TAX LETTER

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INDEXATION OF PERSONAL TAX AMOUNTS FOR 2014

The federal income tax brackets and most personal credit amounts are indexed every year to account for inflation, using the Consumer Price Index. The Canada Revenue Agency (CRA) recently announced the increases in these amounts from the 2013 taxation year to the 2014 taxation year. The increases are a modest 0.9% over the 2013 amounts. Some notable changes are as follows.

The 2014 federal income tax brackets (note that Quebec residents receive a 16.5% abatement to compensate for Quebec income taxes) are:

- 15% tax bracket for the first $43,953 of taxable income (up from $43,561 in 2013) ;
- 22% tax bracket begins at taxable income above $43,953;
- 26% tax bracket begins at taxable income above $87,907 (up from $87,123); and
- 29% tax bracket begins at taxable income above $136,270 (up from $135,054)

The 2014 federal income tax credits are 15% of the following:

- Basic personal amount of $11,138;
- Spousal or common-law partner amount of $11,138*, and reduced if spouse or common-law partner has any income;
- Age (65 and over) amount of $6,916, and phased out beginning when income exceeds $34,873;
- Child under age 18 amount of $2,255* per child;
- Canada employment amount of $1,127;
- Disability amount of $7,766;
- Caregiver credit amount of $4,530*, and reduced if dependant's income exceeds $15,472;
- Infirm dependant amount of $6,589, and reduced if dependant's income exceeds $6,607; and
- Medical expense amount of qualifying expenses exceeding the lower of 3% of net income and $2,171.

* Increased by $2,059 if the dependant is infirm and the credit qualifies for the "family caregiver amount"

The amount at which the old age security "claw-back" tax starts to apply is increased for 2014 to $71,592 of net income, up from $70,954.

The annual maximum dollar amount for tax-deductible contributions to registered retirement savings plans (RRSPs) is increased to $24,270 for 2014, up from $23,820 (with indefinite carry-forwards for unused deduction room).

The annual contribution amount for tax-free savings accounts (TFSAs) remains at $5,500 (with indefinite carry-forwards for unused room), as it is always rounded to the nearest $500.

SYNTHETIC DISPOSITIONS

In the 2013 Federal Budget, the government announced new rules regarding so-called synthetic dispositions. These rules were enacted in Bill C-4, which received Royal Assent on December 12, 2013.

Generally speaking, "synthetic disposition arrangements" are transactions that eliminate a person's economic risk in owning a property (e.g. effectively locking in an accrued gain) while the person maintains legal ownership in the property. According to the Department of Finance:

"A synthetic disposition transaction typically involves a taxpayer entering into an arrangement under which the taxpayer eliminates their future risk of loss and opportunity for gain or profit in respect of a property and acquires another property (or a right to acquire another property) the value of which approximates what the taxpayer would have received as proceeds from disposing of the property. A taxpayer may enter into a synthetic disposition transaction to defer the tax associated with a sale or to obtain tax benefits associated with the continued ownership of a property."

Under the new rules, where a taxpayer enters into a synthetic disposition transaction, the taxpayer will be deemed to dispose of the subject property for fair market value proceeds (thus triggering any accrued gain) and to immediately afterward acquire the property at a cost equal to that fair market value.

Basically, this new rule ensures that a taxpayer cannot defer the tax consequences

of disposing of a property for more than one year by entering into a synthetic disposition arrangement.

The following is an example of a synthetic disposition transaction (adapted, with modifications, from the Department of Finance explanatory notes):

Example (using a "put-call" arrangement)

> John owns a property with a cost of $50 and current fair market value of $85. John acquires a right to sell the property for $100 in five years (a put option) and grants a right to Bill to buy the property for $100 in five years (a call option).
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> John has effectively eliminated all or substantially all of his risk of loss and opportunity for further gain in respect of the property. For example, if at the end of five years the property is worth $115, Bill can be expected to exercise the call option and purchase the property from John for $100. If, instead, the property is worth $85 at the end of five years, John can be expected to exercise the put option and sell the property for $100.
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> Accordingly, under the new rules, John will be deemed to dispose of the property for proceeds equal to its current fair market value of $85, thus triggering a $35 gain. The new deemed cost of the property will be $85.
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> If he sells the property in five years for $100 under the put or call option, he will realize the further $15 gain at that time, and because of the new character conversion rules (discussed in the next section), the $15 will be considered ordinary income (fully included in income) rather than a capital gain.

The new rules apply to agreements and arrangements entered into after March 20, 2013, and to agreements and arrangements entered into before March 21, 2013 if their term is extended beyond March 20, 2013.

The Department of Finance notes that new rules will generally not apply to ordinary hedging transactions that involve managing only the risk of loss, "ordinary-course" securities lending arrangements, or ordinary commercial leasing transactions. Also, if under the arrangement the property is disposed of within one year, then the rule does not apply (*Income Tax Act* para. 80.6(2)e)). It appears therefore that one year of such deferral can be obtained.

CHARACTER CONVERSION TRANSACTIONS

The 2013 Federal Budget also took aim at so-called "character conversion transactions". Basically, these are arrangements or transactions that attempt to convert, through the use of derivative contracts (such as forward agreements), the returns on an investment that would otherwise be ordinary income (fully included in income) to capital gains (only ½ included in income as taxable capital gains).

The Budget introduced new rules that will treat the returns on these transactions as ordinary income. Like the rules described above, these rules were enacted in Bill C-4, which received Royal Assent on December 12, 2013.

The new rules apply when a taxpayer acquires or sells a property under a "derivative forward agreement". In very general terms, a derivative forward agreement is one under which the purchase

or sale price of the property at a specified future date is not based on the performance or value of the property itself, but instead is determined by reference to some other measure such as a portfolio or index of ordinary income investments.
The rules apply only if the derivative forward agreement has a term exceeding 180 days, or if the agreement is part of a series of agreements with a term that exceeds 180 days.

If a taxpayer disposes of a property under a derivative forward agreement, the amount by which the proceeds of disposition of the property exceeds the fair market value of the property at the time the agreement is entered into is fully included in the taxpayer's income. Conversely, the taxpayer will realize a loss if the fair market value of the property at the time the agreement is entered into exceeds the proceeds of disposition.

If a taxpayer acquires a property under a derivative forward agreement, the amount by which the fair market value of the property at the time it is acquired exceeds the cost to the taxpayer of the property is included in the taxpayer's income. The taxpayer will realize a loss if the amount paid for the property exceeds the fair market value of the property at the time it is acquired by the taxpayer.

Example (amended version from the Department of Finance explanatory notes)

> A taxpayer purchases a portfolio of Canadian shares worth $1 million. The taxpayer then enters into a forward sale agreement to sell the portfolio to a counterparty in five years for a price determined by reference to the performance of a bond fund (that is, the price will equal the amount that a $1 million investment in the bond fund would be worth after five years).
> Assume that at the end of the five years, the portfolio of Canadian shares is worth $1.1 million and the notional investment in the bond fund is worth $1.3 million. Pursuant to the forward sale agreement, the taxpayer would sell the portfolio of Canadian shares for $1.3 million.
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> Under the new rules, the taxpayer would include $300,000 in income in the year of sale ($1.3 million sales price minus $1 million value of the shares when the agreement was entered into). There would be no capital gain or loss on the sale.

The new rules generally apply to derivative forward agreements entered into after March 20, 2013, and to agreements entered into before March 21, 2013 if their term is extended beyond March 20, 2013.

ELIMINATING LABOUR-SPONSORED TAX CREDIT

The 2013 Federal Budget announced the phasing out and elimination of the federal income tax credit for investments in a Labour-Sponsored Venture Capital Corporation (LSVCC).

An LSVCC is basically a mutual fund corporation that is sponsored by a labour union. LSVCCs make "venture capital" investments in small and medium-sized businesses. The LSVCC must be registered either under the Federal Income Tax Act or under applicable provincial legislation.

Currently, you get a 15% federal tax credit for purchasing shares of an LSVCC on the first $5,000 of such purchases each year. The maximum federal credit is therefore

$750 per year. Some provinces provide a similar tax credit. You get the credit whether you purchase the shares personally or through your RRSP.

Pursuant to the Budget announcement, the federal LSVCC credit will be eliminated beginning in 2017. The tax credit will remain at 15% for the 2013 and 2014 taxation years, but it will be reduced to 10% for 2015 and 5% for 2016. These changes were enacted in Bill C-4, which passed through Parliament and received Royal Assent on December 12, 2013.

As well, on November 27, 2013, the Department of Finance released draft proposals that will allow the "orderly exit" of LSVCCs from the federal tax credit program. Basically, the proposals will remove existing investment requirements and penalties for federally registered LSVCCs that give notice of their intent to exit the tax credit program. Furthermore, federally registered LSVCCs will be allowed to issue new classes of shares that will not be subject to the investment rules currently applicable to LSVCCs, although the new shares will not be eligible for the LSVCC tax credit.

EMPLOYEE STOCK OPTIONS

Most employee stock options benefits are only half-taxed – that is, in most cases only one-half of the benefit is included in the employee's taxable income. As such, these benefits are taxed similarly to capital gains, which are also only one-half taxed.

In particular, you are allowed to deduct one-half of your stock option benefit in computing taxable income (meaning that only one-half is taxed), in the following circumstances:

- The shares you acquire in your employer corporation are "prescribed shares", generally meaning that they are common shares or shares that have characteristics very similar to common shares;

- You deal at arm's length with your employer; and

- The fair market value of the shares at the time the option was granted to you was not greater than the option exercise price.

Alternatively, if the employer is a Canadian-controlled private corporation (CCPC), you get the one-half deduction if you own the shares for at least two years, even if the above criteria are not met. A CCPC is basically a private corporation resident in Canada that is not controlled by any combination of public corporations or non-residents.

The amount of the benefit is the fair market value of the shares at the time you acquire them in excess of the total of the option exercise price and the amount, if any, paid to acquire the option (this latter amount is usually nil).

The benefit is included in the year in which you acquire the shares, except in the case of CCPC shares in which case the benefit is included in the year in which you subsequently sell the shares. In other words, with CCPC options, you can defer the taxation of the benefit until the year of sale. (This recognizes that it may be impossible to determine the value of CCPC shares until you sell them, since there is no market for them.)

Example

In 2012, your employer corporation granted you an option to acquire 1,000 common

shares in the corporation at an exercise price of $10 per share. The shares were worth $9 per share at the time of the grant of the option.

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For 2012, there would have been no tax consequences to you upon the grant of the option.

In 2014 you exercise the option when the shares are worth $15 per share. You will report a benefit of $5 per share ($15 fair market value minus $10 exercise price), but only one-half of this amount will be included in your taxable income assuming you meet the above-noted criteria.

If the corporation is not a CCPC, you include the benefit in 2014. If the corporation is a CCPC, you include the benefit in the year in which you sell the shares.

The amount of the benefit is added to the cost of your shares, to avoid double taxation when you sell the shares. In the above example, your cost of the shares would be $15 per share (the $10 you paid for the shares plus the $5 benefit amount). Thus, for example, if you subsequently sell the shares for $16, you will have a capital gain of $1 per share. If you sell the shares for $14, you will have a capital loss of $1 per share.

Unfortunately, if you do incur a capital loss on the sale of the shares, the loss cannot serve to reduce the amount of the stock option benefit included in your income. This is because capital losses can be used to offset capital gains only and not other sources of income. The employee stock option benefit is considered income from employment rather than a capital gain (even though, as noted, it is basically taxed the same as a capital gain).

The employee stock option rules typically apply where an employer corporation grants options to its employees to acquire shares in the corporation itself. However, the rules (including the 1/2 inclusion rule) also apply where an employer corporation grants options to its employees to acquire shares in another non-arm's length corporation (for example, a subsidiary or parent corporation). The rules also apply where a corporation grants options to acquire shares in itself to employees of a non-arm's length corporation.

ADOPTION TAX CREDIT PERIOD EXTENDED

The federal adoption tax credit equals 15% of eligible adoption expenses relating to the completed adoption of a child under the age of 18. The maximum amount of expenses that qualify for the credit was $11,669 per child for 2013, and is $11,774 per child for 2014. The credit can be claimed only in the tax return for the taxation year in which an adoption is finalized.

Until recently, eligible adoption expenses that qualified for the credit were those incurred in the period that started (i) when the child was "matched" with the adoptive family (more particularly, when the child's adoption file was opened with a provincial ministry responsible for adoption or a licensed adoption agency), and ended (ii) when the child began to permanently reside with the family.

For 2013 and subsequent years, the beginning of the expense period is extended. It starts at the time that an adoptive parent *makes an application* for registration with a provincial ministry responsible for adoption or with a licensed adoption agency (or if an adoption-related application is made to a Canadian court at an earlier time, that earlier time).

The government made this change to account for the fact that expenses such as fees for provincially-required home study, to complete adoption courses, or other necessary training often take place before the child is matched with parents. These expenses will qualify under the new rules.

This amendment was included in Bill C-60, which passed through Parliament and received Royal Assent in June 2013.

AROUND THE COURTS

Supreme Court allows "rectification" in Quebec for tax purposes

Rectification has been applied by some courts for income tax purposes. Typically, where rectification is applied, it ensures that the taxpayers involved are not taxed adversely based on unintended errors in their transactions and accompanying documents. However, until recently it was thought that rectification was unavailable in Quebec, which is governed by the *Civil Code of Quebec*, unlike the rest of Canada's provinces, which are governed by the "common law" (developed by judges over the centuries).

Recently, the Supreme Court of Canada decided its first rectification cases for income tax purposes. The two cases, *AES* and *Riopel*, were heard concurrently. Both cases involved corporate re-organizations in Quebec that were meant to take place on a tax-deferred basis. However, because of errors made by their tax advisors, the forms of the re-organizations as reflected in the various documents gave rise to a tax liability.

The taxpayers' appeals for rectification were upheld by the Quebec Court of Appeal. In upholding that appeal, the Supreme Court of Canada found that there was sufficient evidence to find that the true and common intentions of the parties had not been reflected in the documents involved in the re-organizations. Basically, the re-organizations had not been formally structured as planned. The Supreme Court held that the documents could be amended or interpreted in a way so as to implement those true and common intentions, which, as noted, would allow the re-organizations to take place on a tax-deferred basis.

The Supreme Court declined to comment on how rectification applies in the common-law provinces, but the principle has been considered many times by the Courts of those provinces. What is not yet resolved is the extent to which rectification will be available, particularly in cases where the documents *do* what the parties intended, but the parties made a mistake in determining what they wanted to do because they did not correctly figure out the tax consequences. There have been conflicting decisions from the Courts on this point.

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