Davidson & Company
CHARTERED PROFESSIONAL ACCOUNTANTS

TAX UPDATE

Did You Know

In the world of US Tax, penalties can be devastating. Our US tax professionals have a wealth of experience dealing with the IRS and are equipped with the tools to navigate your various US tax compliance and planning needs. Call us at: **604.687.0947** or visit our website: **https://davidson-co.com/service/us-tax/**

SALE OF BUILDING USED FOR BUSINESS OR RENTAL – POSSIBLE DENIAL OF TERMINAL LOSS

If you own a building and land used for income earning purposes – such as in your business or by renting out the property – you will often deduct capital cost allowance ("CCA") for the building. CCA is the depreciation that is allowed for income tax purposes, and it differs from financial accounting depreciation.

The CCA that you deduct reduces the tax depreciation pool in respect of the *building*, otherwise known as the undepreciated capital cost ("UCC"). If you subsequently sell the building for an amount greater than the UCC, you will have recapture, which is fully included in

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your income. (If you sell the building for more than its original cost you will also have a capital gain.) Conversely, if you sell the building for an amount less than the UCC, you may have a terminal loss, which is fully deductible in computing your income.

On the other hand, *land* is not depreciable property. If you sell the land at a gain, only one-half of the gain is included in your income as a taxable capital gain (unless you bought the land with the intention of resale, in which case it would be fully included as income from a business.)

A special rule in the Income Tax Act (subsection 13(21.1) provides that if you sell the building and land and have a capital gain on the land and a terminal loss on the building, you must re-allocate some of the proceeds from the land to the building. Basically, the proceeds from the land, to the extent of the gain from the land, must be re-allocated to the building to reduce the terminal loss.

> *EXAMPLE*
>
> *You sell a building and land used in your business. Your cost of the land was $200,000 and your cost of the building was also $200,000. The UCC of the building (the only property in its class) was $150,000. You sell both for a combined $500,000 – allocated in the Agreement of Purchase and Sale as $400,000 for the land and $100,000 for the building.*
>
> *Before applying subsection 13(21.1), you would have a $200,000 gain on the land (only half-taxed) and a $50,000 terminal loss on the building (fully deductible). However, the subsection 13(21.1) will re-allocate $50,000 of the proceeds from the land to the building.*
>
> *Accordingly, your proceeds for the land are reduced to $350,000, resulting in a $150,000 capital gain and $75,000 taxable capital gain (income inclusion).from the land. The proceeds for the building will be $150,000, resulting in a nil terminal loss.*

If there is no terminal loss before the re-allocation of proceeds, the rule does not apply.

CANADIAN INTER-CORPORATE DIVIDENDS

General rule

A Canadian corporation ("recipient") that receives a dividend from another Canadian corporation ("payer") must include the dividend in income. However, an offsetting deduction is allowed in computing the recipient corporation's taxable income, so that the dividend is normally not subject to tax for the recipient (subject to the comments below regarding Part IV tax).

The reason why the recipient corporation is allowed the offsetting deduction is that the dividend is normally paid out of the payer corporation's after-tax income. If the recipient were also subject to tax on the dividend, there would be double taxation. And if there were multiple "stacked" corporations (e.g. the payer corporation was a shareholder of another corporation that itself was a shareholder of another corporation), there could be triple, quadruple or further taxation as the dividend was paid up the corporate chain.

The offsetting deduction in computing taxable income generally means that dividends can flow up through a corporate chain on a tax-free basis. (There are exceptions for dividends on certain preferred shares and other financing vehicles created to take advantage of these rules, but these are generally of limited application.) Once the dividends are paid to an individual (human) shareholder, they are included in the individual's income.

Special Refundable Tax

However, in certain cases, a recipient private corporation will be subject to a special refundable federal tax under Part IV of the Income Tax Act (called the '*Part IV tax*') . This tax is payable on dividends received from payer corporations with which the recipient is not "connected". In general, a recipient and a payer are not 'connected' if the recipient owns 10% or less of the shares in the payer corporation, counting both votes and fair market value.

The Part IV tax makes it less attractive for you to hold your share investments through a private corporation. For example, in the absence of the Part IV tax, you could put your publicly-traded shares into a private corporation, which could receive dividends on the public shares on a tax-free basis as discussed above. Although you would be subject to tax when your corporation paid you a dividend, this tax would be deferred to the extent the monies were left in your corporation. The Part IV tax takes away the potential tax deferral advantage.

The Part IV tax for the recipient corporation is 38 1/3% of the dividends received from the payer corporation (for taxation years ending before 2016, the rate was 33 1/3%). The tax forms part of the recipient corporation's "refundable dividend tax on hand" and is refundable to the corporation when it pays a dividend to its own shareholders, at a rate of 38 1/3% of the dividend.

EXAMPLE

In year 1, a recipient private corporation receives a $100,000 dividend from a non-connected payer corporation (e.g. from an investment in a widely-held public corporation. The recipient corporation is subject to Part IV tax of $38,333. However, if it pays out a $100,000 dividend to its shareholders, it will receive a refund of $38,333, meaning that it will have zero net Part IV tax payable for the year.

If the recipient paid no dividend in year 1, there would be no refund in that year. However, the $38,333 would carry over to the next year as part of the recipient's refundable dividend tax on hand. So if the recipient corporation paid a dividend in year 2, it would receive a refund of 38 1/3% of the dividend in year 2, to a maximum refund of $38,333 (assuming no other transactions).

Usually, a recipient corporation that receives dividends from a payer corporation with which it is connected will not be subject to the Part IV tax. The corporations will be *connected* if the recipient controls the payer corporation or it owns more than 10% of the shares in the payer corporation on a votes and fair market value basis.

However, if the payer corporation itself gets a refund of Part IV tax when it pays the dividend to the recipient corporation, the tax is regenerated in the hands of the recipient corporation, in a proportion equal to the dividends it receives to the total dividends paid by the payer.

> *EXAMPLE*
>
> *A private recipient corporation receives a $100,000 dividend from a connected payer corporation. The payer paid a total of $200,000 dividends in the year. As a result of the payment of the dividends, the payer claimed a Part IV refund of $40,000.*
>
> *One-half of that refund, or $20,000, will be subject to Part IV tax for the recipient corporation (since the recipient received half of the $200,000 dividends paid out). However, that tax will in turn be refundable to the recipient, at a rate of 38 1/3% of dividends it pays to its shareholders (as above).*

Lastly, instead of claiming a refund of the Part IV tax, the recipient can reduce its Part IV tax payable for a year by 38 1/3% of its non-capital losses for the year, or by 38 1/3% of its non-capital losses carried over from up to 20 years preceding or 3 years following the year.

SMALL BUSINESS CORPORATION GOING PUBLIC

Under the lifetime capital gains exemption, you are allowed to earn a certain amount of capital gains on a tax-free basis. The amount of possible exempt capital gain on qualified small business corporation shares ("QSBC shares") is $835,716 as of 2017 ($417,858 of taxable capital gains) and is indexed annually to inflation. For qualified farm and fishing property, the amount is $1 million of capital gains ($500,000 of taxable capital gains).

QSBC shares are shares in certain types of small business corporations. Among other things, the following criteria must be met: 1) the corporation must be a Canadian-controlled private corporation; 2) at the time of disposition of the shares, 90% or more of the corporation's assets must be assets that are used principally in an active business carried on primarily in Canada shares or debt in small business corporations, or a combination of the two; and 3) normally you have to own the shares for at least two years.

Obviously, a Canadian-controlled private corporation does not include a public corporation. So what happens if you own QSBC shares and the corporation goes public? From that point on, the shares will no longer qualify as QSBC shares and therefore will no longer qualify for the capital gains exemption.

Fortunately, you can access your capital gains exemption on your accrued QSBC capital gains up to the time that the corporation goes public. You can elect, under section 48.1 of the Income Tax Act, to be deemed to have sold your QSBC shares immediately before that time for proceeds equal to any amount between your cost of the shares and their fair market value. Therefore, you can elect to trigger the entire accrued gain or only part of it, depending on how much capital gains exemption you have available. You will be deemed to reacquire the shares at the same elected amount.

EXAMPLE

You own QSBC shares with a cost of $100,000 and fair market value of $900,000. You have $600,000 of your capital gains exemption remaining (covering $300,000 of taxable capital gains).

If you make an election and elect at $700,000, you will have a capital gain of $600,000 and resulting taxable capital gain of $300,000, which will be tax-free because of your exemption (although Alternative Minimum Tax could apply – this has to be considered in light of all of your sources of income and deductions). The cost of your shares will be bumped up to $700,000.

The election should be made by your tax filing-due date for the year. You can file late for up to two years after your filing-due date, if you pay a penalty. The penalty is 0.25% of your capital gain, but with a maximum of $100, times the number of months or part months late.

SECTION 84.1: THE DEEMED DIVIDEND TRAP

When you sell shares in a corporation that are capital property to you, any gain is normally considered a capital gain and only half of that gain is included in your income as a taxable capital gain. Furthermore, if the shares are QSBC shares (see discussion above), some or all of the gain may be effectively exempt from tax under the lifetime capital gains exemption.

However, the situation may be different if you sell shares in a corporation (the "subject corporation") to another corporation (the "purchaser corporation") with which you are non-arm's length, generally if the purchaser corporation then 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, and a corporation that a related person (such as your spouse, child, or parent) controls, among others.

In such a case, if you receive non-share consideration 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 to the extent that the fair market value of the non-share consideration ***exceeds the paid-up capital*** in respect of the subject shares that you transferred. (There may be other calculations involved.) The paid-up capital is the income tax version of the stated capital of the shares – it is based on the legal stated capital but with various adjustments made for income tax purposes to generally reflect the after-tax amounts paid on the original issuance of the shares.

This deemed-dividend rule creates at least two potential problems for you. First, the marginal tax rates applicable to dividends are generally higher than the tax rates on capital gains. Second, the deemed dividend is not eligible for the capital gains exemption.

Even if you have a deemed dividend, the sale of the subject shares still reflects a disposition for capital gains purposes. To avoid double taxation, the amount of the dividend is subtracted from the proceeds of disposition for capital gains purposes.

EXAMPLE

You sell shares in a subject corporation to a purchaser corporation that you control. The shares had an adjusted cost base to you and paid-up capital of $10,000 and fair market value of $100,000.

As consideration, you receive shares in the purchaser corporation plus a $100,000 promissory note. The note is the non-share consideration.

Due to section 84.1, you will have a deemed dividend of $100,000 minus-$10,000, or $90,000. You will also have a disposition of the subject shares for capital gains purposes, but the proceeds of disposition are reduced from $100,000 to $10,000. Therefore, in this example, there is no capital gain.

Note that if the adjusted cost base is higher that the paid-up capital of the subject shares, you could have a capital loss along with the deemed dividend. However, the capital loss cannot serve to offset the inclusion of the dividend, because capital losses can be offset only against capital gains.

RRSP HOME BUYERS' PLAN

Most withdrawals from your registered retirement savings account ("RRSP") are included in your income. However, there are some exceptions. One of the main exceptions relates to the RRSP Home Buyers' Plan.

Under this plan, you can withdraw up to $25,000 from your RRSP for the purpose of purchasing a home on a tax-free basis. If you are married or in a common-law partnership, your spouse or partner can also withdraw $25,000 from their RRSP tax-free. So the two of you can withdraw a total of $50,000.

There are some conditions that have to be met. First, you can participate in the plan only if you and your spouse (or partner) did not own an owner-occupied home in the period going back to the beginning of the 4th year before the withdrawal and ending 31 days before the withdrawal. So, for example, if you want to withdraw an amount on August 31, 2017, neither you nor your spouse must have owned a home from the beginning of 2013 to the end of July 2017. However, you could acquire your home within the 30 days before August 31, 2017 and still make the withdrawal.

If you are disabled (qualifying for the Disability Tax Credit (DTC)) or are acquiring the home for a disabled relative (again, qualifying for the DTC), the above 4-year ownership period limit does not apply. In other words, you can still withdraw under the plan even if you or the disabled relative owned a home in the 4-year period before the year of withdrawal. However, in such case the new home must be one that is more accessible by the disabled person or in which that person is more mobile or functional, or it must provide an environment better suited to the personal needs and care of the disabled person.

In terms of when you must acquire the home, you must acquire it in the period beginning 30 days before the withdrawal and ending on September 30 of the year following the withdrawal. Therefore, in the above example, you could acquire the home from August 1, 2017 through the end of September 2018. You must inhabit the house as your principal residence within one year after the acquisition.

In order to withdraw the funds tax-free, you must provide your RRSP issuer with the Form T1036 "Home Buyers' Plan (HBP) - Request to Withdraw Funds from an RRSP", which sets out the location of the home and that you are either residing in the home or intend to reside in it within one year of acquiring the home. Also, you must have already entered into an agreement to purchase the home or to have it built.

The withdrawal from your RRSP under the Home Buyers' Plan is essentially an interest-free loan from the RRSP to you. You must repay the withdrawal in a maximum of 15 annual instalments. The first payment is due in the second taxation year following the withdrawal, and it can be made in that taxation year or within 60 days after that year.

To the extent you do not fully repay the required instalment amount in a year, the amount not repaid is included in your income.

AROUND THE COURTS

Parking pass for employee was a taxable benefit

If an employer pays for an employee's parking at or near the work place, the amount paid is normally a taxable benefit for the employee. As such, the employer must report the amount on the employee's T4 slip.

According to the Canada Revenue Agency ("CRA"), a taxable benefit does not arise if the parking provided is "scramble parking", which generally means a public parking lot where the number of available spaces is less than the amount of parking passes available. For example, if there are 100 parking spots available during the day and more than 100 employees have parking passes, this will normally constitute scramble parking and there will be no taxable benefit.

In the recent *Smith* case, the taxpayer was a flight attendant with a Canadian airline. He lived in Calgary, and was provided a free parking pass from the airline for parking near the Calgary airport. Apparently, there were many more parking spots available than the number of parking passes provided, so it was not "scramble parking". The CRA assessed the taxpayer, including in his income the amount paid by his employer for the parking pass.

The taxpayer argued that the parking pass should not be a taxable benefit. He argued that the airline required the flight attendants to be "reliable and flexible" and could be asked to work on short notice. Essentially, he argued that the parking pass was more of a benefit to the airline because the attendants would be more likely to show up for work on a punctual basis.

On appeal to the Tax Court of Canada, the CRA assessment was upheld. The Court conceded that the airline may have benefitted somewhat from the parking passes. However, it also concluded that the "evidence did not show that flight attendants who commuted to the Calgary airport using their own car were more reliable and flexible than those using other means of transportation". Therefore, the parking pass benefited the employee more than the employer, and it was a taxable benefit to the employee.

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 Update, which are appropriate to your own specific requirements.

Davidson & Company
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1200 - 609 Granville Street,
PO Box 10372, Pacific Centre
Vancouver, B.C. Canada V7Y 1G6

Tel: (604) 687-0947

Davidson-Co.com