Davidson & Company
CHARTERED PROFESSIONAL ACCOUNTANTS

TAX UPDATE

Did You Know…

We will be attending PDAC 2019 – pop by our booth and say hello!

DEBT FORGIVENESS RULES

If you owe a debt that is forgiven or settled without full payment, the Income Tax Act contains rules that may affect some tax amounts or tax attributes, or may result in an income inclusion. The main rules are summarized below.

The rules apply only if the debt is a "commercial obligation", which basically means you used the debt (the borrowed money) to earn business or investment income. Debts used for personal purposes are not affected by the rules.

Application of the rules

If your debt is forgiven without full payment, the remaining principal amount owing ("remaining debt") is subject to the tax treatment in the order described below. Note that some of the steps are mandatory and some are optional:

1) First, the remaining debt reduces your non-capital losses and farm losses from previous years. Earlier years' losses are reduced in the order in which they arose.

2) Next, for any remaining debt, one-half of that amount serves to reduce your allowable business investment losses (ABILs) from prior years, if any. After that, one-half of the remaining debt reduces your net capital losses from prior years. The one-half rule applies here because only one-half of business investment losses and capital losses are otherwise deductible. (Note that for certain loss years, for example, most of the 1990s, the loss deduction rate was 3/4 or 2/3, so that would be the applicable fraction for those years.)

In determining the remaining debt after a portion was applied to reduce ABILs and net capital losses, you multiply the applied amount by two, and subtract that to determine whether you have a remaining debt after this step. For example, if the remaining debt was $10,000 before this step, you applied $3,000 of the debt to reduce net capital losses, the remaining debt afterwards would be $4,000 ($10,000 – 2 x $3,000).

3) This next step is optional. You can elect to use any remaining debt to reduce the capital cost and the undepreciated capital cost (UCC) of any depreciable property that you own.

4) The next step is also optional. Any remaining debt can be used to reduce certain resource expenses and resource pools (this is typically relevant only for corporate debtors).

5) This next step is also optional, if you have fully applied steps 3) and 4) above, if applicable. Any remaining debt can be used to reduce the costs of your non-depreciable capital properties (not including personal-use properties). For properties that are shares or debt, an ordering rule provides, in general terms, that you must reduce the costs of shares or debt in corporations and partnerships in which you do not have significant holdings or to which you are not related, before you can reduce the costs of shares or debt in corporations and partnerships in which you do have significant holdings or to which you are related.

6) If there is a remaining debt, and you have fully applied steps 3) through 5) where applicable (as noted, they are optional), it is applied to reduce your capital losses for the current year in excess of your capital gains for the year, if any.

7) At this point, if there is any remaining debt, one-half of the amount will be included in your income. This inclusion is subject to the "eligible transferee" rule described below.

Reserve for income inclusion

If you are required to include a remaining debt amount in income under step 7) above, you may be able to deduct a reserve. The reserve is limited to the amount by which the included debt income exceeds 20% of the amount by which your net income exceeds $40,000.

For example, if your net income otherwise computed for the year is $50,000 (that is, without counting

the included debt amount), and the included debt amount is $14,000, you can deduct a reserve of $12,000 ($14,000 minus 20% x $10,000). If your income otherwise computed is $40,000 or less, you can deduct the entire debt amount as a reserve. In either case, this reserve will be added back to your income in the next year, and you can claim a further reserve.

For a corporation or a trust, a different reserve mechanism generally allows the included debt amount to be spread out over 5 years, with a net inclusion of 20% per year.

Transfer to "eligible transferee"

Instead of including half of the remaining amount in income under step 7) above, the debtor can "transfer" it to an "eligible transferee". The amount effectively becomes a forgiven amount for the eligible transferee, who will apply it to reduce its tax attributes under all the steps outlined above. This may be more desirable than the income inclusion for the debtor.

An eligible transferee is generally a taxable Canadian corporation or Canadian partnership that controls the debtor, or that is controlled by the debtor and/or related persons. It also includes a taxable Canadian corporation or Canadian partnership that is related to the debtor.

Death of debtor

If you have a remaining debt that is forgiven after your death, the rules will apply either to you for the taxation year of your death, or to your estate. Generally, they will apply to you in the year of death if the debt is forgiven within 6 months after your death (or such longer period as the CRA and your estate agree). If the rules result in an income inclusion, you can claim the reserve described above, which will be a final deduction since it will not be added back to your income in the next year.

If the debt is forgiven after the 6-month period (or the longer period), the rules will normally apply to your estate.

Exceptions: Where the debt forgiveness rules do not apply

There are various exceptions where the rules do not apply. Some of the main ones are as follows. First, as noted earlier, the rules do not apply to debts used for personal purposes.

If the creditor dies, the rules do not apply if the remaining debt is settled on the death as a result of a bequest or inheritance. For example, if you owe a remaining debt and the creditor dies and forgives the debt as part of your inheritance, the rules do not apply.

The rules do not apply if the remaining debt is included in your income as a forgiven debt from your employer. Similarly, they do not apply if the remaining debt is included in your income under the shareholder benefit rules. These exceptions provide no consolation, since the remaining debt will be included in your income rather than being subject to the less onerous rules discussed above.

The rules do not apply where the debt is a debt secured by property (e.g. a mortgage) and is forgiven or settled on the transfer of the property to the creditor. In such case, you may have a capital gain or loss depending on the amount forgiven and

your cost of the property. These secured-property rules will be discussed in a subsequent Tax Letter.

TAXATION OF TRUSTS AND BENEFICIARIES

A trust is a "person" and a taxpayer for income tax purposes. As a result, it will be subject to income tax on its taxable income for a taxation year. In turn, if some or all of the trust income for the year is "paid or payable" to a beneficiary of the trust, the trust can generally deduct that amount from income and the beneficiary will normally be taxed on the income instead.

For most purposes, a trust is considered an "individual" under the Income Tax Act, like a human being. However, there are some important exceptions.

Taxation of trust on retained income

Income earned and retained in the trust for taxation year – that is, the income is not paid or payable to a beneficiary in the year – is normally taxed to the trust.

Most trusts are subject to tax on their taxable income at a flat rate equal to the highest marginal rate that applies to individuals. Currently, the federal rate is 33%; the provincial rate depends on the province. Typically, the combined federal+provincial rate is about 50% or higher.

The rationale for the high flat rate is to prevent individuals from setting up numerous trusts and attempting to split income at graduated rates that otherwise apply to individuals.

There are two exceptions, where trusts are subject to the same graduated tax rates that apply to individuals. First, the graduated rates apply to a "graduated rate estate", which is generally a deceased's estate for up to 36 months after the death (certain conditions must be met). Second, the graduated rates apply to a "qualified disability trust". Generally, this is a testamentary trust (one that arises upon your death, normally created by your Will), where the beneficiary is disabled and eligible for the disability tax credit.

Taxation of beneficiaries on retained income of the trust

There are a couple of instances where income retained by the trust is taxed to a beneficiary rather than the trust.

First, this can occur where there is a "preferred beneficiary" under the trust and the trust makes a preferred beneficiary election. In such case, the elected amount is subject to tax in the hands of the beneficiary rather than the trust. This election can save tax if the beneficiary's rate of tax is lower than the tax rate of the trust (as noted, the trust usually pays the highest marginal rate of tax).

A preferred beneficiary must either be eligible for the disability tax credit, or dependent on another individual by reason of physical or mental infirmity and have income less than the basic personal credit amount ($12,069 for 2019). Other conditions apply.

Second, a beneficiary will be taxed on income retained by the trust that is not otherwise paid or payable to a beneficiary under the age of 21. The beneficiary must have an unconditional right to the income in the year (which will typically be paid out

in the future), although the right may be conditional upon the beneficiary reaching a certain age that is 40 years or younger.

In either case, where the income is taxed to the beneficiary in a current year, it can be paid out in a future year on a tax-free basis.

Taxation of beneficiaries on distributed income

To the extent income of a trust is payable to a beneficiary in a taxation year, it is normally deductible for the trust and included in the income of the beneficiary. As a result, there is typically only one level of taxation – either at the trust level or the beneficiary level.

Income is considered "payable" in a year if it is paid to the beneficiary in the year or if the beneficiary has the right in the year to enforce payment of the income. This latter point will often depend on the terms of the trust.

The trust can designate some types of income paid or payable to a beneficiary to preserve or "flow through" the nature of the income.

For example, the trust can designate that its dividends from Canadian corporations that are paid to a beneficiary flow through as dividends in the hands of the beneficiary. An individual beneficiary can then benefit from the dividend tax credit, since such income from the trust is considered to be dividend income.

A trust can also designate that its net taxable capital gains flow through to the beneficiary, which will be useful if the beneficiary has capital losses (since capital losses can only offset capital gains). If the capital gains result from dispositions of property eligible for the capital gains exemption, such as qualified small business corporation shares and family farm or fishing property, the availability of the exemption will flow out to the beneficiary to the extent of his or her remaining lifetime exemption.

Inclusion for trust where income is distributed to beneficiary

There is a rule that allows the trust to designate its income paid or payable to a beneficiary – that would otherwise be included in the beneficiary's income as discussed above – to be included in the trust's income and not the beneficiary's income. This rule can be useful if the trust has loss carryforwards available to offset the income inclusion, as the income can than be paid out tax-free to the beneficiary.

Example

A trust has $50,000 of income this year, and $30,000 of unused non-capital losses from previous years. It pays out $50,000 to its beneficiary.

The trust can deduct $20,000 of the income paid to the beneficiary, leaving the trust with $30,000 of income. The $20,000 amount is included in the beneficiary's income.

The trust can designate the remaining $30,000 to be included in the trust's (and not the beneficiary's) income, which can be offset by the $30,000 non-capital loss carryforward, resulting in no tax for the trust. The $30,000 amount is received tax-free by the beneficiary.

Deemed disposition rules

Most personal trusts are subject to the so-called "21-year deemed disposition" rule. This rule provides a deemed disposition and reacquisition of almost all trust property at its fair market value every 21 years. The deemed disposition ensures that accrued capital gains cannot be deferred indefinitely, although the rules can also trigger capital losses.

There are some exceptions where the deemed disposition occurs at a different time. For example, under certain spousal (or common-law partner) trusts, the first deemed disposition occurs on the death of the spouse beneficiary. Similarly, for an alter ego trust (generally, a trust in which you are the settlor and sole beneficiary during your lifetime), the first deemed disposition occurs on your death.

Income and gains that result from the deemed disposition rules are subject to tax in the trust and are not taxed to the beneficiary.

RRSP vs. TFSA – WHERE TO CONTRIBUTE?

Funds invested in either a registered retirement savings account (RRSP) and a tax-free savings account (TFSA) grow tax-free while in the account.

However, there is a difference between the accounts in terms of contributions and withdrawals.

Assuming you have sufficient contribution room, contributions to an RRSP are deducted from your income and therefore save you tax in the current year. Contributions to a TFSA are not deducted and therefore come out of your after-tax income.

Conversely, withdrawals from an RRSP are included in your income, whereas withdrawals from a TFSA are not included in your income.

So which account is more advantageous in terms of tax savings?

The answer depends on your marginal tax rate in the year of contribution relative to your marginal tax rate in the year of withdrawal. If the rates in those years are equal, the two accounts are essentially equivalent in terms of tax savings, although due to the deduction, the RRSP will allow you to have more money grow tax-free. If the rate in the year of contribution is greater, you are likely better off with the RRSP contribution. If the marginal tax rate in the year of contribution is less, you may be better off with a TFSA contribution.

Example

This year, you are in a 50% tax bracket. You contribute $2,000 to your RRSP, which saves you $1,000, so that your net investment is $1,000 after tax.

You also contribute $1,000 to your TFSA. Since this amount is not deductible, your net investment is also $1,000 after tax.

Both amounts double in value by a future taxation year. Therefore, the RRSP investment grows to $4,000 and the TFSA investment grows to $2,000. You withdraw both amounts and are again in the 50% tax bracket. The RRSP withdrawal is subject to 50% tax and nets you $2,000. The TFSA withdrawal is not included in your income and therefore nets you $2,000.

On the other hand, if your future tax rate is less than 50%, the RRSP withdrawal would net you more than

$2,000. If your future tax rate is greater than 50%, the RRSP withdrawal would net you less than $2,000.

Lastly, it is important to use your "effective" tax rate for the above purposes. For example, if your "regular" tax rate remains the same, but the RRSP withdrawal in the future year would subject you to the Old Age Security clawback tax, or reduce your age credit, your effective tax rate in the future year would be higher than the earlier effective rate. In such case, the TFSA investment would come out ahead.

Note also that TFSA contribution room can be used over and over. If you withdraw funds from the TFSA, your contribution room is increased by a matching amount the next January 1. With an RRSP, your contribution room built up each year is lost once you have used it, and you need additional "earned income" in later years to build up more room. So if you expect that you might need funds on a periodic basis from your plan, a TFSA is better for this purpose.

PRESCRIBED AUTOMOBILE RATES FOR 2019

The maximum tax-free car allowance deductible for employers for allowances paid to their employees for work purposes is increased by 3 cents from the 2018 amount to 58 cents per kilometre for the first 5,000 kilometres driven, and to 52 cents per kilometre for each additional kilometre driven during the year. For the Northwest Territories, Nunavut and Yukon, the maximum deductible tax-exempt allowance is 4 cents higher, so it is 62 cents per kilometre for the first 5,000 kilometres driven, and 56 cents per kilometre above that.

The rate to be used to calculate the taxable benefit of employees relating to the personal portion of automobile operating expenses paid by their employers will be increased by 2 cents to 28 cents per kilometre. For taxpayers who are employed principally in selling or leasing automobiles, the rate will be increased by 2 cents to 25 cents per kilometre.

For the deduction of car expenses, the following maximum ceilings that have been in place since 2001 remain in place.

- For capital cost allowance (tax depreciation), the maximum cost is $30,000 plus applicable GST/HST and any provincial sales tax;

- For interest on a car loan, the maximum deduction is $300 per 30-day period; and

- For car lease costs, the maximum deduction is $800 plus applicable sales taxes per 30-day period, which may be reduced further if the manufacture's list price of the car exceeds a certain cost ceiling.

AROUND THE COURTS

Taxpayer's anxiety and panic disorder qualified for disability tax credit

To qualify for the disability tax credit (DTC), an individual must have a prolonged and severe impairment in physical or mental functions, resulting in a marked or significant restriction in one or more basic activities of daily living. Furthermore, the impairment must be certified, in prescribed form, by a physician.

In the recent Cochrane case, the taxpayer claimed the DTC because she had serious depression and anxiety, which led to a panic disorder that in turn allegedly affected her basic daily activities. The CRA denied the claim, and Ms. Cochrane appealed to the Tax Court of Canada.

The Tax Court judge accepted evidence from the physician and concluded that Ms. Cochrane qualified for the DTC because she "had a severe and prolonged impairment…causing her to largely be unable to leave her house. This is indicative of a marked restriction in mental functions necessary for everyday life, being a basic activity of daily living."

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.

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