectively be allowed in the future on another disposition.

Example

Henry sells 1,000 common shares in XCorp at a loss of $10,000 (his cost was $20 per share, and he sells them for $10 per share). Within 30 days after the sale, his spouse Joan buys 1,000 common shares in XCorp at a cost of $12 per

share, for a total cost of $12,000, and continues to own them at the end of the 30-day period.

Henry’s $10,000 loss is denied, but is added to Joan’s cost of the shares, which becomes $22,000. Thus, Joan’s shares will effectively inherit Henry's accrued loss of $10,000 because of the stepped-up cost. If she subsequently sells the shares when they are worth $14,000, she will have a loss of $8,000 ($22,000 − $14,000) that she can use at that time (assuming Henry or Joan don’t reacquire the shares and trigger the superficial loss rules again).

The superficial loss rules do not apply to losses triggered by your death (as discussed below, there is a deemed disposition of your capital properties at fair market value). Therefore, if you leave property to your spouse on your death and a loss is triggered, it will not be denied.

TAXATION ON DEATH

Despite the lack of Canadian estate or succession tax, there may be income tax payable on death, due to certain "deemed disposition" rules under the Income Tax Act.

In particular, when you die, you are deemed to have disposed of most of your capital properties (and land inventory and certain resource properties), immediately before death, for proceeds equal to their fair market value. Thus, if that value exceeds your cost of the property, you will have a capital gain, half of which will be a taxable capital gain included in your income for the year of death. The person acquiring the property as a consequence of your death will have a cost equal to the fair market value.

If the value is less than your cost, you will have a capital loss, half of which will be an allowable capital loss and deducted against your taxable capital gains, if any. Furthermore, any excess allowable capital losses will be deductible against your other sources of income in the year of death or the preceding year – which is different from the regular rule regarding capital losses during your lifetime, which prevents them from being deducted from other sources of income.

Example

Joe died in 2013. At the time of death, he owned two capital properties. One had a cost of $100,000 and fair market value of $200,000, while the other had a cost of $240,000 and a fair market value of $100,000.

Joe will have a deemed capital gain of $100,000 and taxable capital gain of $50,000. He will also have a deemed capital loss of $140,000 and allowable capital loss of $70,000. Therefore, the net taxable capital gains will be nil, leaving another $20,000 of allowable capital losses that can be deducted against his other sources of income in 2013 or the preceding year 2012.

Rollover to spouse

An exception to the above rule applies if you leave capital property to your spouse (or common-law partner). In this case, you have a deemed disposition of those properties at their cost to you (a tax-free “rollover”), which means there is no gain or loss, and your spouse takes over your cost of the property.

There is a similar rollover if you leave property to a qualifying spousal trust, which

must meet certain conditions under the Income Tax Act.

However, your executor has the option of electing out of the rollover on a property-by-property basis, which results in the deemed disposition at fair market value under the regular rules discussed above. This election may be useful if the property has an accrued loss, so as to trigger the loss and apply it against other income in the year of death. Even if the property has an accrued gain, it might be useful to use the election to trigger the gain if you have other losses that can serve to offset the gain. In such case, your spouse would benefit from a bumped-up cost of the property to its fair market value.

The election out of the rollover can also be useful if the property is a qualified small business corporation share or qualified farm or fishing property, the gains from which are eligible for the $750,000 lifetime capital gains exemption. Assuming you had an exemption remaining, the triggered gains could be offset by your exemption, and again your spouse would benefit from a bumped-up cost of the property.

INCOME SPLITTING AND THE ATTRIBUTION RULES

Due to our progressive income tax brackets, you can save tax if you can successfully split income with your family members. For example, if you are in the top federal tax bracket of 29% (for 2013, income over $135,054), it would obviously be beneficial if you could shift some income to your spouse or child in the lowest federal bracket of 15% (not to mention that their tax credits could offset some or all of the tax on the shifted income). The tax savings are even greater when you factor in the provincial income tax, which also applies at progressive rates in most provinces.

Unfortunately, things are not quite that simple. There are "income attribution rules" under the Income Tax Act that can apply when you lend or transfer property to your spouse (or common-law partner) or child under 18. When these rules apply, any income from the property will be attributed to you and included in your income rather than in their income. In addition, taxable capital gains on property lent or transferred to your spouse can be attributed back to you.

If the rules apply, they will continue to apply to income or capital gains from property substituted for the property that you lent or transferred. For example, if you give your spouse cash and he uses the cash to purchase bonds that pay interest (income from property), the interest will be included in your income, unless you fall within one of the exceptions described below. And if he sells the bonds and uses the proceeds to buy another income-producing property, the attribution rules can continue to apply.

There is normally no attribution if you lend or transfer property to your children and they realize subsequent capital gains from dispositions of the property. Therefore, you can easily and legitimately split capital gains with your children. For example, you can purchase publicly-traded common shares or equity mutual funds for your minor children, and subsequent taxable capital gains on the property will be included in their income, rather than yours. (Note however that the so-called "kiddie tax" described below can apply at a high rate to certain capital gains earned by children under 18.)

The attribution rules are two-sided, so losses from the lent or transferred property will also be attributed to you rather than your spouse or children.

Exceptions

Fortunately, there are quite a few exceptions to the attribution rules. The main ones are as follows.

The rules do not apply to income from business. Therefore, you can give or lend property to your spouse or minor children to earn business income and the resulting income will not be attributed to you.

The rules do not apply if you lend money at the prescribed rate of interest, as long as they actually pay the interest each year or by January 30 of the following year. The prescribed rate is currently 1%, so now is an ideal time to engage in this type of income-splitting. For example, suppose you lend money to your low-tax bracket spouse at 1%, and he earns a 5% return by investing the money. Assuming he pays the interest on a timely basis, the attribution rules will not apply, so he will include a net of 4% in income each year (the 5% he earns, minus the 1% interest he pays to you). You will include the 1% interest that you received from him as income.

The rules do not apply if you receive at least fair market value consideration for the property. Similar to the lending exception above, if the consideration is debt, you must charge at least the prescribed rate of interest, and they must pay you the interest each year or by January 30 of the following year. Also, in the case of your spouse, if you transfer property under this exception you must elect out of the tax-free “rollover” on the transfer, which is otherwise available for transfers between spouses. This means that the transfer of the property will normally take place at fair market value, which could generate a capital gain for you if the value exceeds your cost of the property. Unfortunately, because of the superficial loss rules described above, any loss on the transfer will normally be denied.

The rules do not apply to "secondary" income. If you transfer property to your spouse or minor child and they earn income that is attributed back to you, but they reinvest that income, the secondary income earned on the reinvested income is not subject to attribution.

The rules do not apply throughout the year in which your minor child turns 18 or later years. Thus, in effect, you can lend or give funds to your child in the year they turn 17, as long as the funds are invested so as not to pay any interest or dividend until the next year, the year in which the child turns 18.

The rules do not apply to transfers of property to children 18 years of age or older. However, for *loans*, there is an anti-avoidance rule that can apply if you lend money to a child (minor or adult) or another non-arm’s length person and one of the main reasons is to reduce your tax payable. As above, there is an exception to this anti-avoidance rule if you charge at least the prescribed rate of interest on the loan (currently 1%).

In the case of loans or transfers to spouses, the rules cease to apply when you divorce. Furthermore, the income attribution rules cease to apply during your separation, although the capital gains attribution rules cease during your separation only if you and you ex-spouse make an election.

The rules obviously do not apply if the property generates no income or capital gains.

Since income or capital gains from a tax-free savings account (TFSA) are not included in income, you can put cash into your spouse’s

or adult child's TFSA and there will be no attribution on any subsequent income. Of course, this has to be within the spouse's or child's TFSA contribution room limit.

Tax on split income of minor child ("kiddie tax")

In addition to the attribution rules, there is a separate rule that applies to tax the "split income" of a minor child at the highest marginal rate of tax. (This is known informally as the "kiddie tax".) Thus, although there is no attribution, the splitting of such income is not beneficial because the child is subject to tax at the highest rate.

For these purposes, split income includes shareholder benefits and dividends received from shares of corporations other than publicly-traded shares and mutual funds. In general terms, it also includes certain trust or partnership income derived from services or property provided to a business in which a parent is involved (more specific criteria actually apply).

In addition, the 2011 federal budget added to the concept of split income. Now, if a child sells property (other than publicly-listed shares or mutual funds) to a non-arm's length person at a gain, the amount of the gain is deemed to be a dividend and is therefore "split income" subject to the kiddie tax.

The tax on split income does not apply in the year in which the child turns 18 or later years. It also does not apply to income or gains from property inherited from a parent, or inherited from anyone else if the child is enrolled full-time in post-secondary education or is disabled.

In most (but not all) cases, the parent of the child is jointly and severally liable, along with the child, to pay the tax.

CHILDREN'S FITNESS AND ARTS CREDITS

These federal credits are each worth up to 15% of $500 (i.e. $75) of eligible fitness or arts expenses per year incurred per child 16 years of age or under during the year, or 18 years of age or under if the child is disabled and eligible for the disability tax credit. In addition, if you incur at least $100 on such a disabled child, you can earn an additional $75 federal credit.

Either parent can claim the credit, or the parents can share the credit. If they do not agree on the portions of the credit to share, the Canada Revenue Agency will make the decision.

The eligible expenses include registration fees for a prescribed physical activity, or prescribed artistic or cultural activity, as the case may be. Such fees can include amounts paid for administration of the program, instruction, rental or required facilities, and uniforms.

The qualifying physical programs include activities such as football, soccer, baseball, hockey, ballet, karate, and golf, among others. The qualifying arts programs include visual arts, music, media, languages, and the performing arts.

Generally, the program must be a minimum of eight consecutive weeks, or in the case of children's camps, at least five consecutive days. You should receive a tax receipt from the organization providing the fitness or art activity.

Note that some provinces also provide a provincial credit for such expenses.

ERRATUM RE: CHILD CARE EXPENSES

In last month's letter, the example involving child care expenses had an error regarding the deduction for the husband, Jack. His deductible amount should have been $2,850, **not** $7,850. The correct version of the example, with the correct amount in bold, is as follows.

Jack and Jill are married and have two children aged 4 and 9. Jill had earned income of $90,000 and Jack had earned income of $15,000 in the year. Jack attended university on a full-time basis for 26 weeks in the year. They paid $15,000 of child care expenses for the year.

Jill's deduction: Lesser of

- 2/3 of $90,000 earned income = $60,000
- $7,000 + $4,000 annual child amounts = $11,000
- $15,000 expenses
- 26 weeks that Jack was in school x ($175 + $100) = $7,150

Therefore, Jill can deduct $7,150.

Jack's deduction: Lesser of

- 2/3 of $15,000 earned income = $10,000 − $7,150 claimed by Jill = **$2,850**
- $11,000 annual amounts − $7,150 claimed by Jill = **$3,850**

Therefore, Jack can deduct **$2,850**.

We sincerely apologize for the error.

AROUND THE COURTS

Amounts received under "Ponzi scheme" were income

In the recent *Johnson* case, the taxpayer was introduced to an investor by a close friend. She was led to believe that the investor could earn her significant amounts by trading in options. She invested money with the investor over a number of years, and earned significant profits in the two taxation years in question − over $600,000 in each year. On the investor's advice, she did not report the amount for income tax purposes.

Subsequently, the investor was investigated in respect of and charged with operating a "Ponzi scheme", under which the taxpayer was paid from money that the investor had "shuffled", having received the money from other people through the operation of his Ponzi scheme. (Many people lost significant amounts under the scheme.) The taxpayer had been unaware of the Ponzi scheme, having believed that the investor was successfully trading in options. The CRA then re-assessed the taxpayer, including the Ponzi profits in her income. CRA won the appeal since the Court of Appeal ruled that such payments were income from property in the pursuit of profit.

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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.