Davidson & Company

CHARTERED PROFESSIONAL ACCOUNTANTS

TAX UPDATE

DAVIDSON & COMPANY LLP
Chartered Professional Accountants

Personal Tax Rates
2021 Marginal Tax Rates in B.C.

Taxable Income*	Salary & Interest	Capital Gains	Non-Eligible Dividends [a]	Eligible Dividends [a/b]
$ 11,070 - 42,184	20.1%	10.0%	10.4%	0.0%
$ 42,185 - 49,020	22.7%	11.4%	13.5%	0.0%
$ 49,021 - 84,369	28.2%	14.1%	19.8%	7.6%
$ 84,370 - 96,866	31.0%	15.5%	23.0%	7.6%
$ 96,867 - 98,040	32.8%	16.4%	25.1%	8.0%
$ 98,041 - 117,623	38.3%	19.1%	31.4%	15.6%
$ 117,624 - 151,978	40.7%	20.4%	34.2%	18.9%
$ 151,979 - 159,483	44.0%	22.0%	37.9%	23.4%
$ 159,484 - 216,511	46.1%	23.1%	40.4%	26.3%
$ 216,512 - 222,420	49.8%	24.9%	44.6%	31.4%
$ 222,421 and up	53.5%	26.8%	48.9%	36.5%

a Effective rates are based off of actual cash dividends. Use 1.15 of the cash non-eligible dividend and 1.38 of the cash eligible dividend to determine the tax bracket.

b The rates disregard the possible application of alternative minimum tax (AMT).

* The additional basic personal amount of $1,387 for 2021 is phased out on a straight-line basis starting at taxable income of $151,979 and fully eliminated at $216,511

Did you know the Federal Government recently updated the Personal and Corporate Tax Rates? Attached is a copy for your convenience. Need help with your taxes? Feel free to reach out to us directly at 604.687.0947.

DEDUCTING INTEREST EXPENSE

Direct use rule

If you borrow money, the interest you pay on the loan is normally deductible if the money is used for the purpose of earning income from a business or property. Income from business is fairly self-explanatory. Income from property includes dividends, rent, and interest income.

Income from property does not include capital gains. However, if you borrow to buy investments like common shares or equity mutual funds for capital gain purposes and

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they are capable of paying dividends or other income from property, you can normally still get a full interest deduction.

If you borrow money that is used for personal purposes, the interest is not deductible. For example, if you have a mortgage on your home, the interest on the mortgage is typically not deductible (although a portion may be deductible if you carry on business through a home office – see our June 2020 Tax Letter for details).

In terms of the "use of borrowed money" requirement, the courts have indicated that a *direct* use of the borrowed money is required, and that an indirect use does not normally qualify. The distinction between a direct and indirect use is shown in the following example.

Example

You have $500,000 in cash to invest. You are considering buying a house but also want to buy some stocks and mutual funds. You need to borrow money to accomplish both types of purchases.

If you borrow to buy the house, the direct use of the loan is not for the purpose of earning income (again, subject to the comment above where you use part of the home in your business). You cannot argue that the loan allowed you to acquire the stocks and mutual funds by freeing up your $500,000 cash to purchase them. Therefore, the interest on the house loan is not deductible because the *direct* use is to purchase the house, even though the borrowing indirectly allowed you to buy the stocks and mutual funds.

However, if you take out a loan to buy the stocks and mutual funds, the direct use of the borrowing is for the purpose of earning income. You can then use your $500,000 cash to buy the house. In this case, the interest on the loan would be fully deductible.

A tax planning tip is sometimes called the "interest deduction shuffle", since it involves using borrowed money *directly* to buy income investments, while the borrowing *indirectly* allows you to purchase a personal use property like your home. Some refer to this as the "Singleton shuffle", after the landmark Supreme Court of Canada decision that gave this type of transaction its blessing.

In *Singleton*, the taxpayer was a partner at a law firm. He had about $300,000 of capital (cash) invested in the firm. He wanted to buy a home, but he knew if he took out a loan to buy the home, the interest on the loan would not be deductible. Therefore, he withdrew his capital from the law firm to buy the home, and on the same day borrowed $300,000 from a bank to replenish his capital account at the firm. Since the

direct use of that borrowing was to invest in his law firm, which was for the purpose of earning income from a business, the Supreme Court held that the interest on his loan was fully deductible.

And obviously, the Canada Revenue Agency (CRA) must respect decisions of the Supreme Court of Canada.

So let's look at the Singleton shuffle applied to a variation of the above example.

Example

You currently own stocks and mutual funds worth $500,000. You want to buy a house and would need to take a $500,000 mortgage loan to buy it. If you do, the interest on the loan will not be deductible.

Instead, you sell the stocks and mutual funds for $500,000 and use those proceeds to buy the home. Then, you borrow $500,000 from a bank – secured by a mortgage on your home – to repurchase the stocks and mutual funds (or any other income-earning investments). Now, the *direct* use of your borrowing is an income-earning purpose, and the interest on the borrowing is fully deductible.

From the bank's point of view, the $500,000 loan to you is just as secure as if it were a mortgage taken out to buy the home, since it's done as a mortgage.

This transaction works best if the stocks and mutual funds have little or no accrued capital gain, since any accrued taxable capital gain will be triggered when you sell the funds.

Loans for RRSPs and TFSAs

If you take out a loan to invest in your registered retirement savings account (RRSP) or tax-free saving account (TFSA), you seem to be using the loan to invest and earn income from property. So, based on the above rule, you might think you can deduct the interest on the loan.

Unfortunately, there is a specific provision in the Income Tax Act that overrides the above rule and disallows any interest deduction on loans to invest in RRSPs and TFSAs (as well as other tax-deferred plans, like registered pension plans, registered education savings plans and registered disability saving plans).

The rationale for disallowing the interest deduction on these loans is that even though the money is typically used for the purpose of earning income from property, the income earned while in the RRSP or TFSA is not subject to tax (for a TFSA it is also not taxed when you take the money out). Basically, the government is saying that since we are not taxing the income while it's earned, we are not going to allow you to deduct your interest expense in the meantime.

What happens if you sell the investment at a loss and still owe money?

A potential problem arises if you sell an investment property acquired with a loan, and you subsequently sell the property at a loss. In such case, you might not be able to fully repay the loan. So if some of the loan remains outstanding, can you still deduct the interest expense on the loan?

You might think "no", since you are no longer using the loan for income-earning purposes.

Fortunately, the answer is usually "yes".

There is a specific provision under the Income Tax Act that basically says that the amount of your loan in excess of the proceeds of disposition of the property (at a loss) is deemed to be used for the purpose of earning income from a property. Therefore, an interest deduction will remain for that portion of the loan. The following is an example.

Example

You took out a $100,000 loan to buy stocks. Unfortunately, the stocks went down significantly in value, and you decided to sell them when they were worth $40,000.

You use the $40,000 to partially pay off the loan, and therefore you still owe $60,000. Under the specific provision, your interest on the remaining $60,000 principal amount of the loan will remain deductible, even though you no longer own the stocks.

A similar provision applies if you take out a loan that is used in your business, you later cease to carry on the business, and the value of your business properties is less than the principal amount of the loan still outstanding. In general terms, a portion of the loan is allocated to any property that you sell (and for this purpose, there is a deemed disposition once you begin to use the property for any other purpose). The remaining part of the principal amount of the loan, if any, is deemed to be used for the purpose of earning income from a business and the interest expense on that part remains deductible.

SPOUSAL AND CHILD SUPPORT PAYMENTS

We discussed this issue briefly in the March 2021 Tax Letter (under "Ten Most Common Tax Mistakes"). More details are provided here.

In general terms, **child** support payments made to an ex-spouse or common-law partner are not deductible for the payer, and are not included in the recipient's income. An exception applies if the applicable court order or agreement was made before May 1997, it was not amended or replaced by another order agreement after April 1997, and the parties did not elect to have the current rules apply. (This almost never happens now, since most child support stops around age 18.) In these rare cases, the payer can deduct the child support payment and the recipient must include them in income.

On the other hand, **spousal** support payments are generally deductible for the payer and included in the recipient's income, as long as certain conditions are met. If the conditions are not met, there is no deduction and no inclusion.

The general conditions include the following:

1) The spousal support payment must be a payment made as an "allowance on a **periodic basis**". So normally, a lump-sum or amount that is not periodic does not qualify (some exceptions are noted below). The courts have held that the following factors are relevant in determining the periodic allowance issue:

- The length of the periods in which the payments are made. Amounts that are paid weekly or monthly are more easily characterized as allowances. Where the payments are at longer intervals, the issue is less clear. If the payments are made at intervals of greater than one year, the CRA and ultimately a court may rule that they are not periodic allowances.

- The amount of the payments in relation to the income and living standards of payer and recipient. Where a payment represents a substantial portion of the payer's or recipient's income, the payment is unlikely to be a periodic allowance. On the other hand, where the payment is no greater than might be expected to be required to maintain the recipient's standard of living, it is more likely to qualify as an allowance.

- If the payments include interest up to the date of the payments, a court may rule that this is essentially a lump-sum amount that the payer was allowed to pay over time, rather than a periodic allowance.

- A periodic allowance commonly applies either for an indefinite period or until some event such as the re-marriage of the recipient, or some other event that causes a material change in the recipient's financial needs. Sums payable over a fixed term may be regarded as not being a periodic allowance and therefore not deductible for the payer or included for the recipient.

- If the payments release the payer from future obligations to pay support (for example, upfront payments for a few years rather than over many years), the payments may be viewed as not being periodic allowances.

2) The recipient must have **discretion** over the use of the payment, meaning that the recipient, rather than the payer, determines what to do with the funds. So if the payer sends the funds with a condition that they be used in a specific manner, the payment may not qualify (an exception to this rule is discussed below).

3) The recipient and payer must be **living separate and apart** because of the breakdown of their marriage or common-law partnership.

4) The payment must be pursuant to **a court order or a written agreement** between the parties.

Exception to the general rules

There is a specific provision that overrides the general rules that a spousal support payment must be on a periodic basis and that the recipient must have discretion over the use of the funds.

A lump-sum payment can be deductible for the payer and included for the recipient, even though it is not periodic, the recipient does not have discretion over the use of the funds, and even if the payment is made to a third party instead of directly to the recipient. This specific provision applies **only** if the court order or agreement states that the parties agree that the provision will apply. The provision can apply to expenses such

as medical expenses, tuition, rent, and mortgage payments made by the payer to the recipient or to a third party (for example, a medical facility, school, landlord, or bank). In the case of mortgage payments (principal and interest) made for the recipient's home, the deduction in each year is generally limited to 1/5th of the principal amount of the original mortgage loan.

In addition to this special rule, the CRA takes the view that a lump-sum payment is deductible for the payer and included for the recipient if the lump-sum:

- represents amounts payable periodically that were due after the court order or written agreement and that had fallen into arrears; or
- is paid pursuant to a court order and in conjunction with an existing obligation for periodic maintenance, whereby the payment represents the acceleration, or advance, of future support payable on a periodic basis, for the sole purpose of securing the funds to the recipients, or
- is paid pursuant to a court order that establishes a clear obligation to pay retroactive periodic maintenance for a specified period prior to the date of the court order.

Payments made before court order or agreement

To be deductible, a spousal support payment must be made "pursuant to" a court order or written agreement between the parties. As a result, payments made before the court order is issued or before the agreement is signed would normally not be deductible for the payer or included for the recipient.

However, another provision in the Income Tax Act says that payments made before the court order or written agreement can be deductible for the payer and included for the recipient, if the court order or agreement states that this provision applies. However, this applies only to payments made in the same calendar year as the order or agreement, or the immediately preceding calendar year.

Ordering rule with spousal and child support

If both spousal support and child support are paid each year on a timely basis, this ordering rule is of little significance. However, if the payments are not made in full in any year, this rule applies. In general terms, the support payments will be applied towards (non-deductible) child support until it is paid in full, before they are applied towards (deductible) spousal support.

Example

Ahmed is required under a court order or written agreement to pay $60,000 in annual child support and $40,000 in spousal support, for a total of $100,000. In 2021, because of cash flow issues, he pays total support of only $80,000.

Under the ordering rule, the first $60,000 of the $80,000 paid in 2021 will be considered child support and therefore not deductible in computing his income. The remaining $20,000

will be considered spousal support and deductible.

In 2022, Ahmed has better cash flow and therefore pays a total of $120,000 – being the $100,000 of total support owed in 2022 plus the $20,000 shortfall in 2021. Therefore, in 2022 he can deduct $60,000, which is the $20,000 shortfall from 2021 plus the $40,000 spousal support for 2022.

His ex-spouse has to include in income the same amounts that are deductible to him.

UNEARNED AMOUNTS RECEIVED IN BUSINESS

If you carry on a business, the Income Tax Act requires you to include any amount that you receive in the year even if you have not "earned" it yet. In particular, you must include any amount received in the year that is consideration for services not rendered or goods not delivered before the end of the year.

However, you have the option of deducting a reserve for the amount of services or goods to be provided in a later year, which has the effect of deferring that portion of the unearned amount to the later year. The mechanics of the reserve are illustrated in the following example.

Example

You carry on a business. In year 1, you receive $10,000 for goods to be delivered to a customer in years 2 and 3 – half in year 2 and the other half in year 3.

In year 1, you must include $10,000 in income. You decide to claim the maximum reserve, so you deduct the full $10,000 amount because that reflects the consideration for goods to be provided after year 1.

In year 2, you have to add back into income the $10,000 you deducted in year 1. But you can claim a reserve of $5,000, reflecting the consideration for goods to be provided after year 2.

In year 3, you include the $5,000 reserve you deducted in year 2.

Net effect: You received $10,000 in year 1. You included the net amount of $5,000 in each of years 2 and 3.

* * *

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.

AROUND THE COURTS

IADHD qualified for disability tax credit

The disability tax credit, as the name implies, is available to individuals who are physically or mentally disabled. However, the legal requirements to claim the credit are quite detailed and complex.

Among other requirements, the individual must have one or "more severe and prolonged impairments in physical or mental functions". These impairments must result in the individual's ability to perform a basic activity of daily living being "markedly restricted". The individual must also receive a prescribed form from a medical practitioner certifying that the disability requirements have been met.

If the disabled individual has little or no income and therefore cannot use the credit, they can transfer the credit to a supporting individual, like a parent or spouse.

In the recent *Jungen* case, the taxpayer's son was diagnosed with attention deficit hyperactivity disorder (ADHD) in the taxation years in question, when the son was between nine and fifteen years old. Apparently, the ADHD resulted in extremely anti-social and disruptive behaviour to others, including friends, teachers, and his sister. The taxpayer testified that even with her son's medication for the disorder, she needed to tend to him at least 90% of the time (when he was not in school or otherwise occupied with structured activities).

The son did not have enough tax payable to use the disability tax credit, so he transferred the credit to his mother, the taxpayer, who attempted to claim it. The taxpayer filed the prescribed form from her son's pediatric physician, who certified that he met the conditions required for the disability credit.

The CRA denied the taxpayer's claim. Although the CRA agreed that her son had significant and challenging issues, it held that they did not "markedly restrict" his basic activities of living. This was the sole issue before the Tax Court of Canada, which heard the taxpayer's appeal of the CRA assessment.

The Tax Court held in favour of the taxpayer by accepting the "markedly restricted" requirement. Based on the evidence, the Tax Court held that during the relevant period the son "had substantial impairment of ability to engage in appropriate social interactions with other persons with whom he comes into contact."

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