BUCHANAN BARRY LLP
CHARTERED ACCOUNTANTS

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TAX-FREE TRANSFERS TO YOUR SPOUSE

Under the *Income Tax Act*, you are allowed to transfer capital property to your spouse or common-law partner on a tax-free basis. The transfer takes place at your cost of the property so that there is no gain or loss, and your spouse takes over the property at your cost of the property. The tax-free "rollover" applies both to gifts and to other transfers of property (such as sales).

The tax-free rollover also applies to gifts or transfers made to a trust if your spouse or common-law partner as beneficiary is entitled to all of the income of the trust and no one else is allowed to receive the capital of the trust during his or her lifetime. (It also applies to transfers made to a "joint spousal or common-law partner trust", which is a trust where you and/or your spouse or common-law partner as beneficiaries are entitled to all of the income of the trust and no one else is allowed to receive the capital of the trust during your lifetimes.)

Interestingly, the tax-free rollover also applies to transfers made to your former spouse or common-law partner in settlement of rights arising under the marriage or common-law partnership – for example, where you are required to transfer some of your assets to your former spouse on your divorce under family law rules.

If you wish, you can elect out of the rollover in an election filed with your tax return for the year in which you transfer the property. In such case, a gift of property will take place at its fair market value, which may generate a capital gain. This could be useful if you have losses to offset the gain, because the cost of the property would be stepped-up to its fair market value in the hands of your spouse. However, the election cannot create a loss on the transfer to your spouse because of the “superficial loss” rules in the *Act*.

The election out of the rollover might also be desirable if you wish to avoid the income attribution rules, because those rules could otherwise apply to income earned on the property by your spouse. Electing out of the rollover, and receiving fair market value consideration that is actually paid to you on the transfer of the property, is a way to avoid the income attribution rules.

A similar tax-free rule applies upon your death. Although most capital properties at your death are deemed to be disposed of at their fair market values, an exception applies to property left to your spouse or common-law partner, or a trust as described above. An election out of the rule can be made by your executor or legal representative, which will mean that the property will be deemed to be disposed of at its fair market value. Note that the superficial loss rules do not apply upon death, so losses can be triggered on property left to your spouse if your executor or legal representative makes this election.

MEAL AND ENTERTAINMENT EXPENSES

If you carry on a business, you are generally allowed to deduct half the cost of meal, beverage and entertainment expenses incurred for the purpose of earning your business income. Thus, for example, you normally get a deduction if you entertain clients or customers of your business, or take them out for dinner.

In some cases, employees can deduct meal expenses (*e.g.* during work-related travel), and certain commissioned sales employees can deduct meal and entertainment expenses incurred for employment purposes. For employees, among other conditions, the form T2200 is required, signed by the employer certifying that the employee is required to incur expenses.

However, in all cases, a deduction for meals or entertainment is limited to 50% of the actual expenses incurred. The arbitrary 50% rule reflects the fact that at least some of these expenses are for personal enjoyment rather than for the purpose of earning income.

Interestingly, the 50% rule applies even if you don't personally consume the meals or beverages or enjoy the entertainment. For example, if you give your customers or clients tickets to a sporting event or concert in appreciation of their business, but you don't attend the event yourself, your deduction for purchasing of the tickets is still limited to 50% of the cost. Although there is an argument that this treatment is not appropriate, it was confirmed by the Federal Court of Appeal (in the *Stapley* case), and not surprisingly, it remains the position of the Canada Revenue Agency (CRA).
There are some exceptions to the 50% rule. For example, it does not apply to an employer who pays for an employee's meals, beverages or entertainment where the payment is included in the employee's income as a taxable benefit from employment. It does not apply to meals, beverages or entertainment that relates to a fund-raising event the primary purpose of which is to benefit a registered charity. It does not apply to an employer in respect of up to six special events per year in which meals, beverages or entertainment are generally available to all employees of a particular location of the employer's business.

A different limitation applies to certain long-haul truck drivers. Their deductible portion of food and beverages is 70% of the actual cost for the 2009 year, increasing to 75% for 2010 and to 80% beginning in 2011.

ESTATES AND TESTAMENTARY TRUSTS

Estates and testamentary trusts (generally, trusts arising as a consequence of your death, with certain other requirements) are taxed at the same graduated tax rates that apply to natural individuals. This contrasts with "*inter-vivos*" trusts (generally, trusts created during your lifetime), which are taxed on their income at a flat rate, being the highest marginal tax rate applicable to individuals (currently 29% federal tax, plus provincial tax).

Furthermore, testamentary trusts can have a taxation year ending at any time, as long as it does not exceed 12 months. One of the possible benefits of this rule relates to the fact that when a beneficiary receives income of the trust from a trust's taxation year, it is included in the beneficiary's taxation year in which the trust's taxation year ends. This can allow a one-year deferral of the income inclusion.

For example, if a testamentary trust has a taxation year ending on January 31 of each year, the trust's income from February 1, 2010 to January 31, 2011 that was paid to a beneficiary would be included in the beneficiary's income for 2011. The beneficiary will report and pay tax on this income in their 2011 return filed in spring 2012, even though most of the income may have been earned by the trust during 2010.

Inter-vivos trusts have a calendar year end, so the above deferral is not available.

Since each testamentary trust is subject to graduated tax rates, and the income attribution rules do not apply after your death, it is possible to split income by setting up multiple trusts under your will, provided the multiple trusts do not have the same beneficiaries.

For example, if you are married with three children, you could set up four trusts under your will, with each of your spouse and children as a beneficiary of one of the trusts. That would effectively split the income from your estate four ways. Furthermore, each trust could either retain the income, in which case it would be taxed, or pay it out to the beneficiary, in which case the beneficiary would be taxed. As a result, income could effectively be split 8 ways.

Note that although a trust pays tax at graduated rates, meaning relatively low tax on low levels of income, it is not entitled to any of the personal credits, including the basic personal credit which allows an individual to earn over $10,000 of taxable income each year before paying any tax. As a result, the first dollar of income reported by the trust on its own return will be subject to combined federal-provincial tax of about 20% (varying by province).

FOREIGN ACCRUAL PROPERTY INCOME (FAPI)

Canadian residents are taxed on their world-wide income, whereas non-residents are taxed in Canada only on their Canadian-sourced income and not on their foreign-sourced income. As a result, a Canadian resident individual might consider setting up a non-resident corporation to earn investment income offshore. That is, since the corporation would not be subject to Canadian tax on that income, the individual might think they can earn foreign income through the corporation and leave it there, with the hope of not attracting Canadian income tax.

The "foreign accrual property income" (FAPI) rules are intended to thwart such relatively simple schemes (as well as more complex schemes). Generally, if you own shares in a "controlled foreign affiliate" corporation, you will be subject to tax on your proportionate share of the corporation's FAPI in a taxation year even if you don't receive it. In general terms, FAPI includes investment income such as interest, dividends, royalties, certain rental income, most taxable capital gains, and income from a business that is not an "active business".

Most of the rules and definitions relating to FAPI are horrendously complex and far beyond the scope of this Letter. However, in general terms, a “foreign affiliate” will be considered your “controlled foreign affiliate” if it is controlled by you, or would be controlled by you if you also owned all of the shares owned by persons not dealing at arm's length with you and those shares owned by up to four other Canadian residents. A foreign affiliate is generally a foreign corporation in which you have at least a 1% "equity percentage", and in which you and persons related to you have at least a 10% equity percentage.

There are rules to ensure that the FAPI is not subject to double taxation. For example, if FAPI is included in your income in a taxation year even though you did not receive any of it, future dividends you receive from the corporation out of the FAPI are generally tax-free.

As noted, the FAPI rules are very complex, and if you are contemplating setting up a foreign company for any purpose, you should seek professional advice.

Note also that if you set up a non-resident company, then even without the FAPI rules it may be considered resident in Canada if its "central management and control" are in Canada. If you are essentially directing the company's activities, the CRA will likely take the view that it is Canadian resident and thus must pay tax to Canada on all its income from all sources including foreign sources.

CARRYING OVER LOSSES TO OTHER TAXATION YEARS

If you have a net loss for a year from business or property, after offsetting it against all your income sources for the year, the loss is considered a “**non-capital loss**”. A non-capital loss can be optionally carried back to the 3 immediately preceding taxation years and deducted in computing your taxable income for any of those years. The non-capital loss can also be carried forward. For non-capital losses arising in the 2006 and later taxation years, the loss can be carried forward 20 years and optionally deducted in computing taxable income in any of those years. Non-capital losses that arose in taxation years that ended after March 22, 2004 and before 2006 may be carried forward 10 years. For losses incurred in earlier years, non-capital losses can be carried forward seven years.

A "**net capital loss**" in a year occurs when your allowable capital losses for the year (half of your actual capital losses) exceed your taxable capital gains for the year (half of your actual capital gains). The net capital loss cannot normally be deducted against other forms of income for the year. However, it can be carried back three years or forward indefinitely to offset taxable capital gains in those years. (For the year of death and the immediately preceding year, net capital losses can generally offset all types of income.)

An “**allowable business investment loss**” or “ABIL”, is one-half of a business investment loss, which generally is a capital loss incurred on disposition of shares or debt of a "small business corporation", subject to certain other requirements. An ABIL is deductible against all forms of income, rather than only against taxable capital gains.

To the extent there is an unused ABIL in a taxation year, it is added to the non-capital loss pool as described above and therefore can be utilized in other years against all forms of income. However, the ABIL can remain in the non-capital loss pool for only 10 years (for ABILs incurred in taxation years ending after March 22, 2004), after which, to the extent the ABIL remains, it becomes a net capital loss. From that point on, it is deductible only against taxable capital gains. For ABILs incurred in taxation years ending before March 23, 2004, the ABIL can remain in the non-capital loss pool for only the subsequent seven years, after which it becomes a net capital loss.

Most capital losses from the disposition of **personal-use property** are denied and deemed to be zero. Thus, for example, losses from the sale of your personal residence, your car, your furniture, and so on, are not recognized for income tax purposes.

However, you are allowed to deduct losses from the disposition of "**listed personal property**" (LPP) against gains from the disposition of LPP. Generally, half of your losses from LPP are deductible against half of your gains from LPP in a taxation year, and any excess can be carried back 3 years or forward 7 years to offset gains from LPP in those years.

For this purpose, LPP means a print, etching, drawing, painting, sculpture, or other similar work of art; jewellery; a rare folio, rare manuscript, or rare book; a stamp; or a coin.

CANADA PENSION PLAN CONTRIBUTIONS FOR 2010

The maximum pensionable earnings under the Canada Pension Plan (CPP), on which CPP contributions are payable, will be $47,200 for the 2010 year. This is up from $46,300 for 2009.

The employee and employer contribution rates for 2010 remain unchanged at 4.95%, and the self-employed contribution rate will remain at 9.9%. Therefore, the maximum contribution for an employer and employee to the plan for 2010 will be $2,163.15, and the maximum contribution for a self-employed person will be $4,326.30. The maximum amounts in 2009 were $2,118.60 and $4,237.20, respectively. If you are self-employed and do not have employment income, you must calculate and pay this contribution on your income tax return each year, though you get a partial income tax credit and deduction that typically reduces the cost by about 30% (varying by province and your income level).

Since the $47,200 is the ceiling amount, individuals earning more than that in 2010 are not required to make additional contributions to the CPP over the amounts indicated above.

The basic exemption amount for 2010 remains $3,500. Thus, individuals who earn less than this amount do not contribute to the CPP.

The Quebec Pension Plan amounts and limits are the same as those for the CPP as described above.

PRESCRIBED INTEREST RATES

The CRA recently announced the prescribed annual interest rates for the coming quarter that will apply to any amounts owed to the CRA and to any amounts the CRA owes to taxpayers for income tax purposes. These rates are adjusted quarterly and will be in effect from January 1 to March 31, 2010**.** The rates are unchanged from the quarter that ended on December 31, 2009.

- The interest rate charged on overdue income taxes, Canada Pension Plan contributions, and Employment Insurance premiums will be 5%.
- The interest rate paid on refunds paid by the CRA (after 30 days) will be 3%.
- The interest rate used to calculate taxable benefits for employees and shareholders from interest-free and low-interest loans will be 1%.

AROUND THE COURTS

Rental losses denied – no intention of profit

At one time, the courts held that a taxpayer could not claim losses from a business or property if the taxpayer did not show a "reasonable expectation of profit" (REOP). The REOP doctrine was overturned by the Supreme Court of Canada in 2002 (in the *Stewart* and *Walls* decisions). In its place, the Supreme Court formulated a general test that, where the activity in question is not “clearly commercial”, the proper inquiry is whether the taxpayer has an "intention to profit", and this requires the taxpayer to establish that his predominant intention is to make a profit from the activity and that the activity has been carried out in accordance with objective standards of businesslike behaviour.

In the recent *Landriault* case, the two taxpayers purchased a two-unit residential home in Ottawa. They lived in the lower unit, and they rented out the upper unit to one of their sons. Initially, they rented it to him at a below-market rent, but they contended that this was only a temporary arrangement until he began receiving disability assistance payments from the Province of Ontario. Once he received those payments, they raised the monthly rent from $300 to $450. However, their expenses still far exceeded the rent they received, and they tried to deduct the resulting losses for income tax purposes.

The CRA denied the deductions, and on appeal by the taxpayers, the Tax Court of Canada also disallowed the deductions. The Tax Court concluded that on the balance of probabilities, the taxpayers had no real intention of making a profit from renting out the unit to the son, and that this was a family arrangement under which a minimal rent was paid to help defray the operating costs of the property.

Essentially, the Court concluded that the rental activities were not carried out on a commercial basis. The initial rent was below the fair market value payable for a similar unit in the area, and even after it had been increased, the rent was (in the words of the Court) “utterly insufficient for the property to be capable of showing a profit.”

Cost of swimming pool not eligible for medical tax credit

In the recent *Barnes* case, the taxpayer installed a swimming pool in his backyard to assist his daughter Zoe, who had hemiplegia associated with brain damage, and also suffered from cerebral palsy and severe epileptic seizures that affected her ability to walk, talk, dress, and to go to the washroom by herself. Two neurosurgeons and a physiotherapist recommended that she take up swimming, which they indicated would enhance her neuromuscular functions and abilities and improve her quality of life. The taxpayer therefore installed the swimming pool for his daughter.

Zoe started swimming and in fact trained for the Special Olympics. The swimming worked to build up her strength and control, which resulted in a notable improvement in her ability to walk, dress and go to the washroom by herself.

The taxpayer claimed the cost of the swimming pool as a medical expense for the purposes of the medical expense credit. Such an expense can qualify under the *Income Tax Act*, if, among other things, it relates to "alterations to a dwelling of the patient who lacks normal physical development or has a severe and prolonged mobility impairment, to enable the patient to gain access to, or to be mobile or functional within, the dwelling."

Unfortunately for the taxpayer, a recent amendment to the *Act* provides that such an expense must be "of a type that would not normally be incurred by persons who have normal physical development or who do not have a severe and prolonged mobility impairment." On these grounds, the CRA denied the credit because the expense of installing a swimming pool is normally incurred by healthy persons not in Zoe's condition.

Upon appeal to the Tax Court of Canada, the Court reluctantly upheld the CRA decision and disallowed the credit. The Court regretted that it could not allow the credit, essentially because the wording of the *Income Tax Act* was clear, and it had no jurisdiction to otherwise grant relief to the taxpayer.

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