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TAX NEWSLETTER

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CANADA REVENUE AGENCY CLOSES TELEFILE SERVICE

On June 27, 2012, the Canada Revenue Agency (CRA) announced that it is discontinuing its "TELEFILE" service (it will still be available until September 28 of this year). The TELEFILE service allows you to file your tax return by phone if you received a simplified tax package from the CRA indicating that you could use the service (it is limited to "individuals with less complicated tax situations").

The CRA noted that the use of TELEFILE has declined, on average, by 10 per cent every year and that only 1.2% of all tax returns are filed using TELEFILE. In its announcement, the CRA encouraged taxpayers to file their returns electronically (apparently 66% of taxpayers did so this year) and to use the CRA's online services. Of course, you can still file using the tried-and-true method of a paper return.

If you have questions regarding the ending of the TELEFILE and the availability of the other filing methods, the CRA encourages you to refer to the CRA Web site at cra.gc.ca/getready or to call them at **1-800-959-8281**.

PERSONAL LOANS TO YOUR CHILDREN

Parents often help out their children with the purchase of their first major consumer item, such as a car or a home. These forms of financial aid generally carry no problematic income tax consequences.

For example, if you simply give cash to your adult children and they use it for personal purposes, or even for income-earning purposes, there are no attribution rules or other problematic issues.

Similarly, you can lend cash to your adult children for personal purposes. If you charge interest, the interest will be included in your income, although they cannot deduct the interest if the loan is used for personal purposes. Of course, you do not have to charge interest. However, if the purpose is to transfer investment income to your child, a special rule in Income Tax subsection 56(4.1) can attribute the income back into your hands.

If you decide to forgive the personal loan, there are no income tax consequences.

Similarly, if the loan remains outstanding on your death, and it is settled or forgiven under the terms of your will as part of the bequest or inheritance of your child, there are no income tax issues. In particular, the debt forgiveness rules of the Income Tax Act do not apply to loans that are cancelled on death, including personal and non-personal loans.

LOSS CARRYOVERS

Provisions in the Income Tax Act allow you to carry back or forward certain losses that cannot be used in a taxation year.

First, there are rules governing "non-capital" losses. Generally speaking, these are your losses from employment, business or property (but not capital losses) in excess of your positive income from all sources for a taxation year. You can carry these losses back 3 years or forward 20 years. (For non-capital losses that arose in 2004 or 2005, the carry-forward period is only 10 years, and for losses in years before 2004 the carry-forward period was only 7 years.)

If you incur a capital loss in a year (from selling shares in the stock market, for example), half of it is an "allowable capital loss". This can be deducted only against taxable capital gains in the year, and not against other sources of income (except in the year of death and the preceding year). If your allowable capital losses for the year exceed taxable capital gains, the excess is called a "net capital loss". The net capital loss can be carried back 3 years or forward indefinitely, but can only be used against taxable capital gains of those other years.

Allowable business investment losses (ABILs) are one-half of capital losses from debt or shares in "small business corporations" (and subject to certain conditions). Your ABILs in a taxation year can be used to offset all sources of income, and not just taxable capital gains. To the extent they cannot be used in a taxation year, they can be carried back 3 years or forward 10 years (7 years for losses that arose in years before 2004) to offset all sources of income in those years. If they are not utilized by that tenth (or seventh) carry-forward year, they become regular net capital losses and then can be deducted only against taxable capital gains in future taxation years.

As noted in the section below, there are separate carry-over periods for losses from "listed personal use property".

PERSONAL USE PROPERTY

Gains and losses from the disposition of personal-use property are treated differently for income tax purposes. Gains above a certain threshold are recognized and taxed, while losses are generally deemed to be nil and therefore are not allowed (an exception is made for listed personal property, described below).

Therefore, for example, if you dispose of a personal-use diamond ring at a gain, one-half of the gain will be a taxable capital gain and included in your income. (All personal-use property is subject to a minimum deemed cost and proceeds of $1,000, so if you have, say an old lamp you bought for $200 and you sell it for $800, there is no gain for tax purposes since both cost and proceeds will be deemed to be $1,000.)

However, if you sell the ring at a loss, you cannot claim the resulting capital loss against your gains on the stock market. Similarly, if you sell your furniture at a loss, you cannot claim the loss for tax purposes.

The rationale for denying the recognition of most personal-use property losses is that they generally reflect your previous personal consumption of the property. Personal consumption is generally not deductible for income tax purposes.

Personal-use property is defined to include property that is used primarily for the personal use or enjoyment of you and/or individuals related to you.

LISTED PERSONAL PROPERTY

Special rules govern gains or losses from "listed personal property" (LPP).

Gains and losses from these properties in a year are netted together, and if there is a net gain, one-half of it is taxable.

If there is a net loss, it cannot be used in that year. However, it can be carried back 3 years or forward 7 years, and can be used to offset net gains from LPP in any of those years (but not any other gains). One-half of the net gain in that other year, if any, is then included in your income.

LPP includes the following properties:

- prints, etchings, drawings, paintings, sculptures, or similar works of art;
- jewellery;
- a rare folio, rare manuscript, or rare book;
- stamps and coins.

REPLACEMENT PROPERTY RULES

If you dispose of a capital property at a gain, the "replacement property" rules in the Income Tax Act may allow you to defer recognizing the gain for tax purposes if you acquire a replacement property. Similarly, if you dispose of a depreciable property and realize “recapture” (generally, where your proceeds exceed the undepreciated capital cost of the property), you may be able to defer the recognition of the recapture if you acquire a replacement property.

The deferral is optional. If you want it to apply, you make an election in your tax return for the year in which you acquire the replacement property.

For involuntary dispositions of property – for example, if your property is stolen, destroyed or expropriated – the replacement property must be acquired by the end of the second taxation year following the year of disposition (or 24 months after the end of that year, whichever is later).

For voluntary dispositions of property, the timeline is shorter. You must acquire the replacement property by the end of the first taxation year following the year of disposition (or 12 months after the end of that year, whichever is later).

For voluntary dispositions, the deferral applies only to capital properties that are land and buildings used in a business, other than a rental business.

For involuntary dispositions, the rules potentially apply to any capital property, other than a share of a corporation.

Deferral of capital gain

As a general rule, if the cost of your replacement property is at least equal to your proceeds of disposition of the former property, the entire gain from the former property can be deferred. If the cost of the replacement property is less than your proceeds from the former property, the amount of the deferred gain will be reduced proportionately, meaning you will include at least a portion of the gain.

EXAMPLE

Mike ran a business in a factory located on same land outside of Toronto. The factory and the land each had a cost of $200,000. In 2011, he sold them for $300,000 each, for a total of $600,000. As such, his initial gain on the factory and land was $100,000 each.

If Mike buys a replacement factory and land by the end of 2012, he can defer the gain on both former properties if they cost at least $300,000 each. He will not report any gain in 2011.

However, if one of the replacement properties – say, the replacement factory – cost only $280,000, then only $80,000 of the initial gain would be deferred, such that $20,000 of the initial gain would be reported in 2011. Half of that, or $10,000, would be a taxable capital gain included in Mike's income in 2011.

Reduction of cost of replacement property

Since the rules allow you to defer the gain on the former property, the cost of the replacement property is reduced by the amount of the deferred gain.

Thus, if Mike in the above example acquired a new factory for $300,000, such that the entire $100,000 gain from the former factory was deferred, the cost of his new factory would be reduced by $100,000 to $200,000.

Deferral of recapture

The rules also allow you to defer any recapture on the sale of depreciable property. Generally speaking, recapture can occur where your proceeds of disposition (up to your initial cost of the property) exceed the undepreciated capital cost (UCC) of the property. The UCC generally reflects the cost of the property that has not yet been depreciated for income tax purposes under the capital cost allowance (CCA) provisions.

The rules allow the deferral of the recapture as long as the cost of the replacement property equals at least the amount of the recapture.

Thus, in the above example, if the factory (a depreciable property) had a UCC of $180,000, the initial recapture on Mike's sale would be $20,000 (excess of proceeds over UCC, but only up to original cost of $200,000). As long as the cost of the replacement property equaled or exceeded $20,000, he could defer the recognition of the recapture. (As noted above, in order to also defer the capital gain on the former factory, the cost of the replacement property would have to equal at least the amount of the proceeds of the former factory.)

The amount of the deferred recapture then effectively reduces the UCC in respect of the replacement property.

Meaning of "replacement property"

Generally, a "replacement property" is one that is used in the same or similar manner as the former property. Assuming the former property was used by you for the purpose of earning income from a business, the replacement property must be used for the purpose of earning income from that or a similar business. Furthermore, it must be "reasonable to conclude" that the replacement property was acquired to replace the former property.

PARTNERSHIP INFORMATION RETURNS

A partnership is not a taxpayer. Therefore, it does not pay income tax or file an income tax return. Instead, the members of the partnerships report their shares of the income or loss from the partnership on their tax returns and pay any tax thereon.

However, in many cases a partnership is required to file an information return for its fiscal period. The return is Form T5013, with related schedules. The form and schedules require information such as the names and addresses of the partners, their Social Insurance Numbers if individuals, and their share of the partnership's income and loss and other relevant amounts for the fiscal period.

The CRA waives the partnership information return requirement for many small partnerships. CRA administrative policy requires a partnership to file the T5013 for a fiscal period if it carries on a business in Canada, or it is a Canadian partnership with Canadian or foreign operations or investments, but only if:

- at the **end** of the fiscal period,
  - the partnership has an “absolute value” of revenues plus an absolute value of expenses of more than $2 million, or has more than $5 million in assets (“absolute value” is described below); or

- at **anytime during** the fiscal period,
  - the partnership is a tiered partnership (has another partnership as a partner or is itself a partner in another partnership);
  - the partnership has a corporation or a trust as a partner;
  - the partnership invested in flow-through shares of a principal-business corporation that incurred Canadian resource expenses and renounced those expenses to the partnership; or
  - the CRA requests one in writing.

The CRA describes the absolute value concept as follows:

“The absolute value of a number refers to the numerical value of the number without regard to its positive or negative sign. For example, "3" is the absolute value of both 3 (positive 3) and -3 (negative 3). To determine if a partnership exceeds the $2 million threshold, add total expenses to total revenues rather than subtract expenses from revenues as you would to determine net income. For example, a partnership with revenues of $1.5 million and expenses of $1.25 million would have an absolute value of revenues plus an absolute value of expenses of $2.75 million ($1.5 million plus $1.25 million).”

The filing due-date for the T5013 depends on the makeup of the partnership, as follows.

If all of the partners are corporations (other than professional corporations) throughout the fiscal period, the form must be filed within five months after the end of the fiscal period.

If all of the partners are all individuals (and/or professional corporations) throughout the fiscal period, the form must be filed by March 31 of the year after the calendar year in which the fiscal period ends.

In any other case, the form must be filed by the earlier of:

- the day that is five months after the end of the fiscal period, and
- March 31 of the year after the calendar year in which the fiscal period ends.

FOREIGN EXCHANGE GAINS AND LOSSES

If you realize capital gains or losses on foreign exchange transactions, they are generally treated the same as other capital gains and losses. That is, half of the gains are taxable capital gains and half of the losses are allowable capital losses.

However, for individuals, the first $200 of net gains or losses in a taxation year are ignored for these purposes. Thus, for example, if you had $600 of net foreign exchange gains in a year, only $400 of those would be considered capital gains, and half of that, or $200, would be the amount of taxable capital gains.

Foreign exchange gains or losses can occur when you convert a foreign currency into Canadian currency. For example, say I previously purchased some US dollars when the Canadian dollar was trading at par. Now, I exchange $10,000 of those US dollars back into Canadian dollars when the exchange rate is $US1 = $C1.03. I will have a foreign exchange gain of (.03 x $10,000), or $300.

However, the gains or losses can occur in other circumstances. For example, say I borrowed US$10,000 when the US dollar was trading at par with the Canadian dollar. I used the loan to purchase some capital property. Now I repay the loan when the exchange rate is $US1 = $C1.03. In this case, I will have a foreign exchange **loss** of (.03 x $10,000), or $300. That is, the repayment of the loan cost me $300 more in Canadian dollars than the original amount of the loan, so I have incurred a loss.

PRESCRIBED INTEREST RATES

The CRA recently announced the prescribed annual interest rates which are in effect from July 1, 2012 through September 30, 2012.

- The interest rate charged on overdue income tax, Canada Pension Plan contributions, and Employment Insurance premiums is 5%, compounded daily.
- The interest rate to be paid on late refunds paid to corporations is 1%, compounded daily.
- The interest rate to be paid on late refunds paid to other taxpayers is 3%, compounded daily.
- The interest rate used to calculate taxable benefits for employees and shareholders from interest-free and low-interest loans is 1%.

AROUND THE COURTS

Corporation was CCPC by virtue of Unanimous Shareholders Agreement

A Canadian-controlled private corporation (CCPC) enjoys various tax preferences under the Income Tax Act. For example, it is entitled to the small business deduction on its first $500,000 of active business income in a year, and it is entitled to enhanced investment tax credits.

Generally speaking, a CCPC is defined as a corporation resident in Canada that is not controlled by public corporations, non-residents, or any combination thereof.

In the recent *Price Waterhouse Coopers* case (as trustee in bankruptcy for *Bioartificial Gel Technologies*), the issue was whether a Canadian resident

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corporation was a CCPC even though more than 50% of its voting shares were owned by non-residents. The CRA argued that it was not a CCPC because it was controlled by non-residents.

However, on the taxpayer's appeal to the Tax Court of Canada, the Court allowed the appeal and held that the corporation was a CCPC. The Court found that there was a binding unanimous shareholder agreement in the years in question, which restricted the non-resident shareholders from electing a majority of the board of directors. As a result, only the Canadian shareholders of the corporation could elect the majority of the board. Therefore, the Canadian resident shareholders had *de jure* control of the corporation.

In reaching its decision, the Tax Court followed the Supreme Court of Canada decision in the *Duha Printers* case, where the Supreme Court held that in determining *de jure* control, one "must also consider any specific limitation on either the majority shareholder's power to control the election of the board, or the board's power to manage the business and affairs of the company (as manifested in either the constating documents of the corporation, or in any "unanimous shareholder agreement"…)"

The federal government has appealed the *Price Waterhouse Coopers* case to the Federal Court of Appeal. It remains to be seen whether the Court of Appeal agrees with the reasoning of the Tax Court.

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