TAX LETTER

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CHANGES TO ELIGIBLE CAPITAL PROPERTY RULES

The Federal government first announced these changes in the 2014 Federal Budget. The changes are now in draft legislation form. They generally take effect on January 1, 2017.

The main changes provide that eligible capital property of a business – which includes intangibles such as goodwill, unlimited licenses, and customer lists – will no longer be subject to the cumulative eligible capital (CEC) depreciation rules. Instead, the property will form a new class 14.1 of depreciable property, and will be subject to the regular capital cost allowance (CCA) rules that apply to other depreciable property.

Summary of current rules

Under current law, 3/4 of your expenditures on eligible capital property are added to the CEC pool. In computing your income from the business, you are allowed to deduct or depreciate the CEC pool on a declining balance basis at the annual rate of 7%.

When you sell a property, 3/4 of the proceeds of disposition reduce your CEC pool. If the CEC pool becomes negative, you must include "recapture" in your income. The "recapture" applies because you sold

the property for more than the CEC balance, which is another way of saying you previously "over-depreciated" the property. However, if you sell the property for more than its original cost, only ½ of that excess is included in your income as business income (for certain farming or fishing businesses, the ½ excess can be eligible for the capital gains exemption).

Summary of new rules

Under the new rules beginning in 2017, the full cost of property that is currently eligible capital property is added to the Class 14.1 undepreciated capital cost (UCC) pool of depreciable property. The cost of the property may be depreciated at an annual rate of 5% under the capital cost allowance rules. The depreciation rate is therefore close to the rate under the old rules (which, as noted, allowed a deduction of 7% of ¾ of the original cost).

When you sell a property, the lesser of the proceeds and your original cost of the property reduces your UCC pool. If the UCC pool becomes negative, the negative amount results in recapture under the existing depreciable property rules. If you sell the property for more than its original cost, the excess is a capital gain, half of which is a taxable capital gain. So these rules on the sale of the property are similar to the old rules, except for the capital gains treatment.

Various transitional rules

There are many transitional rules, and they are far too lengthy and complex to review here in detail. But basically, the main transitional rule applies to eligible capital property acquired before 2017. In general terms, adjustments are made to convert your former CEC balance to a new Class 14.1 balance that will ensure tax results after 2016 similar to those under the old system.

For property acquired before 2017, the transitional rules allow a capital cost allowance deduction of 7% of the UCC of the property, for taxation years through 2026.

FOREIGN EXCHANGE GAINS AND LOSSES

As discussed below, there are essentially three ways you can realize a foreign exchange (FX) gain or incur an FX loss.

Exchange of foreign currency

First, a loss or gain can occur when you sell foreign currency for Canadian currency. For example, say you bought some US dollars when the US and Canadian (C) dollars were trading at par. Later, you exchange US$10,000 of that amount back into C$11,000 when the currencies are trading at US1$ = C$1.1. That exchange will net you a foreign gain (FX gain) of C$1,000.

A special rule in the Income Tax Act provides that you must total all of your FX gains and losses from exchanges of foreign currency for the taxation year. The resulting total gain or loss for the year, net of the first $200 net gain or loss, is a capital gain or capital loss. In the above example, if you have no other FX gains or losses in the year, you would report an $800 capital gain, and half of that or $400 would be the taxable capital gain included in your income.

The exclusion of the first $200 net gain or loss alleviates record-keeping for persons who make relatively small FX gains or losses on exchanging foreign currency (e.g.

you take one trip to the US this year and exchange only a few hundred dollars).

Purchase and sale of property with foreign currency

The Canadian income tax system uses Canadian dollars for reporting income, losses, tax, and all other amounts. As a result, you must always report the purchase price and sale price of property in Canadian dollars. A resulting gain or loss on the property upon its disposition may include an FX gain or loss.

Example

You bought some US shares on a US stock exchange at a cost of US$10,000. At the time of purchase, the exchange rate was US$1 = C$1.10. Therefore, your cost of the shares in C$ was C$11,000.

You subsequently sell the shares for US$15,000. At the time of sale, the exchange rate is US$1 = C$1.20. Therefore, your sale proceeds are C$18,000 (US$15,000 x 1.20).

You will have a capital gain of C$7,000 ($18,000 − $11,000). Half of that amount will be included in your income as a taxable capital gain.

Note that of the total $7,000 gain, a portion is actually an FX gain resulting from the increase in value of the US dollar from the time of purchase to the time of sale. If the US$:C$ exchange rate had remained constant, your sale proceeds would have been only C$16,500 ((US$15,000 x 1.10).

Repayment of foreign currency debt

Lastly, you can realize an FX gain or loss upon the repayment of a loan or other debt obligation denominated in foreign currency. For these purposes, you must report the amount of the debt in C$ at the time the debt was incurred and subsequently when the debt is repaid. Any gain or loss resulting from currency fluctuation will be an FX gain or loss.

Example

You took out a US loan of US$10,000. At the time of the loan, the exchange rate was US$1 = C$1.10. Therefore, the amount of your loan in C$ was C$11,000.

You subsequently repay the loan when the exchange rate is US$1 = C$1.20. Therefore, your repayment $ is C$12,000.

You will have a capital loss of C$1,000 ($12,000 − $11,000). Half of that amount can be claimed as an allowable capital loss.

The above discussions assume the properties and loans are capital in nature, so that the resulting gains or losses are capital gains or losses. If they were on income account, the analysis would be the same, except the full gains or losses would be reported rather than just half of the amounts, and the $200 threshold exclusion would not apply.

WHAT HAPPENS ON A CHANGE OF CONTROL OF A CORPORATION?

There are numerous tax consequences that occur as a result of the acquisition of control of a corporation. (We use the term “acquisition of control” and “change of control” synonymously.)

Deemed taxation year end

First, there is a deemed taxation year-end of the corporation immediately before the acquisition of control. Then there is a deemed beginning of a new taxation year at the time of the acquisition of the control. The deemed year-end will typically result in a short taxation year. The corporation will have to file a tax return for that short year within the normal time frame (6 months after the year-end). It will have to pay the balance of its tax owing for the year within 2 months after the year-end (or 3 months, for certain Canadian-controlled private corporations).

The short taxation year will require a pro-rating of certain deductions. For example, the corporation's deduction of capital cost allowance (tax deprecation) will have to be pro-rated to account for the short year. As well, one more year is used up for rules that "count" taxation years.

Perhaps more significantly, the change of control will trigger income tax consequences that do not apply to a "regular" year end. Most of the rules limit the extent to which certain tax losses and other attributes can be carried over or back beyond the change of control. The significant rules are summarized below.

Restriction for net capital loss and non-capital loss carryovers

There is a blanket restriction for the carryover of net capital losses (unused allowable capital losses – generally half of capital losses) beyond the change of control. In other words, net capital losses from years before the change of control cannot be used to offset capital gains after the change of control. Similarly, net capital losses from years after the change of control cannot be carried back to offset capital gains from before the change of control.

For non-capital losses (generally, business and property losses), the same restriction applies, but not in all cases.

Non-capital losses from a business before the change of control may be carried forward to years after the change of control, but only if the same business is carried on after the change of control with a reasonable expectation of profit, and only to offset income from that business or a similar business.

Similarly, non-capital losses after the change of control from a business can be carried back to years before the change of control only if the same business is carried on with a reasonable expectation of profit, and only to offset income from that business or a similar business.

Otherwise, non-capital losses cannot be carried forward or back beyond the change of control.

Write-down of accrued capital losses

Immediately before the change of control of the corporation, all of the accrued capital losses of the corporation are triggered and the cost of each property with an accrued loss is reduced to its fair market value. The accrued capital losses are recognized in the taxation year that ends upon the change of control. This rule, in conjunction with the carryover restrictions, ensures that capital losses cannot be carried over to taxation years beyond the change of control.

However, the corporation can elect to trigger accrued capital gains in respect of other property owned at the change of control. The triggered capital gains can then be

offset by any accrued losses recognized as noted above. More specifically, the corporation can elect that a capital property with an accrued capital gain is deemed to be disposed of for any amount between its cost and its fair market value. The corporation will have a deemed re-acquisition cost of the property at the same elected amount.

Example

A corporation undergoes a change in control. Immediately before the change of control, it owns a capital property A with a cost (adjusted cost base) of $100,000 and a fair market value of $60,000.

Under the write-down rules, the corporation will have a deemed capital loss of $40,000 and allowable capital loss of half of that amount or $20,000.

The corporation also owned a capital property with a cost of $50,000 and fair market value of $80,000. The corporation can elect that property B is disposed of for $80,000, resulting in a capital gain of $30,000 and taxable capital gain of $15,000.

The allowable capital loss from property A will completely offset the taxable capital gain from property B. The corporation's cost of property B will be bumped up to $80,000.

The corporation will be left with a net capital loss of $5,000 ($20,000 allowable capital loss from property A less the $15,000 amount that offset the taxable capital gain from property B). This $5,000 amount cannot be carried forward beyond the change of control, but can be carried back for up to 3 years to offset taxable capital gains, if any, in those years.

Restriction for carryover of investment tax credits

A corporation can earn an investment tax credit (ITC) in various ways. Perhaps the most common credit relates to a business that incurs scientific research and development expenses (SR&ED); these expenses generate a tax credit of 15% of the expenses and up to 35% in the case of certain Canadian controlled-private corporations. The credits can normally be carried forward 20 years or back 3 years.

However, upon the change of control of a corporation, the carryover of ITCs is restricted. Basically, ITCs earned before the change of control from a business can be carried forward to offset taxes after the change of control resulting from income from the same or similar business. Similarly, ITCs earned after the change of control can be carried back to offset taxes resulting from income from the same or similar business. Otherwise, the ITCs cannot be carried over beyond the change of control.

What is an acquisition of control?

As noted, the above rules apply to an acquisition or change in control of corporation. So when does this occur?

First, a change in control will normally occur when a transaction (such as the purchase and sale of shares) results in a new person or group of persons owning shares in the corporation carrying more than 50% of the votes required to elect the board of directors. This type of control is often called "*de jure*" (legal) control. This rule does not normally apply if another person related to the person or group of persons controlled the corporation before the transaction. For example, if you transfer your controlling

shares in a corporation to your spouse, there will not be a change of control.

Another rule deems a change of control when a person or group of person acquires shares in the corporation having a fair market value of more than 75% of the fair market value of all of the shares in the corporation (even if the shares are not voting shares). The rule does not apply if the person or group already had *de jure* control as discussed in the preceding paragraph.

NEW RULES FOR "SWITCH FUNDS"

Mutual funds can be structured either as trusts or corporations. Most are trusts, but a significant number are corporations.

If you own units in a mutual fund trust and wish to exchange those units (old units) for units in another mutual fund (new units), even if within the same "group" of mutual funds, you will have a deemed disposition of the old units at their fair market value. This may result in a capital gain or capital loss.

On the other hand, a mutual fund corporation can issue different classes of shares in the corporation, with each class representing a different class of investment. Under various corporate "rollover" provisions in the Income Tax Act, you can exchange shares in one class for shares in another class without tax consequences. In street parlance, these types of funds are called "switch funds", since you can switch between funds without triggering any tax.

Unfortunately, the 2016 federal Budget put an end to the favourable tax treatment of switch funds. Under the Budget changes, if you exchange your shares of one class for shares of another class of the mutual fund corporation, you will have a deemed disposition of the former shares at fair market value. (There are some limited exceptions.)

This change effectively levels the playing field between mutual fund trusts and mutual fund corporations.

The changes will apply to exchanges or dispositions of shares occurring after 2016.

NEW TESTAMENTARY TRUST RULES IN FULL SWING

The 2016 taxation year saw some significant changes to the taxation of testamentary trusts.

A testamentary trust is generally one that results as a consequence of your death, including your estate and a trust created under your will. On the other hand, an "*inter-vivos*" trust is generally a trust created during your lifetime.

Before 2016, testamentary trusts enjoyed several income tax benefits not available to inter-vivos trusts, including:

- They were subject to the same graduated tax rates as individuals, as opposed to a flat tax at the highest marginal rate that applies to *inter-vivos* trusts.
- They were not required to make tax instalments.
- They could have an off-calendar year taxation year.
- They were not subject to the alternative minimum tax.
- They could flow out investment tax credits to their beneficiaries.

Starting in 2016, the only trusts that continue to enjoy all of these benefits are "graduated rate estates". Basically, a

graduated rate estate is the estate of an individual for up to 36 months after death (certain other conditions must be met). An individual can have only one graduated rate estate. If the estate remains in existence beyond the 36-month period, it will no longer enjoy these tax benefits.

In addition, a "qualified disability trust" is subject to graduated tax rates, although it does not enjoy the other tax benefits listed above. In general terms, a qualified disability trust is a testamentary trust (i.e. set up by a taxpayer's will) for a beneficiary who is eligible for the disability tax credit (again, there are certain other conditions).

AROUND THE COURTS

Charity registration revoked even though it helped to prevent poverty

Getting a charity registered for income tax purposes has obvious benefits. A registered charity pays no income tax. Donations to the charity are encouraged through the tax system, as they earn either a tax credit (individuals) or deduction (corporations).

In the recent case of *Credit Counselling Services of Atlantic Canada*, the stated objects of the charity were to prevent poverty, provide professional financial and debt counselling to the community, develop and promote educational programs for the public on family money management, budgeting and use of credit, and conduct and fund research on credit-related concerns.
The charity was initially registered for income tax purposes. However, the CRA subsequently revoked the registration on the grounds that the charity was not exclusively carrying on charitable activities.

One of the acceptable purposes of a charity is to relieve poverty. The CRA argued that the charity's activities were not limited to helping poor people. Thus, at most, their activities may have been helping to *prevent* poverty, but not *relieve* it.

The Federal Court of Appeal upheld the CRA's decision. The Court agreed that, based on the case law, merely helping to prevent poverty is not an accepted charitable purpose.

The grounds on which a charity can be formed have basically remained the same as they were in 17th century in England, and the Federal Court of Appeal has been unwilling to expand these grounds.

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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.