

TAX LETTER

January 2020

INCREASED BASIC PERSONAL CREDIT SUPERFICIAL LOSSES SECTION 85 ROLLOVERS TO CORPORATION AROUND THE COURTS

INCREASED BASIC PERSONAL CREDIT

The Federal basic personal credit is a non-refundable tax credit. ("Non-refundable" means that it's not paid to you if you have no tax to pay for the year. It *can* create a refund of tax withheld at source or that you paid by instalments.)

Every individual is entitled to the credit, which equals 15% multiplied by the "**basic personal amount**", which is indexed annually for inflation. For your 2019 return, the credit is 15% of \$12,069. The 15% rate, which is equal to the lowest Federal marginal tax rate, was chosen to ensure that everyone is treated the same regardless of their tax bracket; that is, until 2020, as discussed below.

The basic personal amount will continue to be indexed for inflation, as was the case before. Therefore, in 2020, the basic personal amount is \$12,298, and will continue to be

indexed thereafter. Based on its projections, the government estimates that the 2021 through 2023 amounts will equal \$12,554, \$12,783, and \$13,308, respectively.

An additional enhanced basic personal amount applies to all individuals whose net income is less than the amount at which the 29% marginal federal tax rate begins to apply (\$150,473 for 2020). For these individuals, the enhanced basic personal will be \$13,229, \$13,808, \$14,398, and \$15,000 for taxation years 2020 through 2023, respectively (and the credit will continue to be 15% of this amount).

For individuals whose net income is in the top tax bracket where the marginal federal tax rate is 33% (net income over \$214,368 for 2020), the enhanced credit is not available, and the basic personal amount remains at \$12,298 for 2020 (and indexed after that).

For individuals in the 29% tax bracket (net income between \$150,473 and \$214,368 for

2020), the enhancement to the credit is gradually phased down to zero as net income approaches the top of that bracket (\$214,368 for 2020).

(Interestingly, the income limits at which the enhanced credit is phased out or eliminated are based on *net* income, and not the (sometimes lower) "taxable income", even though the tax rates themselves apply to taxable income.)

Examples for 2020

If your income is \$214,368 or greater, you get only the regular credit of 15% x \$12,298. You do not get the enhanced credit.

If your income is \$150,473 or less, you qualify for the entire enhanced credit of 15% x \$13,229.

If your income is \$182,420, which is half-way into the 29% tax bracket, you get the regular credit of 15% x \$12,298, plus one-half x 15% x (\$13,229 – \$12,298), which equals a total of 15% x \$12,763.

The enhanced credit amount will also apply to the spousal or common-law credit, with the same income limits for the person claiming the credit. As before, the credit amount for the person claiming the credit is reduced by the dependant spouse or common-law partner's income. Thus, for example, if your income qualifies you for the enhanced credit amount in 2020 but your spouse's income is \$13,229 or more, you get no spousal credit. If your spouse's income is between zero and \$13,229, the spousal credit is pro-rated.

Similar amounts and rules to the spousal credit apply to the eligible dependant credit,

which you may claim if you are not married or in a common-law relationship, but have a related individual like a minor child living with you (certain other conditions apply).

SUPERFICIAL LOSSES

Some readers who trade in securities may be aware of the "superficial loss" rules that apply for income tax purposes. The rules are intended to prevent a taxpayer from selling a property at a loss (say, to use against capital gains you have), in cases where the loss is deemed to be "superficial" because the property or a similar property is re-acquired within a set period of time.

General rules

Basically, the rules apply in the following circumstances:

You sell a capital property at a loss, and in the period beginning 30 days before the day of the sale and ending 30 days after the sale, you or an "affiliated person" acquire the same or identical property and own it at the end of that period. The period is therefore a total of 61 days (including the day of the sale).

An "affiliated person" includes your spouse or common-law partner, a corporation that you or your spouse or partner control either together or individually (normally meaning ownership of more than 50% of the voting shares of the corporation), among other persons.

Interestingly, an "affiliated person" does not include your child. Therefore, if your child acquires the property within the 61-day period, the superficial rules do not apply.

When the rules do apply, any capital loss on your initial sale of the property is denied and

deemed to be zero. On the positive side, the amount of the denied loss is added to the cost of the other property acquired by you or the affiliated person. As such, the loss is not denied forever, because it will be recognized when you (or the affiliated person) eventually dispose of the property.

Example

You sell 1,000 common shares in XCorp for \$12 each (total proceeds \$12,000). Your cost of the shares was \$22 per share (total cost \$22,000). In other words, your total capital loss was \$10,000.

Within 30 days after the sale, you repurchase 1,000 XCorp common shares (“identical shares”) for \$13 per share and continue to own them at the end of the 30 days.

Your initial loss of \$10 per share or \$10,000 in total is denied. However, your cost of each identical share is bumped up by the denied loss per share, so that your new cost of the identical shares becomes \$23 per share.

If you later sell the identical shares for, say, \$13 per share, you will have a capital loss of \$10 per share. Half of that, or \$5 per share, or \$5,000 in total, will be an allowable capital loss, which can be applied against any of your taxable capital gains.

Meaning of “identical property”

As noted, the superficial loss rules can apply if you or the affiliated person acquires an “identical property” within the set 61-day time period.

In terms of shares in corporations, identical properties include shares of the same class of the same corporation. But they do not include shares in different classes. For example, if you sell common shares in XCorp at a loss and purchase preferred shares of a different class in XCorp, the two types of shares are not identical and the superficial loss rules do not apply.

A similar rule applies to units in mutual funds. Generally, in order to be identical, the units must be in the same fund and of the same class.

In terms of debt instruments such as bonds or debentures, they are deemed to be identical if they are issued by the same debtor, provided they are identical in respect of all rights attaching to the instruments, but without regard to the principal amount of the instruments.

Using the rules to shift losses to spouse or common-law partner

Although the superficial loss rules are generally detrimental in nature, they can be used in certain tax planning scenarios.

For example, say you own publicly-listed shares with an accrued capital loss. However, you have no capital gains so you cannot currently utilize the capital loss.

However, your spouse has some capital gains, and could use some capital losses to offset those gains.

In such case, you could sell the shares at a loss. Your spouse could purchase identical shares, and the amount of your denied loss would be added to your spouse’s cost of the identical shares. Assuming your spouse later sold them when they were trading for less than your spouse’s (bumped-up) cost, he or she can use the loss.

Example

Let's use the same example as above, except that your spouse purchases the identical shares within the 61-day period and owns them at the end of that period.

Your initial \$10,000 loss is still denied. However, your spouse's cost of each identical share is bumped up by the denied loss per share, so that their new cost of the identical shares becomes \$23 per share. If they later sell the shares at, say \$13 per share, they will have a capital loss of \$10 per share, an allowable capital loss of \$5 per share, and a total allowable capital loss of \$5,000.

SECTION 85 ROLLOVERS TO CORPORATION

The section 85 "rollover" under the Income Tax Act is a provision that allows you to transfer property to your corporation without immediate tax consequences. That is, you can transfer it in without realizing a gain, or with realizing a partial gain.

When the rollover applies

The rollover applies if you transfer a property (eligible property, as described below), to a taxable Canadian corporation, and you receive at least one share back as consideration for the transfer.

You and the corporation must file a joint election, by the earlier of your filing-due date and the corporation's filing-due for the year of the transfer. A late election is allowed if made within three years of the earlier date, or later if the CRA allows it. However, a late election is subject to monetary penalties.

Eligible property includes:

- Capital property, other than real estate owned by a non-resident (except a non-resident selling a business in certain circumstances);
- Inventory other than land inventory; and
- Canadian or foreign resource property.

Effect of rollover

In the joint election, you specify an "elected amount", which becomes your proceeds of disposition of the property and the corporation's cost of the property. Therefore, for example, if the elected amount equals your cost amount of the property for tax purposes, you will have no gain or loss on the transfer; this explains why the transfer takes place on a tax-free "rollover" basis.

However, there are limits on the elected amount and other rules come into play as discussed below.

In addition, the elected amount forms your cost of the property received from the corporation in consideration for the transfer of the property. If you receive shares and non-share-consideration (the latter is often called "boot") from the corporation, the elected amount is first allocated to the boot, next to any preferred shares received, and last to any common shares received from the corporation.

Example 1

You transfer eligible property to a taxable Canadian corporation. Your tax cost of the property was \$100,000 and its fair market value is \$300,000. You receive back from the corporation \$40,000 worth of boot and 100 common shares.

If your elected amount is \$100,000, you will have no gain or loss on the transfer, since your tax cost of the property was \$100,000.

The corporation's cost of the property is \$100,000.

Your cost of the boot is \$40,000. Your cost of the common shares is \$60,000 (the \$100,000 elected amount minus the \$40,000 allocated to the cost of the boot).

Basic limits on the elected amount

There are three basic limits, although other rules can apply to adjust the three limits.

First, the elected amount cannot exceed the fair market value of the property that you transfer to the corporation.

Second, subject to the first rule, the elected amount cannot exceed the fair market value of the boot that you receive from the corporation. Since this rule is subject to the first rule, if the fair market value of the boot exceeds the fair market value of the property transferred to the corporation, the elected amount cannot exceed the latter amount (but this may cause tax problems; see "Other considerations", below).

Third, the elected amount generally cannot be less than the lesser of the fair market value of the property and the tax cost of the property. In the case of non-depreciable property, the cost is the adjusted cost base, and for inventory it is the cost. For depreciable property of a class (i.e. property subject to capital cost allowance or tax depreciation), it is the lower of the undepreciated capital cost of the class and the cost of the property (with possible adjustments).

Example 2

Like Example 1, you transfer eligible property to a taxable Canadian corporation. Your tax cost of the property was \$100,000 and its fair market value is \$300,000. You receive back from the corporation \$40,000 worth of boot and 100 common shares.

If you try to elect an amount of \$80,000, under the third rule above it will be increased to your tax cost of the property of \$100,000. Therefore, the results will be the same as under Example 1.

If you try to elect an amount of \$320,000, under the first rule the elected amount will be reduced to the fair market value of the property of \$300,000. In such case, your proceeds and the corporation's cost of the property will be \$300,000 (so you will realize a \$200,000 capital gain). Your tax cost of the boot will remain \$40,000, and the tax cost of your common shares will be \$260,000 (the \$300,000 elected amount minus the \$40,000 allocated to the cost of the boot).

Other considerations

As noted above, if the fair market value of the boot you receive from the corporation exceeds the fair market value of the property you transferred into the corporation, the elected amount limit is the latter amount rather than the former amount. However, in such case, you will be required to include the excess of the fair market value of the boot over the elected amount as a "shareholder benefit", which is fully included in income and not treated as a capital gain. That is not good, to say the least.

For example, say you transfer property to the corporation whose fair market value is \$100,000, and elect \$100,000 and receive back \$120,000 of consideration from the corporation. In such case, the excess \$20,000 will be added to your income as a shareholder benefit (essentially, you've extracted an extra \$20,000 in value from the corporation and you have to pay tax on it).

On the other hand, if the fair market value of the property you transfer to the corporation exceeds the greater of the elected amount and the fair market value of the total consideration received from the corporation, and it is reasonable to conclude that the difference is a benefit that you wished to confer on a related person, the elected amount is bumped up to the fair market value of the property.

For example, say you and your spouse (a related person) are each 50% shareholders of a corporation. If you transfer property to the corporation that is worth \$100,000 and elect \$80,000 and receive back only \$80,000 of consideration, it may be reasonable to conclude that the \$20,000 difference is a benefit you wished to confer on your spouse as the other common shareholder. If so, the excess \$20,000 will be added to the elected amount to increase it and your proceeds of disposition of the property to \$100,000.

Transfer of shares in one corporation to another corporation

The definition of “eligible property” includes capital property, which can include shares in a corporation.

Thus, you can use the section 85 rollover if you sell shares in one corporation (“subject corporation”) to another corporation (“purchaser corporation”).

However, adverse tax consequences may result if you are non-arm’s length with the purchaser corporation, and after the transfer the purchaser corporation controls the subject corporation or owns more than 10% of the shares of the subject corporation on a fair market value and votes basis. A non-arm’s length purchaser corporation can include a corporation that you control, a corporation that a related person controls (such as your spouse, child, or parent), among others.

In such case, if you receive boot from the purchaser corporation as part or whole consideration for the sale of the subject shares, you may have a deemed dividend instead of a capital gain. Generally, instead of a capital gain, you will have a deemed dividend if the fair market value of the boot exceeds the greater of the paid-up capital and your “hard” adjusted cost base in respect of the subject shares that you transferred. (There may be other calculations involved; this is a simplified explanation.) The paid-up capital of the subject shares is generally the after-tax amounts paid for the shares on their original issuance. To avoid double taxation, the amount of the deemed dividend is subtracted from your proceeds of disposition of the subject shares.

Example

You own shares in XCorp with an adjusted cost base and paid-up capital of \$100, and a fair market value of \$100,100. You transfer the shares to a non-arm’s length YCorp and elect at \$100,100, thus apparently triggering a \$100,000 capital gain (you might do this if you had capital losses to offset the gain, or the shares were eligible for the capital gains exemption). YCorp then controls XCorp.

For consideration on the transfer, you receive back shares in YCorp and boot worth \$100,100.

The \$100,100 value of the boot in excess of \$100, or \$100,000, is a deemed dividend. Your proceeds on the disposition of the XCorp shares are reduced to \$100.

AROUND THE COURTS

Deduction allowed for legal fees incurred by former employee

Under paragraph 8(1)(b) of the Income Tax Act, a taxpayer may deduct legal fees incurred to collect or establish a right to receive an amount that would be considered employment income if it were received.

In the recent *Kurnik* case, the taxpayer Mr. Kurnik was promised an employment bonus from his former employer corporation upon the closing of the sale of the corporation. After the sale, the corporation refused to pay the bonus. The taxpayer sued for the bonus. The corporation countered with two parallel lawsuits of its own – one a counterclaim against the taxpayer and the other a lawsuit against the taxpayer’s family trust for amounts paid to it while the taxpayer was employed there.

The taxpayer incurred legal fees in (1) pursuing his lawsuit, (2) defending against the corporation’s counterclaim against him and (3) defending against the lawsuit against the family trust. The CRA allowed the portion of fees relating to (1) and (2). However, it disallowed the legal fees Mr. Kurnik paid for defending the lawsuit against his family trust.

Upon appeal to the Tax Court of Canada, the Court allowed the deduction of all of the legal fees. The Court found that the second

lawsuit resulted from the first, and that the taxpayer had to incur legal fees with respect to both in order to collect the bonus. In the Court’s words, “Both lawsuits were litigated together, resolved contemporaneously and funded by the employee directly from the proceeds of the settlement from which Mr. Kurnik was fully successful in receiving his promised, but unpaid bonus... As such, he should be entitled to the deduction for all the legal fees.”

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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.