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TAX LETTER

November 2014

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CHILD FITNESS CREDIT DOUBLED AND WILL BE REFUNDABLE

Enhancement of credit

The child fitness tax credit was introduced several years ago, to encourage parents to enrol their children in fitness activity programs and to make it slightly more affordable to do so. Until recently, the regular federal credit (where the child is not disabled) was equal to 15% of up to $500 of eligible fitness expenses per year per child 16 years of age or under during the year. As such, the maximum credit was $75.

On October 9, 2014, the Prime Minister's Office announced that the amount of this credit will be doubled, to a maximum of 15% of $1,000 eligible fitness expenses per child paid in the year. Thus, the maximum credit will be $150. This change will apply to the 2014 taxation year, so that individuals will be able to claim the increased credit when filing their 2014 returns in the spring of 2015.

Furthermore, beginning in the 2015 taxation year, the credit will be refundable, meaning that even if a taxpayer has no federal tax to pay for the year, the credit will be paid to the taxpayer. Currently, the credit is non-refundable, meaning it can reduce tax to zero, but any remaining credit is lost. Refundable credits are generally more beneficial to low-income individuals and are therefore perceived

to be more equitable than non-refundable credits.

There is also an additional credit in respect of disabled children who are 18 years of age or younger and eligible for the disability tax credit. The additional credit for a disabled child applies if you incur at least $100 of eligible expenses on the child, in which case you earn an additional $75 federal tax credit. The amount of this credit remains the same, but it also becomes a refundable credit starting with the 2015 taxation year.

Either parent of the child can claim the credit. Alternatively, the parents can share the credit. If the parents do not agree on the portions of the credit to share, the Canada Revenue Agency (CRA) will make the decision for them. Obviously, single parents can claim the entire credit.

What expenses qualify?

Registration fees paid for “prescribed programs” of physical activity include the following, as long as they are not part of a school’s curriculum:

- a weekly program that is at least 8 consecutive weeks in duration, in which all or substantially all of the activities include a significant amount of physical activity (the CRA generally assumes that “all or substantially all” means 90% or more of the time);
- a program that is at least 5 consecutive days of which more than 50% of the daily activities include a significant amount of physical activity (this can include children’s camps); and
- a program of at least 8 consecutive weeks, offered to children by a club, association or similar organization where a participant in the program may select among a variety of activities if
  - more than 50% of those activities offered to children by the organization are activities that include a significant amount of physical activity, or
  - more than 50% of the time scheduled for activities offered to children in the program is scheduled for activities that include a significant amount of physical activity.

As such, the physical programs that qualify include activities such as football, soccer, baseball, hockey, ballet, karate, horse-riding, and golf, as long as the 8-week or 5-day tests are met.

The organization or facility providing the fitness activity should provide you with a tax receipt indicating that the activity qualifies for the credit. The federal government provides the organization with guidelines that help it determine whether its program qualifies.

Note that in some cases, a much more useful option than the fitness credit is to claim expenses of a children's program as **child-care expenses**.

REPLACEMENT PROPERTY – POSSIBLE TAX DEFERRAL

Normally, if you sell a property and replace it with another, any gain on the sale of the first property will be taxed and the sale will not affect the cost for tax purposes of the second property. However, in certain cases, you can defer paying tax on the gain, in which case the cost of the second property will be reduced to your original cost of the first property. The mechanics of these tax rules are illustrated further below.

When the deferral can apply

More specifically, if you sell a capital property at a gain, but replace it with a new replacement property within a specified period of time, it is possible to defer the recognition of the capital gain in respect of the original property (and recapture, if it is depreciable property). There are two types of dispositions and properties that qualify for the deferral.

First, the deferral can apply to involuntary "dispositions" such as theft, destruction, or expropriation of property (in these situations your proceeds of disposition will typically include your insurance proceeds, or expropriation proceeds received from the government). In this case, any capital property except for a share in a corporation can qualify. The acquisition of the replacement property must occur before the later of the end of the second taxation year following the year of the disposition and 24 months after the end of the disposition year. (For individuals, this means within 2 calendar years after the year of disposition.)

Second, the deferral can apply to actual dispositions of a "former business property". This generally means land and buildings used primarily for business purposes, but not including a rental property. In this case, you must acquire the replacement property by the later of the end of the first taxation year following the year of disposition and 12 months after the end of the disposition year.

For the above purposes, a new property will qualify as a replacement property generally if

- it is reasonable to conclude that the property was acquired to replace the original property; and
- it was acquired for a use that is the same as or similar to the use of the original property; and
- if the original property was used for the purpose of earning income from a business, the new replacement property was acquired to earn income from the same or a similar business; and
- in the case of a non-resident taxpayer, if the original property was taxable Canadian property, the replacement property is taxable Canadian property (i.e., property that will be subject to Canadian tax on the capital gain when sold by a non-resident).

The deferral in both cases is elective. The election is made in your tax return for the year in which you acquire the replacement property. If you have a loss on the disposition of the original property, the election is not available.

Mechanics and amount of deferral

In order to defer the entire capital gain on the original property, you must spend at least the amount of proceeds of disposition from that property in acquiring the replacement property. Every dollar of proceeds that is not spent on acquiring a replacement property will result in a capital gain that will not be deferred.

The amount of the deferred capital gain reduces the adjusted cost base of the replacement property. Therefore, the capital gain is deferred and not eliminated, because the cost for tax purposes of the new property will reflect the accrued gain.

Example

In year 1, you dispose of a capital property with an adjusted cost base of $100,000 for proceeds of $150,000, resulting in a $50,000 capital gain. In year 2, you purchase a replacement property for $150,000, and make the election to defer the gain on the original property.

Since you spent the entire $150,000 proceeds on the replacement property, the $50,000 capital gain is deferred and is not taxed in year 1. The adjusted cost base of your replacement property is reduced by $50,000, from $150,000 to $100,000. Thus, if you later sell the property, say, for $160,000, the $60,000 capital gain will include the $50,000 deferred gain.

On the other hand, if in year 2, you spent only $140,000 on the replacement property, $10,000 of the capital gain from the original disposition would not be deferred. One-half of that, or $5,000, would be a taxable capital gain included in your income in year 1. The remaining $40,000 capital gain would be deferred, and would serve to reduce the adjusted cost base of the replacement property from $140,000 to $100,000.

Deferral of Recapture on Depreciable Property

The same types of dispositions and time periods can qualify for a deferral of "recapture" realized on the disposition of a depreciable capital property.

In order to defer the inclusion of the entire amount of the recapture, you need to spend an amount on the replacement property at least equal to the recapture on the original property. The deferred amount will decrease the UCC of the replacement property. As such, the recapture is deferred but not necessarily eliminated, because it will be reflected in the UCC of the replacement property and may be realized later upon another disposition.

PRINCIPAL RESIDENCE EXEMPTION

Most readers are likely aware of the general aspects of the principal residence exemption, which in many cases (but not all) exempts the capital gain realized on the sale of your home from taxation. Some of the specific rules governing the exemption are discussed here.

The exemption is based on the number of years that the home was your principal residence while you were resident in Canada, relative to the number of years that you owned the property. In particular, the exempt portion of the gain is:

A x B/C, where
A = the gain otherwise determined;
B = 1 + number of years during which the home was your principal residence and you were resident in Canada; and
C = number of years during which you owned the property.

Note: B/C cannot exceed 1.

Thus, if the home was your principal residence for all years of ownership or all years but one, the entire gain from the sale of your home will be exempt from tax. (The reason for the "1 +" figure is discussed below.) If the home was your principal residence for less than this period of time, part of the gain will be taxed as capital gain.

Example

You owned a house for 10 years and it was your principal residence during 6 of those years. You sell it for a gain of $100,000.

The exempt portion of the gain will be $100,000 x (6 + 1/10), or $70,000. The remaining $30,000 will be a capital gain, and half of that, or $15,000, will be included in your income as a taxable capital gain.

You can claim a home as your principal residence for a year if you or your spouse or common-law partner or child "ordinarily inhabited" the home in the year. The "ordinarily inhabit" test has a fairly low threshold. For example, if you stay at your cottage or vacation property for a couple of weeks during the year, it can likely qualify as your principal residence for that year. The home does not have to be in Canada.

The catch, however, is that for every taxation year (after 1981), your family unit (generally, you, your spouse or common-law partner and minor children) can designate only one home as your principal residence per year. So if you own more than one home that could otherwise qualify, you will have to decide which home to designate for which year. Because of this rule, the exemption formula above includes the "1+" figure to account for the fact that people typically sell a home and buy another in the same year. Since they can designate only one home per year, this rule ensures that the gain on both homes will be fully exempt.

The designation is normally made in your tax return for the year in which you sell the home. However, if the principal residence exemption applies to exempt the entire gain on the sale, the CRA does not require that you make the designation in the tax return. As a result, most homeowners do not actually make a designation in their tax return (although they are still subject to the rule of only one home designated per year).

Another rule provides that the land surrounding your home can count as part of your principal residence, but generally only up to ½ hectare (slightly more than 1.2 acres). If the land exceeds that amount, the excess can qualify only if you establish that it was "necessary for the use and enjoyment" of your home. This could be the case if zoning laws or by-laws prevent you from purchasing land that is less than ½ hectare. If the excess does not qualify, then the gain on that portion will not be exempt under the principal residence exemption.

Renting out your home

Special rules apply where you live in your home and subsequently rent it out, or where you rent it out first and then later move in. In these circumstances, if you make an election, even though you do not "ordinarily inhabit" the home while you rent it out, you can designate the home as your principal residence for up to 4 years while you rent it out. But you are still limited to one home designated per year, so if you live in another home you own during those years, you are limited to one designation for those years.

Furthermore, the designation for the rental years generally cannot be made if you deduct capital cost allowance (tax depreciation) during the rental years. So a decision must be made whether the capital cost allowance deduction or the principal-residence designation is more beneficial in your circumstances.

If you moved from your home as a consequence of a relocation of employment, the rental period can qualify as your principal residence beyond the 4 year period, as long as you move back in during your employment or by the end of the year following the end of your employment.

Exemption applies only to capital property, not inventory

The principal residence exemption does not apply if you are in the business of buying and selling houses. Even if you don't think you are in that business, if you buy even one property and re-sell it after owning it for only a few months, the CRA may consider you to be in the business of buying and selling, in which case the entire gain will be included in your income as profit and the exemption will **not** be available.

We noted this issue in our September 2014 Tax Letter, when discussing "Ten Common Tax Mistakes". The CRA has become extremely aggressive on this point, particularly when it comes to home builders who move in and out of homes and sell them, hoping to shelter their profits with principal residence exemption, but also where an individual buys a condominium to be built, but does not live there long because circumstances have changed by the time the condo is ready for occupancy.

RESERVES FOR RECEIVABLES AND UNEARNED RECEIPTS

If you or your corporation carry on a business, you (or the corporation) must normally include amounts receivable in income in a taxation year, even if they have not been received in the year. Conversely, in some cases you will receive an unearned receipt – on account of goods or services to be rendered in a future year – and will be required to include the amount in income in the year of receipt. Fortunately, there are two reserves that can apply in these circumstances to defer the inclusion to a future year.

Amounts receivable

Amounts receivable for the sale of goods or property in your business can qualify for an optional reserve, meaning a deduction can be claimed to offset the inclusion of the amounts. However, the reserve is fairly limited. In the case of selling real estate (if your sale is considered business income), the reserve can be claimed in a year if any of the proceeds from the sale are due in a future year. However, for the sale of other property, the reserve is available only if part of the proceeds are due at least 2 years from the date of sale.

The reserve in a year is generally equal to the profit from the sale multiplied by the fraction equal to (amount of proceeds due after year / total proceeds). The reserve is added back into income the next year, and a further reserve, if available, can be claimed in the next year.

Example

Your company is in the business of selling real estate. In year 1 it sells a property for $200,000, realizing a $50,000 profit. Three-quarters of the proceeds are received in year 1, while the remaining ¼ is due in year 2.

In year 1, the maximum reserve is $50,000 profit x ¼, so if it is claimed, only the net amount of $37,500 ($50,000 minus $12,500) will be included in income in year 1. The $12,500 reserve will be added back into income in year 2.

The other major limitation is that the reserve can be claimed in a taxation year only if the sale occurred less than 36 months before the end of the year. Normally, this means that the reserve can be claimed for a maximum of 3 years.

Lastly, if the amount receivable ultimately cannot be collected because it becomes a doubtful or bad debt, a reserve or deduction can usually be deducted at that time under other provisions of the Income Tax Act.

Unearned receipts

If you carry on business and in the course of that business receive an amount in one year on account of goods to be delivered or services to be rendered in a subsequent year, or as an advance rental payment in respect of a subsequent year, you can claim a reserve to offset the inclusion in the year of receipt. The maximum reserve is the amount that can be reasonably considered to be on account of the goods, services, or rent that relates to the later year.

The reserve is optional. If it is claimed, the reserve is added back into income for the next year, and if the goods or services etc. are still not rendered, a further reserve can be taken in that year.

Interestingly, unlike the reserve for the amounts receivable, this reserve has no apparent time limit. Thus, for example, if you received an amount in year 1 on account of goods to be delivered in year 6, the reserve could be claimed in years 1 through 5, so that the ultimate income inclusion could be deferred until year 6.

AROUND THE COURTS

Moving expenses denied because move was for personal reasons

You may deduct certain moving expenses from your income, generally if the move enables you to carry on business or be employed in a work location and your new home is at least 40 kilometres closer to the work location relative to your old home. In the case of employment, some cases have held that a change in employers is not necessarily required in order to get the deduction.

In the recent *Dueck* case, the taxpayer moved while employed with the same employer. He fulfilled the 40 kilometre requirement. He moved because his former home was a large house in a rural area, and owing to his deteriorating health, he felt it necessary to move to a smaller urban home that was closer to his place of employment and easier to maintain. The CRA denied his claim for moving expenses primarily on the grounds that the move must occur because of a change in circumstances in employment, and that the taxpayer had moved for personal reasons.

Upon appeal to the Tax Court of Canada, the Judge upheld the CRA's position and denied the moving expenses. The Judge ruled that the move was for personal purposes, and that the taxpayer did not establish that it was made to enable him to be employed or that it was the result of a change in his employment circumstances.

* * *

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.