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TAX LETTER

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THE CAPITAL GAINS EXEMPTION

Under the Income Tax Act, every individual resident in Canada has a lifetime $750,000 capital gains exemption that applies to capital gains from certain types of property (described below). The exemption is actually a deduction, in that one-half of the capital gains, or $375,000 of the taxable capital gains, is deductible in computing your taxable income.

In this year's Federal Budget, the government increased the lifetime limit to $800,000 of capital gains ($400,000 taxable capital gains), beginning for capital gains realized in 2014. After that, the limit will be increased annually to account for inflation. So even if you have used your maximum exemption, a small amount of new exemption room will be created every year.

The exemption applies to taxable capital gains realized from the disposition of a qualified small business corporation share ("QSBC share"). In general terms, a QSBC share is a share of a "small business corporation", which is a Canadian-controlled private corporation ("CCPC"), all or substantially all of whose assets are comprised of

1) assets used principally in an active business carried on primarily in Canada, and/or

2) shares or debt in other small business corporations with which it is "connected" (meaning it either controls the other corporation or owns at least 10% of the shares (votes and value) of the other corporation).

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For these purposes, the Canada Revenue Agency (CRA) takes the position that "all or substantially all" means 90% or more. "Principally" or "primarily" means more than 50% of the time.

In general terms, a CCPC is a private corporation resident in Canada that is not controlled by non-residents, public corporations, or a combination of the two.

Furthermore, there are two holding period requirements.

First, for the 24 months prior to the disposition by the taxpayer, the QSBC share must not have been owned by anyone other than the taxpayer or a related person.

Second, throughout the same 24 month period, more than 50% of the corporation's assets (on a fair market value basis) must have been comprised of assets used principally in an active business carried on primarily in Canada, or shares or debt in other CCPCs that met the same over-50% threshold. (This is a general explanation. The actual requirements are somewhat more technical.)

Exemption reduced by ABILS

The exemption that you can claim in a year is reduced to the extent of allowable business investment losses (ABILs) that you have claimed. An ABIL is, in general terms, one-half of a capital loss incurred on the disposition of a share or debt in a small business corporation (with certain other criteria). An ABIL is deductible against all sources of income, and not just taxable capital gains.

Example

In 2013, you realize a taxable capital gain of $100,000 from the disposition of QSBC shares. You have not previously used any of your capital gains exemption. However, in 2012 you claimed an ABIL of $40,000.

The amount of the taxable capital gain eligible for the exemption in 2013 is reduced to $60,000. The remaining taxable capital gain of $40,000 will be included in your taxable income.

Exemption reduced by CNILs

The exemption you can claim in a year is also reduced by your cumulative net investment loss (CNIL) at the end of the year. The CNIL is basically the total of your investment expenses in excess of your investment income for all years going back to 1988.

Other properties

Lastly, the capital gains exemption also applies to gains from dispositions of qualified farm or fishing properties, which include shares in certain corporations and interests in partnerships that carry on a farming or fishing business in Canada. Various criteria must be met, including a holding period similar to that for QSBC shares.

INCOME TAX RELIEF FOR FIRST TIME HOME BUYERS

The Income Tax Act contains significant tax benefits for individuals acquiring a home: the Home Buyers' Plan and the First-time

Home Buyers' Credit. Although each applies to first-time buyers, as discussed below, these measures can apply to certain other purchasers as well.

Home Buyers' Plan (HBP)

Under the HBP, you are allowed to withdraw up to $25,000 from your registered retirement savings plan (RRSP) for the purchase of a home on a tax-free basis, although it must be repaid over 15 years as explained below. Your spouse (or common-law partner) is also allowed to withdraw the same amount from his or her RRSP, so a couple can withdraw up to $50,000 tax-free.

As noted, the HBP withdrawal is aimed at first-time buyers, but it is actually broader. The tax-free withdrawal under the HBP is allowed in a year if neither you nor your spouse owned another home in the period beginning at the start of the fourth year before the year of withdrawal and ending on the 31st day before the withdrawal. This ownership period is waived for homes acquired for disabled persons eligible for the disability tax credit, where the acquisition was made to provide a more accessible home or better-suited environment for that person.

The new home must be acquired by October 1 of the year following the year of withdrawal. You can acquire it up to 30 days before the withdrawal.

When you make the withdrawal, you must fill out Form T1036, which will be provided by your RRSP issuer. No tax will be withheld from the withdrawal.

The HBP withdrawal must be repaid to the RRSP within 15 years, without interest. The repayments are made by way of a regular contribution to your RRSP, with a repayment designation made in your tax return for the year.

The repayment period starts in the second year after the year of withdrawal, with a minimum of 1/15 due each year. The repayment can be made in the year or within 60 days after the end of the year (similar to regular RRSP contributions). Unlike other RRSP contributions, the repayments are not deductible. Early or extra repayments are allowed.

If you do not repay the minimum amount in a year, the shortfall will be included in your income for that year. If you repay more than the minimum, that reduces the amount you have to repay in the next year.

Lastly, note that the HBP withdrawal does not affect the amount you can withdraw from your RRSP under the Lifelong Learning Plan (for post-secondary education), or vice versa.

First-time Home Buyers' Credit

This is a $750 federal tax credit that applies if you acquire a home and neither you nor your spouse (or common-law partner) owned a home in the period beginning with the start of the fourth year before the year of acquisition and ending on the day before the acquisition. If the home is acquired by a person eligible for the disability tax credit or for a related person eligible for the credit and the acquisition was made to provide a more accessible home or better-suited environment for that person, the 4-year non-ownership rule is waived.

The new home must be inhabited within one year after its acquisition. The credit is claimed on your return for the year of acquisition.

Either you or your spouse can claim the credit, or share the credit. It can only be used to the extent you have federal tax to pay for the year (before applying instalments and tax withheld at source).

REGISTERED EDUCATION SAVINGS PLANS

A registered education savings plan (RESP) allows you to invest funds on a tax-deferred basis for the purpose of funding your child's post-secondary education (or that of your grandchild, or any other person for that matter). The RESP can hold most investments that qualify for RRSP purposes, such as mutual funds, stock and bonds, GICs, and government savings bonds.

Income earned in the RESP is exempt from tax while it remains in the plan. Once your child begins post-secondary education, his or her withdrawals of income from the plan (including the Canada Education Savings Grants described below) are included in your child's income. However, assuming that they will be in a lower tax bracket than you, or might not have enough income to be paying tax at all, the RESP provides an effective means of income-splitting. Withdrawals of the contributed capital are not included in income.

Contribution to the RESP are not tax-deductible. Similarly, if you borrow to contribute to the RESP, the interest on the loan is not deductible.

There are limits on the contribution amounts and periods. Generally, you can contribute to the plan for up to 31 years, and the plan must be terminated within 35 years after it was set up. These periods are extended to 35 years and 40 years, respectively, if the beneficiary of the plan is eligible for the disability tax credit.

There is no annual limit on the contributions. However, there is a lifetime limit of $50,000 per child / beneficiary. There is 1% per month penalty for excessive contributions.

Child does not attend university or college

If your child (or other beneficiary) does not attend post-secondary education, your contributions to the RESP can be returned to you tax-free. The income in the plan can also be distributed to you, generally if at least 9 years have passed since the year the RESP was set up and your child (beneficiary) is at least 21 years old and not attending post-secondary education, the child is deceased, or the plan is being terminated because of the time limits described above. The CRA can waive the 9-year / 21 age requirement if the child is unable to attend school because of a mental or physical infirmity.

The distributed income from the RESP will be included in your income. Furthermore, you will be liable to an additional 20% penalty tax on that amount. The purpose of the penalty tax is to compensate for the fact that the funds in the RESP grew tax-free even though they were not ultimately used for education purposes.

The penalty tax can be avoided on up to $50,000 of such income if it is contributed to your RRSP (assuming you have sufficient RRSP deduction room). The RRSP deduction will also eliminate the regular tax on up to that $50,000 amount.

Canada Education Savings Grant (CESG)

Your annual contributions to an RESP for your child will also attract the CESG from the federal government if your child is under the age of 18. The basic CESG is 20% of up to $2,500 of contributions per year, for a maximum grant of $500 per child per year. The lifetime maximum grant is $7,200 per child. Unused CESG room (where you do not contribute at least $2,500 in a year) is carried forward, although the most CESG that can be received in any one year is $1,000.

For lower income families, an additional 10% or 20% CESG applies to the first $500 of annual contributions (depending on income level).

The CESG is deposited directly by the government into your child's RESP.

When your child is 16 or 17 years old, there is a further requirement for receiving the CESG. One of the two following conditions must be met:

> You contributed at least $2,000 to the RESP before the year in which the child turned 16; or
>
> At least $100 was contributed in at least 4 years prior to the year in which the child turned 16.

The CESG and any income earned on the grant will be included in your child's income when withdrawn.

Lastly, there is further assistance, up to a maximum of $2,000, under the Canada Learning Bond (CLB). The CLB generally applies to lower-income families eligible for the National Child Benefit.

NEW PENALTY TAX FOR EPSPS

An "employees profit sharing plan" (EPSP) is a trust plan that allows employers to share some of their profits with their employees. The employer's contributions to the EPSP are deductible, and each year the EPSP allocates to the employees their share of the contributions and income earned in the plan. The employees include these allocated amounts in their income.

As a result, in the 2012 Federal Budget, the government introduced a new tax to "ensure that EPSPs are used for their intended purposes". The new tax applies to excess EPSP contributions made in a year. Basically, this excess amount is the employer's contributions in a year to the EPSP that are allocated in the year to a "specified employee" in excess of 20% of the employee's other employment income for the year.

The new tax on the excess amount is at the highest marginal federal rate of 29%, plus 14% as a substitute for provincial tax (for all provinces except Quebec). The tax is payable by the specified employee.

For these purposes, a "specified employee" is generally an employee who owns at least 10% of the shares of *any* class of the employer corporation, or who does not deal at arm's length with the employer. There are various deeming rules that apply – for example, for these purposes an employee is deemed to own shares owned by a related person or other person with whom they do not deal at arm's length. Therefore, if you own at least 10% of the shares of a class of the employer corporation, your spouse and children who are employees will be considered specified employees and can be liable for the tax.

The excess amount is deductible in computing regular income for tax purposes, to avoid double taxation of that amount.

The CRA can waive the new tax if it considers it "just and equitable to do so".

NEW LOSS-TRADING RULES FOR TRUSTS

There are numerous "loss-trading" rules under the Income Tax Act that prevent losses being claimed by a corporation after a change in control of the corporation. When control of a corporation is acquired, there is a deemed taxation year end of the corporation. Net capital losses of the corporation before the change of control cannot be carried forward to later years, and net capital losses after the change of control cannot be carried back to previous years. Non-capital losses (e.g. business losses) can be carried forward after the change of control, but only to the extent of income from the same or substantially similar business that the corporation carried on before the change of control. Similar rules restrict the use of certain tax benefits, such as investment tax credits, after a change in control.

Until recently, there were no similar rules for trusts. However, the 2013 Federal Budget introduced new rules that apply to trusts. In general terms, trusts will be subject to the same loss-trading restrictions that apply to corporations. The triggering event for trusts will be a "loss restriction event", which will occur at any time at which a person becomes a "majority-interest beneficiary" or a group of persons becomes a "majority-interest group of beneficiaries" of the trust.

In general terms, a majority-interest beneficiary or group of beneficiaries is a person or group or persons that has an income interest or interests in the trust whose value is more than 50% of the value of all income interest in the trust, or a capital interest or interests in the trust whose value is more than 50% of all of the capital interests.

There are some exceptions to the new trust rules, similar to those applicable to the corporate rules. For example, the new rules will not apply solely by reason of a person acquiring an interest in the trust from an affiliated person, from a person who was affiliated with the trust, or from an estate that arose on the death of another person to whom the person was affiliated. Persons affiliated with you include, among other persons, your spouse and a corporation controlled by you or your spouse.

SELLING A CONDO PARKING SPACE — CORRECTION

In our June letter, we wrote about a "surprise GST/HST refund" that is available to the vendor on a taxable sale of real property, to prevent double tax.

In describing the refund, we used the example of a residential condominium parking space.

That example was incorrect. In most cases, **if an individual sells a condominium parking space that was acquired for personal use, the sale will be exempt** under *Excise Tax Act* section V-I-9, the rule that applies to most sales of vacant land by individuals.

We apologize for the error.

If no GST/HST applies on the sale, then the refund to prevent double tax is not available.

As we noted in the June article, this refund (credit or rebate) applies in situations where a taxpayer buys real property and pays GST or HST that they can't recover, and then sells the property later. For example, it applies to an office building owned and used for their practice by a doctor or dentist who can't claim input tax credits because their services are GST- or HST-exempt, and then sells the building.

As explained in the June article, the refund is based on the "basic tax content" of the property, which is basically the GST or HST paid on buying it, but prorated down if the property has gone down in value. However, note that **in British Columbia** where the HST was eliminated as of April 2013, the 7% provincial portion of the HST paid from July 2010 through March 2013 is excluded from the "basic tax content" and so is not recoverable.

AROUND THE COURTS

Moving expenses denied in year of move but allowed when job found

You are allowed to deduct certain moving expenses incurred in an "eligible relocation", which is generally one that enables you to carry on business or employment in a new work location. Your new home must be at least 40 kilometres closer to the new work location than your former home. Your deductible expenses are limited to your income in the year from the new work location (any excess can be carried forward and deducted in a later year).

In the recent *Evangelist* case, the taxpayer lost his job in the town of Rivière-du-Loup, Quebec in 2010. Later in the same year, he moved to Sherbrooke, Quebec to look for work, incurring over $8,000 in moving expenses. He did not find work in 2010 or 2011, but eventually found a job in 2012. He attempted to deduct the moving expenses in 2010. The CRA denied the deduction, apparently on the grounds that his move was not an eligible relocation.

Upon appeal to the Tax Court of Canada, the Court agreed that a deduction was not permitted in 2010 because the taxpayer had no income from a new work location. However, the Court held that for the purposes of the deduction, moving expenses can be incurred in a year other than the year in which the new work is obtained or begins. As such, it allowed the taxpayer to deduct his moving expenses in 2012 even though he moved and incurred the expenses at a time when he did not have a new job.

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