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TAX LETTER

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SUPERFICIAL LOSSES
ROLLOVERS INTO CERTAIN PERSONAL TRUSTS
SPLITTING PENSION INCOME WITH YOUR SPOUSE
DEDUCTION OF LIFE INSURANCE PREMIUMS
PRESCRIBED INTEREST RATES
AROUND THE COURTS

SUPERFICIAL LOSSES

The superficial loss rules in the Income Tax Act apply to deny capital losses on the disposition of property, if the taxpayer acquires the same or identical property within a certain time period. Basically, the rules are meant to prevent you from triggering capital losses, which can be used to offset any of your capital gains, and then re-acquiring within a short time the same or identical property that generated the loss.

In particular, the superficial rules can apply where

- you sell a property at a loss,
- you or an "affiliated person" acquires the property or an identical property ("substituted property") within the period beginning 30 days before the sale and ending 30 days after the sale ("relevant period"), and
- you or an affiliated person owns the substituted property at the end of the relevant period.

An "affiliated person" includes your spouse (or common-law partner). It also includes a corporation that is controlled by you or your spouse, or by an affiliated group of persons that includes you or your spouse. An affiliated person also includes a partnership in which you are a majority-interest partner, or a trust in which you are a majority-interest beneficiary (which can include RRSP or RRIF). Interestingly, an affiliated person does not include your child or other relative.

Where the rule applies, your capital loss is denied and deemed to be zero. However, the loss is not necessarily "lost" forever, because the amount of the loss is added to the cost of the substituted property. As such, if the substituted property is later sold, some or all of the loss may be realized at that time (assuming the superficial loss rules do not apply on the later sale).

Example

You sell 1,000 XCorp common shares on the open market for $50,000 and realize a $10,000 capital loss. Ten days later, your spouse purchases 1,000 XCorp common shares for $50,000. Two months later, your spouse sells the shares for $52,000 and neither you nor your spouse reacquires the shares.

Your $10,000 capital loss is denied because your spouse acquired the substituted property (the XCorp common shares) within the relevant period and owned them at the end of the period. However, the loss is added to your spouse's cost of the shares, which becomes $60,000. Therefore, on the subsequent sale for $52,000, your spouse realizes a capital loss of $8,000. Effectively, this $8,000 loss reflects your original $10,000 loss, net of the $2,000 gain in the shares that accrued while your spouse owned the shares.

If, instead, your child purchased the shares, you would immediately realize a $10,000 capital loss. On the subsequent sale by your child, there would be a $2,000 capital gain.

If you or the affiliated person acquire only a portion of the property, then a proportionate amount of the loss is denied.

Example

You sell 1,000 XCorp common shares on the open market for $50,000 and realize a $10,000 loss. Ten days later, you purchase 500 XCorp shares for $25,000. Two months later, you sell the 500 shares for $28,000.

One half of your initial capital loss, being $5,000, is denied because you reacquired one-half of your original 1,000 shares within the relevant period and owned them at the end of the period. The other half of your initial loss is allowed.

The $5,000 denied loss is added to your cost of the re-purchased 500 shares, which becomes $30,000. As such, when you later sell those shares for $28,000, you will realize a capital loss of $2,000.

As readers may appreciate, since there is a specific 30-day period under the rule, you can avoid the rule if you (or the affiliated person) reacquires the property *after* the end of the period. For example, if you wish to trigger some capital losses on shares near the end of a taxation year to offset some of your capital gains, you can sell the shares and re-purchase them 31 days later without worrying about the superficial loss rules. (Of course, the longer you wait, the more chance there is that the price of the share will have gone up in the interim.)

Identical Property

"Identical property" is not fully defined in the Income Tax Act. However, the Act does say that a bond, debenture, bill, note or similar obligation issued by a debtor is identical to another such obligation issued by that debtor if both are identical in respect of all rights,

except in respect of the principal amount of the obligation.

Furthermore, the following comments are generally accepted by the Canada Revenue Agency (“CRA”) and most tax experts.

Shares in a corporation are identical if they are of the same class. Shares in two different classes of the same corporation are not considered identical, even if the shares of one class are exchangeable or convertible for shares of the other class.

Shares in two different corporations are not identical even if the corporations are very similar.

Units of mutual funds are identical only if they are units of the same fund.

Corporations, Trusts and Partnerships

The rules discussed above apply to individuals. The rules are a bit different where a corporation, trust or partnership (“transferor”) incurs a superficial loss. Although the loss is denied, the amount of the loss is not added to the cost of the substituted property. Instead, the loss is suspended, and can be claimed by the transferor when neither the transferor nor an affiliated person owns the substituted property (technically, the loss is claimed at the beginning of the first 30-day period throughout which neither the transferor nor an affiliated person owns the substituted property).

ROLLOVERS INTO CERTAIN PERSONAL TRUSTS

Normally, if you transfer property into a personal trust, such as one for the benefit of you or your family members, you are deemed to have sold the property at its fair market value. As a result, any accrued capital gain will normally be triggered, and half of that gain will be included in your income as a taxable capital gain. The trust will be deemed to acquire the property at a cost equal to its fair market value.

However, in some cases, a tax-free “rollover” is allowed for transfers into trusts. By a “rollover”, we mean that you are deemed to have sold the property at your tax cost (so you have no gain for tax purposes), and the trust inherits the same cost. The main examples of these trusts are summarized below.

Spousal or Common-law Partner Trusts

A rollover is allowed for property transferred to this type of trust. Generally, the trust must meet the following criteria:

- The trust is resident in Canada;
- Your spouse (or common-law partner) is a beneficiary of the trust;
- During the lifetime of your spouse, your spouse is entitled to all of the income of the trust and no one else may receive or use the capital of the trust. However, the trust can provide that your children or other beneficiaries are entitled to income or capital after your spouse’s death; and
- If the trust is created upon your death – e.g. under your will – the property must “vest indefeasibly” in the trust within 36 months of your death or such longer time as the CRA may allow. “Vest indefeasibly” generally means that the trust becomes the owner of the property without any outstanding conditions.

On your spouse's death, the trust will have a deemed disposition of its properties at fair market value, which will trigger any accrued capital gains and capital losses. This may result in a tax liability for the trust at that time.

Joint Spousal or Common-law Partner Trusts

The criteria are similar to those described above, except that you and your spouse are joint-beneficiaries of the trust. The requirements relating to entitlement to income and use of capital apply to both you and your spouse during your lifetimes, until the later of your deaths. The deemed disposition also takes place at the later of your deaths.

Furthermore, you must be at least 65 years old at the time of the transfer to the trust.

Alter Ego Trusts

Again, the criteria are similar, except that you are a beneficiary of the trust. The entitlement to income and use of capital requirements apply to you while you are alive. The deemed disposition takes place upon your death.

You must be at least 65 at the time of the transfer to the trust.

Further Restrictions

Of course, the good news regarding the above trusts is the tax-free rollover. However, there are some restrictions that can lead to bad news.

For example, if the trust pays any income to a beneficiary other than the lifetime beneficiary described above (you and / or your spouse, as the case may be), while the lifetime beneficiary is alive, the payment is not deductible for the trust even though it is included in the other beneficiary's income. This will lead to double taxation, since both the trust and the other beneficiary will be taxed on the income.

If the trust distributes property to the lifetime beneficiary, the distribution is usually tax-free. However, if the property is distributed to another beneficiary while the lifetime beneficiary is alive, it is deemed to have been sold at fair market value.

SPLITTING PENSION INCOME WITH YOUR SPOUSE

The government generally frowns on income-splitting amongst family members. However, a specific rule in the Income Tax Act allows you to split certain pension income with your spouse or common-law partner.

The rule provides that you and your spouse can make a joint election, under which you split some of your pension income with your spouse. You can split any amount up to 50% of the income. The split amount is reported on your spouse's tax return, while you report the other portion of the pension income. The election is annual, meaning that you can change the split amount for each taxation year, or you can choose not to split in any particular taxation year.

The split is allowed even if you do not actually transfer any of the pension income to your spouse.

Eligible Pension Income

The pension income must be "eligible pension income".

In general terms, if you are 65 or older in the year, eligible pension income includes annuity income and periodic payments from a registered pension plan (RPP), payments from a pooled RPP, and payments out of a registered retirement savings plan (RRSP) or registered retirement income fund (RRIF).

If you are under 65 at year-end, eligible pension income normally includes **only** "qualified pension income", which means annuity income from an RPP. However, qualified pension income will also include the other pension payments described in the preceding paragraph if they are received as a consequence of the death of a **former** spouse (i.e. not your current spouse with whom you are splitting income).

Eligible pension income does not include income from government pensions such as the Canada Pension Plan, Quebec Pension Plan, or the Old Age Security.

Benefits of the Split

One benefit of the pension split occurs if you are in a higher marginal tax bracket than your spouse. The split will save you tax because the split amount will be subject to a lower tax rate.

A further benefit is the potential doubling of the pension credit. The federal credit is 15% of the first $2,000 of eligible pension income, while the provincial credit depends on the province of residence; the two credits together are worth up to about $450-$500 depending on the province. You can claim the credit, and assuming your spouse also qualifies, your spouse can also claim the credit. In this regard, the character of the pension income in your hands flows through to your spouse. For example, if the pension income is qualified pension income, your spouse can claim the credit even if he or she is under 65. If the pension income is one of the other types, your spouse can claim the credit only if he or she is 65 or over.

> **Example**
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> You are 68 years old and receive RRSP income in the year that is not qualified pension income. You can elect to split up to 50% of the income with your spouse. You can claim the pension credit.
>
> If your spouse is 65 or over, your spouse can claim the pension credit. If your spouse is under 65, he or she cannot claim the credit.

Another possible benefit relates to the Old Age Security (OAS) clawback tax. This is a tax that effectively requires you to repay some of your OAS benefits if your income exceeds a monetary threshold ($75,910 in 2018). The clawback tax is 15% of your net income in excess of the threshold, to a maximum of your OAS income. Therefore, if you would otherwise be subject to the clawback tax, you may be able to reduce or eliminate it if you pension split with your spouse.

In a similar vein, the age credit is phased out starting at $36,976 of income (2018 amount). Depending on your income, the pension split may allow you to reinstate some of your age credit.

Joint and Several Liability

Your spouse will be liable to pay the tax on the split amount that is included in his or her income. However, you will also be jointly and severally liable for that tax. This means that if your spouse does not pay the tax, the CRA can come after you to pay it

DEDUCTION OF LIFE INSURANCE PREMIUMS

Life insurance premiums are not normally deductible for income tax purposes because they are considered personal expenses. However, there are two scenarios under which the premiums are deductible.

First, if an employer pays life insurance premiums for an employee and the insurance is for the benefit of the employee or his or her family (e.g. the beneficiaries are the employee's estate, or spouse or children), there is a taxable benefit for the employee. On the payment side, the employer can normally deduct the premiums as a business expense.

Second, there is a special rule in the Income Tax Act that allows a deduction if a taxpayer takes out life insurance and is required to assign the insurance policy to a financial institution as collateral for a loan. A deduction for the premiums is allowed, generally if the loan is used for the purpose of earning income from a business or property.

As an example, if you own a private corporation that needs a loan, your bank may require insurance on your life as collateral, particularly in the case where the corporation has few hard assets and its value is largely dependent upon your effort and expertise. If your corporation pays the premiums on the insurance, it can normally deduct the premiums.

However, the amount of the deduction is limited to the "net cost of insurance in respect of the year" under the policy. The net cost of insurance is determined using actuarial principles set out in the Income Tax Regulations. In general terms, it uses mortality assumptions and is meant to approximate the cost of the pure life insurance coverage under the policy for the taxation year.

The deduction is also limited to the amount that "can reasonably be considered to relate to the amount owing from time to time during the year" under the loan. For example, if the life insurance coverage under an assigned policy is $1 million and the amount owing under the loan throughout the taxation year is $400,000, the amount deductible is limited to 40% of the lesser of the premiums payable and the net cost of pure insurance under the policy for the year.

The CRA states that it is not necessary that the insurance policy be taken out at the time of borrowing. An assignment of an existing policy is acceptable for these purposes.

PRESCRIBED INTEREST RATES

The CRA recently announced the prescribed interest rates that apply in the third quarter of 2018. The rates remain the same as those that apply in the second quarter.

- The annual interest rate charged on overdue taxes, Canada Pension Plan contributions, and Employment Insurance premiums is 6%, compounded daily.
- The interest rate paid on late refunds paid by the CRA to corporations is 2%, compounded daily.
- The interest rate paid on late refunds paid by the CRA to other taxpayers is 4%, compounded daily.
- The interest rate used to calculate taxable benefits for employees and shareholders from interest-free and low-interest loans is 2%.

AROUND THE COURTS

Rollover into partnership and cost of partnership interest

If you transfer property into a partnership of which you are a member, or a partnership of which you are a member immediately after the transfer, the transfer can take place on a tax-free rollover basis under subsection 97(2) of the Income Tax Act. Basically, you can elect an amount, and the elected amount becomes your proceeds of disposition of the property. Therefore, if the elected amount equals your tax cost of the property, there will be a complete rollover.

In addition, the elected amount, net of any other consideration you receive (other than your interest in the partnership), is added to your adjusted cost base of your interest in the partnership. The other consideration is sometimes called “boot”. For example, if you elect $10,000 and receive back $4,000 boot, you will add $6,000 to the adjusted cost base of your interest in the partnership.

Where the rollover does not apply, a general rule provides that the adjusted cost base of a partnership interest is simply the cost of the interest.

In the recent *Iberville Developments* case, a company transferred property into a partnership under the rollover provision and took back some boot. In accordance with the above rule, the company added the elected amount net of the boot to the adjusted cost base of his partnership interest. However, the company also added the value of the property to the adjusted cost base of the interest, on the grounds that this was the cost of the interest, i.e. the amount it paid for the interest. The company made the unique argument that the rollover rule for the adjusted cost base of the interest applied immediately after the transfer of the property, while the more general adjusted cost base rule applied at the time of the transfer. As such, according to the company, its adjusted cost base of the interest should have included both amounts.

The CRA assessed the company, arguing that the adjusted cost base of the interest was limited to the elected amount net of the boot because the rollover provision took precedence over the general provision.

On appeal to the Tax Court of Canada, the Tax Court Judge sided with the CRA. The Judge further held that the company's position would lead to “an absurd and unintended result”, and that the CRA's interpretation was “more consistent with the purpose of the provisions in question themselves”.

The company has appealed this decision to the Federal Court of Appeal.

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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.