



TAX LETTER

April 2018

FEDERAL BUDGET HIGHLIGHTS SHAREHOLDER LOANS CAREGIVER, SPOUSAL AND EQUIVALENT-TO-SPOUSE CREDITS AROUND THE COURTS

FEDERAL BUDGET HIGHLIGHTS

The Federal government presented its annual budget on February 27, 2018. Some of the major tax announcements are summarized below.

- Enhancement of the Working Income Tax Benefit, to be renamed the Canada Workers Benefit: This is a refundable tax credit that assists very low-income individuals and families who have employment income, to encourage working over taking social assistance. Beginning in 2019, the maximum benefit for single individuals will be increased from \$1,192 to \$1,355, and the maximum benefit for families will be increased from \$2,165 to \$2,335. The rate at which the benefits are phased out (as income goes up) will be reduced. A supplemental benefit for disabled individuals will also be increased.
- Medical expense tax credit: The current credit covers expenses incurred in respect of animals that assist physically disabled individuals, such as dogs that assist blind persons. The Budget provides that the expenses will also include expenses for animals that assist individuals with severe mental impairments in performing specific tasks, for expenses incurred after 2017.
- Mineral exploration credit: This credit has been extended by one year every year since 2003, and this year is no exception. The credit can be claimed by individuals

Currently, individuals must apply for this credit by filling out a schedule with their tax return. The Budget allows the Canada Revenue Agency ("CRA") to determine if individuals are eligible for the credit even if they do not file the schedule.

for certain investments in mining flow-through shares of corporations, and is equal to 15% of the specified mineral exploration expenses renounced by the corporation to the individual. The Budget extends eligibility for the credit by an additional year, so that it can be claimed for flow-through share agreements entered into on or before March 31, 2019.

For the corporation, under a “look-back” rule, funds raised by the corporation in one year that qualify for the credit can be spent on eligible exploration up to the end of the following calendar year. Therefore, funds raised by the corporation in the first 3 months of 2019 can be used on eligible exploration up to the end of 2020.

- Reporting requirements for trusts: Under current rules, some general information regarding a trust must be provided when the trust files its T3 income tax return for a taxation year. However, there is no rule that requires the identity of all of the beneficiaries of the trust.

The Budget proposes new reporting requirements for trusts resident in Canada, and for non-resident trusts that are required to file a T3 return. Such trusts will be required to report the identity of all trustees, beneficiaries, settlors and protectors of the trust, in addition to other specific information. The requirements begin with the 2021 taxation year, and monetary penalties will apply where the reporting is not provided. As well, many more trusts will be required to file the T3 than currently are.

Exceptions to the reporting rules will apply to mutual fund trusts, registered retirements savings plans, registered pension plans and similar deferred income plans that are governed by trusts, graduated rate estates and qualified disability trusts, trusts that have been in existence for less than 3 months, and trusts that hold less than \$50,000 in assets throughout the taxation year where the assets are limited to certain listed deposits and securities.

The Budget also states that a lawyer's general trust account (for multiple clients) will not have to report. This implies that a lawyer's trust account for a specific client would have to file and report information about the beneficiaries. However, that would run into problems with solicitor-client privilege, so it is expected that this part of the proposal either will be modified or might be struck down by the Courts.

- Passive investment income of CCPC: Last year, the Department of Finance announced that it would be changing the income tax treatment of passive investment income earned by a Canadian-controlled private corporation ("CCPC").
- Instead of changing the tax rate on investment income, the Budget provides that the small business deduction limit for the CCPC – currently a maximum of \$500,000 of active business income per year – will be reduced on a straight-line basis, by \$5 for every \$1 of the CCPC's investment income for the previous year in excess of \$50,000. For example, if the investment income was \$75,000, the

maximum small business limit will be reduced to \$375,000, which is another way of saying that up to \$375,000 of the corporation's active business income will be eligible for the small business deduction. Business income over the limit will be subject to the general corporate tax rate.

Another change relates to the refundable dividend tax on hand ("RDTOH") of a CCPC, which tracks the amount of refund the CCPC can obtain when it pays a dividend. Under current rules, it is possible for a CCPC to get the refund even if eligible dividends are paid out of business income, even though RDTOH is meant to track investment income. The Budget proposes that the refund will normally apply only on the payment of non-eligible dividends.

The passive income measures will apply to taxation years that begin after 2018.

- Artificial losses and stop-loss rules: The Budget tightened up certain rules that apply to these losses, to clarify that they can apply where taxpayers create artificial tax losses through the use of equity-based financial arrangements and in certain other circumstances. The changes are very technical in nature.
- At-risk rule for limited partnerships: Generally speaking, losses of a partnership for a taxation year can be allocated to a limited partner to the extent of the partner's "at-risk amount" in respect of the partnership for the year; losses over that amount cannot be deducted in the year by the partner. However, the excess

losses can be carried forward indefinitely to the extent of the partner's at-risk amount in future years.

The Budget clarified that the at-risk rules can apply to tiered partnerships, such as where a partnership (an upper partnership) is itself a limited partner in another partnership. In such case, the losses in excess of the upper partnership's at-risk amount will be denied and will not be allowed the indefinite carry-forward. This effectively overturns the effect of the Federal Court of Appeal's 2017 decision in the *Green* case. The Budget measure applies to taxation years that end after February 26, 2017.

- Re-assessment periods: The normal re-assessment period for an individual or CCPC is three years after the original CRA assessment and four years for other corporations. In conjunction with its assessment duties and general power to administering income tax laws, the CRA may make demands for information from taxpayers.

Under current rules, if the CRA makes a demand for foreign-based information from a taxpayer, the re-assessment period is extended if the taxpayer contests the demand and applies to a court for review, generally by the length of time between the taxpayer's application and the court's final decision. Current rules do not normally extend the re-assessment period if the CRA makes a demand from a taxpayer for non-foreign information. The Budget changes this, so that the extension will also apply to other demands for

information that are contested by taxpayers, as well as compliance order requests made to the Federal Court.

Another technical amendment ensures that where a taxpayer carries back a loss from one year to a previous year, and the CRA re-assesses the first year at a later time because of a transaction with a non-resident person, the CRA can re-assess the loss claimed in the previous year.

SHAREHOLDER LOANS

There are some fairly onerous rules under the Income Tax Act that apply where a shareholder of a corporation receives a loan from the corporation.

The main rule provides that if you are a shareholder and receive a loan from the corporation, the full amount of the loan is included in your income (although it is deductible when repaid, as explained further below). Furthermore, the same general rule applies if a person “connected” with a shareholder of a corporation receives a loan from the corporation.

For these purposes, a person is connected with a shareholder if the person does not deal at arm’s length with, or is affiliated with, the shareholder. Generally, a person does not deal at arm’s length with a shareholder if the two persons are related for tax purposes, but also if they actually do not deal at arm’s length (such as because they are acting in concert without separate interests). For example, if you are a shareholder of a private corporation and your child or spouse receives a loan from the corporation, the loan may be included in their income.

The “affiliated” concept is more complex, but it similarly captures certain relationships between closely-connected taxpayers.

Fortunately, there are some exceptions where the shareholder loan inclusion rule does not apply. The main exceptions are discussed below.

Exceptions

1) **Repayment by end of next taxation year:** One exception applies if you repay the loan in full by the end of the corporate taxation year following the corporate taxation year in which the loan was made. For example, if the corporation has a calendar taxation year, a loan received in January 2018 can be repaid by the end of 2019 in order to avoid the income inclusion. Therefore, in this example, you have almost two full years to repay the loan.

The only catch is that the repayment must not be a series of repayments and loans – for example, the exception will likely not apply if you repay the loan and the corporation immediately gives you another loan.

2) **Ordinary course of money-lending business:** Another exception applies where the loan was made in the ordinary course of the corporation’s ordinary business of lending money where, at the time the loan was made, *bona fide* arrangements were made for repayment of the loan within a reasonable time. Although this exception would normally apply to loans from corporations such as banks and other

financial institutions, it can apply to loans from other corporations, if they have an ordinary business of lending money.

3) **Loans to shareholder / employee:** If you are both a shareholder and an employee of the corporation, this exception can apply. It applies where any of the following is true:

- (a) you are **not** a “specified employee” of the corporation, generally meaning that you deal at arm’s length with the corporation and you and persons that are non-arm’s length with you own less than 10% of the shares of any class of the corporation; or
- (b) you receive the loan to acquire a home in which you will live; or
- (c) you receive the loan to enable you to acquire treasury shares from the corporation or a related corporation; or
- (d) you received the loan to acquire a motor vehicle to be used in your employment duties.

However, in each case, it must be reasonable to assume that you received the loan because of your employment rather than because of your shareholdings, and *bona fide* arrangements were made for repayment of the debt or loan within a reasonable time.

4) **Shareholder is a Canadian corporation:** If the shareholder receiving the loan is another corporation that is resident in Canada, the shareholder loan rules do not apply. The rationale for this exclusion is that dividends normally can be paid to a corporate shareholder free of tax, so there

is generally no policy reason to tax loans made to corporate shareholders.

Repayment of loan

If the shareholder loan was included in your income because none of the above exceptions applied, you get a deduction in the year in which you repay it. The deduction is equal to the amount of the principal that you repay.

Back-to-back loans

Until recently, it was not clear whether “back-to-back” loans were caught by the shareholder loan rules. Recent amendments clarify that they do apply. For example, if you arrange for your corporation to lend an amount to an intermediary third party, which then lends you money, you will likely be caught by these rules.

Effect of Tax on Split Income (“TOSI”) rules

Before 2018, the shareholder loan rules could be advantageous in certain cases where your adult child or other relative in a low tax bracket received a loan when they were in a low tax bracket, and then repaid the loan in a year in which they were in a higher tax bracket.

For example, if your 19-year child, not otherwise active in the corporation, received a loan in a taxation year when they were in a 20% tax bracket and repaid it in a later year when they were in a 50% tax bracket, they could have benefitted from the shareholder loan rules. That is, the deduction would have saved more tax than the tax payable upon the inclusion. However, beginning in 2018, a proposed amendment to the TOSI rules is expected to apply, so that the income inclusion will apply at the highest marginal

rate of tax (generally around 50% or more depending on the province), thus negating the tax advantage that may have previously existed. These amendments have not yet been passed and could still be changed, but as currently proposed they will be retroactive to the beginning of 2018.

Interest benefit rules

If the shareholder loan rules do not apply, so that the principal amount of the loan is *not* included in your income, a deemed interest benefit rule may nonetheless apply.

Normally, this interest benefit rule will apply where the interest charged on the loan is less than the prescribed rate of interest under the Income Tax Act. In such case, you will have an income inclusion for each year in which the loan is outstanding, equal to the prescribed rate of interest during the year on the loan minus the interest you actually pay on the loan in the year or by January 30 of the following year.

Example

On January 1, 2017, you received a \$100,000 interest-free loan from your corporation. Due to one of the exceptions above, you were not subject to the regular shareholder loan rules, and thus the principal amount of the loan was not included in your income. The prescribed rate of interest throughout 2017 was 1%.

For the 2017 year, you must include in your income an interest benefit of 1% of \$100,000, or \$1,000.

If you actually paid any interest on the loan in 2017 or by January 30, 2018, the payment would reduce the benefit included in your income.

CAREGIVER, SPOUSAL AND EQUIVALENT-TO-SPOUSE CREDITS

There are certain tax credits that you can claim when you support another individual and / or the other individual lives with you.

One credit is the spousal credit, which you may be able to claim if your spouse (or common-law partner) does not have a significant amount of income. The credit recognizes that you are likely supporting your spouse if he or she has income below a certain threshold. For 2018, the federal credit is 15% x (\$11,809 minus your spouse's net income). Thus, you get a credit only if your spouse's net income is less than \$11,809. If your spouse is dependent upon you because of a mental or physical infirmity, his or her net income threshold for these purposes is increased by \$2,182 to \$13,991. (These figures are indexed annually to inflation.)

Another credit is the eligible dependant credit, sometimes called the equivalent-to-spouse credit because the amount is the same as the spousal credit. You can claim this credit if you are single, and support a relative who lives with you who is either an individual under 18, your parent or grandparent, or a person who is dependent upon you because of a mental or physical infirmity. As noted, the amount of the federal credit is exactly the same as the spousal credit, and for the net income threshold you use the net income of the dependant.

A third credit is the Canadian caregiver credit. You can claim this credit if a relative 18 years or older is dependent upon you because of a mental or physical infirmity. The dependant does not have to live with you. You can claim this credit whether you are single or married. The federal caregiver

credit is $15\% \times (\$6,986 \text{ minus (dependant's net income over } \$16,405))$. So the credit is phased out gradually if the dependant's income exceeds \$16,405.

As one might appreciate, in some cases, two of these credits could apply in respect of one person that you are supporting. For example, if you are single and support your 20-year child who lives with you and is dependent upon you because of an infirmity, both the equivalent-to-spouse credit and the Canadian caregiver credit could potentially apply. However, an ordering rule provides that you must claim the spousal equivalent credit rather than the caregiver credit (a similar rule says that you must claim the equivalent-to-spouse credit rather than the caregiver credit, if both otherwise apply). Obviously, if only one credit applies in any event, you can only claim that credit.

AROUND THE COURTS

Scheme to extract tax-free dividends from trust disallowed

Under the Income Tax act, a “reversionary trust” rule provides that a person who contributes property to a trust must include in income any income from the property, generally if the property may revert or be returned to the person.

Another rule, quite separate from the above rule, provides that a Canadian resident corporation can deduct dividends received from another Canadian corporation in computing its taxable income. In other words, inter-corporate dividends are normally allowed on a tax-free basis.

In the recent *Fiducie Financière Satoma* case, the corporate taxpayer tried to have the best of both worlds. The corporation contributed shares to a trust to deliberately fall within the reversionary trust rule. Subsequently, over \$6 million of dividends were paid on the shares, and the taxpayers took the position that the corporation, rather than the trust, was required to include the dividends in income. In addition, since the dividends were deductible to the corporation in computing its taxable income as noted above, the corporation paid no tax on the \$6 million of dividends. In the meantime, the dividends were retained by the trust, rather than being paid to the corporation.

The CRA challenged the transactions under the Income Tax Act's general anti-avoidance rule (“GAAR”). On the corporation's appeal to the Tax Court of Canada, the Court upheld the CRA assessment. The Court found that the transactions were abusive of the relevant tax provisions, and so the GAAR applied and allowed the Court to uphold the CRA's assessment that the dividends were taxable to the trust.

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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.