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TAX LETTER

July 2015

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THE INCOME ATTRIBUTION RULES

Income splitting among family members can be beneficial largely because of the graduated tax rates used in our income tax system. For federal income tax purposes, we have four tax brackets: the lowest bracket of 15% applies up to taxable income of $44,701, while the top tax bracket of 29% applies to taxable income over $138,586 (2015 amounts). All provinces similarly have graduated tax rates (Alberta has a flat tax rate of 10%, but that it expected to change with the recent election of an NPD government). As a result, if you are in a lower tax bracket than your family members, the splitting of income can subject the income to a lower rate of tax. In addition, their tax credits can further reduce tax payable on the split income.

The government is aware of this potential tax savings, and generally frowns on income splitting. As a result, there are various income attribution rules that can apply if you transfer property to your spouse (or common-law partner) or minor children. These rules are summarized below, followed by the major exceptions to the rules.

Loans or transfers to spouse

Attribution can apply if you lend or transfer money or property to your spouse (or common-law partner), including a loan or transfer before you became spouses. Under this rule, income or loss from the property (or property substituted for that property) is attributed to you and included in your income (or loss) rather than your spouse's income. Income from property includes items such as interest, dividends and rent. A similar rule can apply to attribute taxable capital gains (or allowable capital losses) from your spouse's dispositions of the property or substituted property.

The substituted-property rule means attribution can continue even if your spouse sells or converts the lent or transferred property and uses the proceeds to acquire another property. For example, if you give your spouse cash and she uses the cash to purchase corporate bonds, the interest from the bonds will be attributed to you. Furthermore, if she sells the bonds and uses the proceeds to buy another income-producing property, the attribution rules can continue to apply to the income or gain from that other property.

The property income attribution stops if you divorce, or are living separate due to the breakdown of your marriage (or common-law relationship). The capital gains attribution ceases after divorce, but stops during your separation only if you make a joint election with your tax returns.

Loans or transfers to minor children

Another attribution rule applies if you lend or transfer property (or money) to your child who is under 18, any other minor child with whom you do not deal at arm's length, or your minor niece or nephew. As with the rule for spouses, income or loss from the property or property substituted for that property is attributed to you. The income attribution does not apply throughout the year in which the minor child turns 18 or in later years.

However, the attribution rules do not apply to capital gains of minor children, so capital gains splitting with your minor children is generally allowed. For example, you can purchase common shares or equity mutual funds for your minor children, and subsequent taxable capital gains on the property will be included in their income and will not be subject to attribution. (But see the discussion below on the "kiddie tax", which can apply to a minor child's capital gains in limited circumstances.) You also have to make sure that, under the law of the province in which you live, your minor children are legally allowed to acquire and own the property in question.

Exceptions

Fortunately, there are various exceptions to the attribution rules. The main ones are summarized below.

The rules do not apply to **income from business**. Therefore, you can give or lend property to your spouse or minor children to earn business income and the income will not be attributed to you.

As noted, the rules do not normally apply to **capital gains of minor children**. Therefore, you can legitimately split capital gains with them. Note however that attribution can apply if you transfer certain farm or fishing property to your child under the rollover provisions of the Income Tax Act.

The rules do not apply if you lend money to your spouse or minor child **at the prescribed rate of interest**, as long as they actually pay you the interest each year or by January 30 of the following year. The prescribed rate is currently 1% (and has been for some time), so now it is an ideal time to set up this type of income splitting. For example, if you lend money to your spouse at 1% annual interest and she uses the fund to purchase an investment that pays an annual return of 8%, the attribution rules will not apply provided she pays you the 1% every year. She will include the 7% net return in income (the 8% gross return minus the 1% interest paid to you). You will include the 1% interest received by you. However, if

your spouse misses or is late with even one interest payment, this exception from attribution ceases to apply.

The attribution rules do not apply if you receive at least **fair market value consideration** for the property. Similar to the lending exception above, if the consideration is debt, you must charge at least the prescribed rate of interest, and they must pay you the interest each year or by January 30 of the following year. Also, in the case of your spouse, if you transfer property under this exception you must elect out of the tax-free "rollover" on the transfer, which is otherwise available for transfers between spouses. This means that the transfer of the property will normally take place at fair market value, which could generate a capital gain for you if the value exceeds your cost of the property. Unfortunately, because of the superficial loss rules (discussed further below in this Letter), any loss on the transfer will normally be denied.

The rules do not apply to **reinvested income.** Thus, if you transfer property to your spouse or minor child and they reinvest the income earned on the property, the income earned on the reinvested income is not subject to attribution.

The rules do not apply to transfers of property to **children over 18**. However, there is an anti-avoidance rule that can apply if you lend money to a relative (minor or adult) or another non-arm's length person and one of the main reasons is to reduce your tax payable. As above, there is an exception to this anti-avoidance rule if you charge at least the prescribed rate of interest on the loan.

The rules obviously do not apply if the property generates **no income** or capital gains. Therefore, you can make personal expenditures for your spouse and children and not worry about any attribution rules. As a planning point, consider paying most or all of your spouse's personal expenses, common household expenses and any income tax your spouse owes, thus freeing up your spouse's own income to invest in income-earning property. The attribution rules will not apply.

Since income or capital gains from a **tax-free savings account** (TFSA) are not included in income, you can put cash into your spouse's or adult child's TFSA and there will be no attribution on any subsequent income. Similarly, as noted earlier, if you contribute to your spouse's **RRSP** (provided it was set up as spousal plan), there is no attribution when the funds and income are withdrawn by your spouse, generally as long as the withdrawal does not take place in the year during which you contributed or the two subsequent years.

If you receive the Universal Child Care Benefit because you have children under 18, the benefit can be invested and all income or gains from the investment are exempt from attribution provided you can track it. So it can be a good idea to put these payments into a separate bank account, if you don't need to spend them.

Other exceptions: the pension income split and Family Tax Cut

Although income splitting is typically seen as a way of getting around the tax system, our current government has decided that it should be expressly allowed in two cases.

First, you can split eligible pension income (e.g. income from your registered pension plan, annuity income from your RRSP, and income from your registered retirement income fund) with your spouse or common-law partner. You can split up to 50% of that pension income per year. (If you are under 60 or 65, there are limitations as to what kind of income qualifies.)

Second, new for 2014 and subsequent years, the family tax benefit allows you a tax credit of up to $2,000, calculated as though you were shifting up to $50,000 of taxable income to your spouse. You do not actually split or shift the income; the credit is given to the higher-income spouse. (As discussed in our December 2014 Tax Letter, the Family Tax Cut is available only if you have at least one child under 18.)

Tax on split income of minor child ("kiddie tax")

Although not an attribution rule, the kiddie tax can apply to the "split income" of a minor child. The tax is levied on the split income of the child at the *highest* marginal rate of tax (i.e. 29% federal, plus provincial tax). Furthermore, the only tax credits available against the tax on the split income are the dividend tax credit and any available foreign tax credits. Thus, although the income is not attributed, the kiddie tax is just as onerous or more so.

"Split income" includes shareholder benefits and dividends received from shares of corporations other than publicly-traded shares and mutual funds. In general terms, it also includes certain trust or partnership income derived from services or property provided to a business in which a parent is involved (the details are somewhat complex). It can also apply to income from a trust or partnership if the trust or partnership provides services to a third party and the parent is actively involved in the provision of the services.

Additionally, if your child sells shares in a corporation (other than publicly-listed shares or those in a mutual fund) to a non-arm's length person at a gain, the amount of the gain is deemed to be a dividend income and therefore split income. The dividend is deemed to be a "non-eligible" dividend, meaning that the less generous dividend tax credit applies to the dividend than applies to dividends from public corporations.

The tax on split income does not apply in the year in which the child turns 18 or in later years. Additionally, it does not apply to income or gains from property inherited from the child's parent, or from anyone else if the child is enrolled full-time in post-secondary education or is disabled.

In many cases, you, as the parent, will be jointly and severally liable to pay the tax on split income along with your minor child.

INTER-CORPORATE DIVIDENDS

Where a Canadian corporation receives a dividend from another Canadian corporation, the dividend is included in the recipient corporation's income but is normally deducted from income in computing its taxable income. In other words, inter-corporate dividends generally pass from one corporation to another corporation on a tax-free basis.

The rationale for this treatment is that dividends are paid out of after-tax income, and taxing the dividend in the hands of the recipient corporation would constitute double taxation. For example, if you own a parent corporation that owns a subsidiary corporation, business income earned by the subsidiary is subject to tax. If the subsidiary paid a dividend to your parent corporation and it was taxable, there would be double tax. In the case of multi-tiered corporate structures (e.g. your subsidiary owns another subsidiary, and perhaps that other subsidiary owns yet another subsidiary), there could be triple tax, or quadruple taxation, or worse.

Despite the "intercorporate dividend deduction", if your corporation receives a dividend from a corporation that is not "connected" with your corporation, it may be subject to a refundable tax under Part IV of the Income Tax Act. The purpose of this tax is to prevent individuals from deferring tax on dividends from public corporations (informally called "portfolio dividends"). Basically, a non-connected corporation is a corporation that is not controlled by your recipient corporation, and your corporation owns 10% or less of the shares of the payer corporation on either a voting or fair market value basis. This will virtually always be true for dividends from public corporations that you buy on the market.

The Part IV tax is levied at the rate of 33.33% of taxable dividends received by your recipient corporation from a non-connected corporation. However, the tax is refundable, generally on a basis of $1 for every $3 of dividends that your corporation pays out.

Example

Your wholly-owned corporation owns common shares in Bell Canada (obviously, far less than 10% of the outstanding shares of Bell!). In 2015, it receives a $1,000 taxable dividend from Bell.
The dividend is included in income and then deducted in computing taxable income, so it has no net effect on your corporation's income.

The Part IV tax is $333. However, if your corporation pays you a dividend of $1,000 in 2015, the $333 is refundable so that your corporation pays no net tax. If it waits until 2016 to pay the dividend, it will pay the tax in 2015 but will get the refund in 2016.

The Part IV tax does not apply to dividends received from a connected corporation, except to the extent the connected corporation gets a refund of tax for dividends received by it. If it does get such a refund, then your corporation is generally subject to the Part IV if it receives dividends from the connected corporation.

Example

Your corporation owns 100% of the shares of a connected corporation and both have calendar year ends. In 2015, the connected corporation pays a $1,000 dividend to your corporation. The connected corporation claims a dividend refund of $333 (it received a $1,000 dividend from a public corporation, which it then paid out to your corporation). Your corporation will be subject to $333 Part IV tax, which is refundable if it pays out a dividend to you, as discussed above.

If your corporation owned less than 100% of the shares of the connected corporation, its Part IV tax would be pro-rated based on the amount of dividends it received relative to other shareholders in the connected corporation. For example, if your corporation received a $600 dividend and other shareholders received $400, your corporation would be subject to a refundable tax of $200 (60% of the $333 refund of the connected corporation).

The Part IV tax can also be offset by 1/3 of your corporation's non-capital losses, including those carried over from other taxation years. A non-capital loss is basically the corporation's losses from business or property in excess of income from business or property for a taxation year (with possible adjustments).

SUPERFICIAL LOSSES

The intent of the "superficial loss" rules is to prevent you from claiming a loss if you sell property at a loss and reacquire it within a specified period. Basically, the government doesn't want you to dump your loss properties, use the capital losses to offset capital gains, and then repurchase the loss properties within the specified period. More particularly, the superficial loss rules apply in the following circumstances:

- You dispose of capital property (typically shares or mutual fund units) at a loss;
- Either you or an "affiliated person" acquires the same property or an identical property in the period that begins 30 days before the disposition and ends 30 days after the disposition; and
- You or the affiliated person owns the property or identical property at the end of the period.

In these circumstances, your loss on the sale of the property is deemed to be nil. Although the loss is denied, it is normally not lost forever, because the amount of the loss is added to the cost of the newly acquired property or identical property. As a result, that property effectively inherits the accrued loss, which will either be realized at a later time or will serve to reduce a gain at a later time.

Example

On December 1, 2014, you sold 1,000 common shares in Acme Ltd. and incurred a $10,000 capital loss. On December 19, 2014, your repurchased 1,000 common shares in Acme Ltd. for $40 each, for a total cost of $40,000. You subsequently sold the 1,000 shares in April 2015 for $50,000.

The superficial loss rules will apply because the above criteria have been met. As a result, your $10,000 capital loss from the December 1 sale is denied. However, the $10,000 amount is added to the total cost of your shares acquired on December 19, which becomes $50,000. Therefore, on the sale of the shares in 2015, you will have no gain. Effectively, the previous $10,000 loss has been preserved through the addition to your cost of the shares, and has been allowed to offset the $10,000 gain that you would have otherwise realized in 2015.

As noted, the superficial loss rules can apply where either you or an "affiliated person" acquires or re-acquires the new property or identical property within the period of time described above. For these purposes, an affiliated person includes your spouse or common-law partner, a corporation that you

control, and a partnership in which you are a majority-interest partner, among others. An affiliated person does not include your child or other relative, so that your losses can be triggered on sales of property to these individuals.

Taxpayers other than individuals

For taxpayers other than individuals, namely corporations and trusts, the result of the application of the superficial loss is somewhat different. The rules still apply in the same circumstances, i.e. a corporation sells a property at a loss, it or an affiliated person acquires the same property or identical property within the 30-day before and 30-day after period described earlier, and the corporation or the affiliated person continues to own the property at the end of the period.

However, the denied loss is not added to the cost of the acquired or re-acquired property. Instead, in general terms, the loss is subsequently allowed for the corporation once the property is sold to a non-affiliated person, as long as the corporation or affiliated persons do not own the property or identical property for a period of at least 30 days.

AROUND THE COURTS

Re-zoning costs deductible from rental income

In the recent *Jennings* case, the taxpayers purchased a rental property in Ottawa with three rental units. When they purchased the property, they assumed that the property was properly zoned for rental purposes.

However, six years later the City of Ottawa informed the taxpayers that the property was not zoned for three rental units. The taxpayers applied for re-zoning of the property and were allowed to rent it out while the decision was made. The taxpayers claimed a deduction for the application fees and fees paid to a consultant who helped with the application. Re-zoning was eventually allowed for two rental units.

The CRA denied the deduction of the fees, taking the position that they were capital expenses (and thus not deductible in the year they were incurred) rather than current expenses. Upon appeal to the Tax Court of Canada, the judge disagreed with the CRA. The judge held that the expenses were ordinary expenses incurred with respect to the day-to-day management of the property. The fees were therefore current expenses, fully deductible in the year they were incurred.

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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.