The Institute™
for Advanced Financial Education

# COMMENT

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## EXPANDING THE CRA'S INVENTORY OF DATA ASSETS

In the 2017 federal budget, the government announced it was considering new ways to improve tax reporting requirements for trusts in order to better collect beneficial ownership data. This has led to an announcement in the 2018 federal budget that outlines the government's intention to bolster the Canada Revenue Agency's (CRA) ability to audit trusts through the introduction of new reporting requirements. While a notice of ways and means motion and technical notes have been introduced, there has not yet been specific legislation with respect to these new reporting rules.

Currently, a trust is not required to file a T3 return if it has not earned any income or made any distributions in the year. It should be noted that if a trust return is not filed, the three-year reassessment period never begins.

Effective 2021, new rules will require certain trusts to file an annual return irrespective of income or distributions. As a result, certain trusts will be required to report information with respect to all trustees, beneficiaries, and settlors of the trust. Currently, the CRA can request all of this information when auditing a taxpayer. Under the new rules, the CRA will have access to this core information upfront. This will provide a wealth of data that can be used for analytical purposes, helping the CRA derive meaningful insights. In addition, the disclosure requirements will include identifying persons who can exert control over decisions of the trustees (as outlined in the trust agreement or related document) with respect to the appointment of income or capital of the trust.

Which trusts are not affected?

- Mutual fund trusts
- Trusts governed by a registered plan, i.e., RRSP, RRIF
- Lawyers' general trust accounts
- General rate estate (GRE) trusts
- Qualified disability trusts
- Not for profit and charitable trusts
- Trusts that have been in existence for less than three months

The new provisions will broaden the penalty for non-compliance. The basic penalty for failure to file will range from a minimum of $100 to a maximum of $2,500. Where a failure to file is done knowingly or is due to gross negligence, an additional penalty equal to five percent of the trust property can be levied.

Non-resident trusts could also be affected. To the extent a non-resident trust is required to file a T3 return in Canada, the trustees will be required to comply with the new disclosure requirements.

Included in the budget is $79 million of proposed funding over a five-year period, to assist the CRA with implementing the new rules and to enhance their audit and administration associated with trusts. Ongoing funding associated with an electronic platform for the processing of T3 returns is also promised in the budget. As with any type of enhanced automation and data collection, the opportunity to aggregate data will transform how the CRA works using its ever expanding inventory of data assets. There is a good probability that the concept of risk-based audits will expand to include trusts in ways not previously possible.

## MEASURING THE ECONOMIC COST OF NEW TAX PROPOSALS

The federal government began public consultations in July 2017 as a means of addressing perceived unfairness in the tax system. In tax proposals released at that time, the Department of Finance noted that Canadian controlled private corporations (CCPCs) are permitted to accumulate funds from earnings taxed at low rates, such as 13.5% in Ontario (combined federal tax rate of 10% plus 3.5% provincial tax rate on active business income below the small business limit). The government also noted that smaller businesses typically have more difficulty accessing capital, so the intention behind the lower rate of tax is to allow CCPCs to accumulate higher levels of retained earnings that can be reinvested in their active businesses.

The perceived inequity observed by the federal government relates to the use of the retained earnings for passive investments, rather than for active business purposes. The initial lower rate of tax is a preferential rate that leaves a higher level of retained earnings in the corporation, and therefore creates more funds than would be available if the money had been paid out to the shareholder and then used for passive investments. Effectively, the corporation's shareholders benefit from a tax deferral advantage.

A CCPC is eligible for the preferential tax rate on up to $500,000 of qualifying active business income (referred to as the 'business limit'). Associated corporations share a single business limit, and it is reduced when total taxable capital employed in Canada by the CCPC and any associated corporations is between $10 million and $15 million. It is eliminated after $15 million.

In an effort to address the government's concerns, the 2018 federal budget proposes to introduce a new measure that will make CCPCs (and their associated corporations) subject to a reduced business limit when their investment income is between $50,000 and $150,000. To achieve this, a new concept – adjusted aggregate investment income (AAII) – is being introduced. A company's small business limit will be reduced by $5 for every $1 of adjusted aggregate investment income in excess of $50,000. The $500,000 small business limit is completely eroded when the company's AAII reaches $150,000.

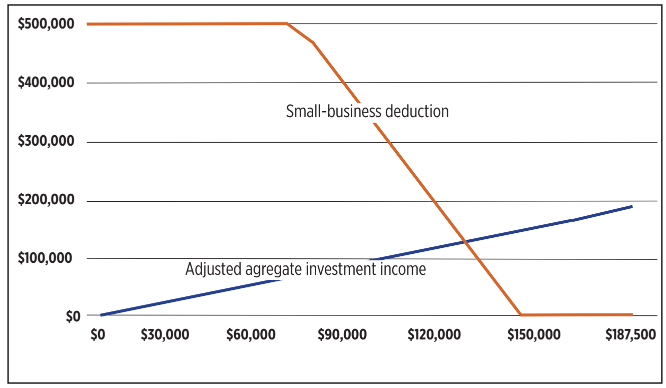
The business limit reduction under the new AAII measure is designed to operate alongside the existing business limit reduction that applies with respect to taxable capital. The new reduction in a corporation's business limit will be the greater of the reduction under the new AAII measure and the existing reduction based on taxable capital.

AAII is a newly defined term that is derived from an existing concept, aggregate investment income, that is used in the calculation of the refundable dividend tax on hand (RDTOH). The following are general considerations in the calculation of new AAII:

- Taxable capital gains realized on the sale of active business assets are not included (as would be expected given the intent of this new measure)
- Taxable capital gains in excess of allowable capital losses are included
- Allowable capital loss carry-forwards are not included
- Income from property, (ie., interest, dividends, rental, lease, royalties, etc., is included)
- Passive income incidental to the active business is not included
- Dividends from connected companies are not included
- Gains from the disposition of life insurance policies are included

As noted, the business limit is a shared amount across all associated corporations, which means that the new AAII is calculated taking into consideration the AAII of the group of associated companies. As such, the AAII of a holding company will be used in the operating company's calculation.

The erosion of a company's small business deduction could be graphed as follows:




Corporations that will be directly affected are those that own an active business AND are accumulating an investment portfolio in the operating company or an associated company.

While the government estimates that only about three percent of CCPCs claiming the small business deduction will be affected by this new measure, the cost could be substantial.

Consider the following example of a corporation that earns $10,000 of passive income in excess of the new $50,000 threshold.

**1)** Passive income is taxed at 50.17% (federal and Ontario provincial 2018 rate), so $5,017 of tax is due on the $10,000 of passive income in excess of the $50,000 threshold.

**2)** The company will lose $50,000 of its small business limit ($5 for every $1 of passive income in excess of $50,000), leaving a business limit of $450,000.

**3)** The business limit is worth about 13% (Ontario 2018 rate calculated as the difference between 26.5% top rate and 13.5% tax rate on the first $500,000 of active business income).

**4)** The outcome of **(2)** and **(3)** above is a loss of $6,500 in tax benefits to the corporation (13% of $50,000).

In the example above, the corporation earned $10,000 of passive income in excess of the new $50,000 threshold. The tax cost of earning the extra $10,000 of passive income is the loss of $50,000 of small business limit ($5 for each $1 of excess income) and the higher tax amount on the $50,000 of lost business limit.

In this example, the corporation's income tax liability will be $6,500 higher under the new provisions. Note, however, because the corporation will pay higher corporate tax on $50,000 of active business income (recall the small business limit was reduced from $500,000 to $450,000), the dividend associated with the $50,000 of income can be treated as an eligible dividend. An eligible dividend is subject to a lower rate of tax than an ineligible dividend that would have been the case under the current rules. The outcome is that the shareholder will experience a lower tax liability when receiving this dividend. The value of the tax savings to the shareholder compared with today will depend on the tax rates at the time of payment.

The rules will take effect for taxation years that begin after 2018. As such, a business with a September year-end will not incorporate the new calculation until its September 2020 year-end; however, because the rules use passive income earned in the prior year (September 2019 year-end) it is important to begin planning now.

Planning could include some or all of the following options:

- Choosing investments that have primarily capital appreciation;
- Choosing capital class funds;
- Individual pension plans (IPP);
- Retirement compensation arrangements (RCA); and,
- Utilization of exempt class life insurance.

This is an important change to the taxation of private companies. Corporations should begin working with their advisors to understand the implications and options.

## PERSONAL-USE PROPERTY: OFTEN OVERLOOKED BUT STILL SUBJECT TO TAX

The sale of a capital asset for proceeds higher than the property's adjusted cost base (ACB) results in a capital gain, 50 percent of which is generally included in income as a taxable capital gain. However, the opposite is not automatically true. A capital loss on personal-use property is not deductible and cannot be netted against the taxpayer's capital gains.

Personal-use property is property purchased primarily for the personal use of the taxpayer and the taxpayer's family. For example, this could include a home, cottage, car, boat and personal effects. In general, personal-use property is not purchased for profit or gain, but rather for the taxpayer's (and his or her family's) personal use and enjoyment.

However, the idea that it is for personal enjoyment does not eliminate the potential for tax consequences when the property is disposed of. To begin with, there is a principal residence exemption available for the disposition of qualifying personal homes. For other personal property, in simple terms, a special rule deems the ACB of personal-use property to be the greater of the property's actual ACB and $1,000. As such, if the property's actual ACB is less than $1,000, the deeming rule will automatically bump it to $1,000 when calculating the capital gain or loss realized on the disposition of the personal-use property. Similarly, the proceeds of disposition for personal-use property are deemed to be the greater of the actual proceeds and $1,000.

Generally, all gains on personal-use property, after applying the deeming rule, are taxable while losses are not deductible (except for listed personal property discussed below). Consider the following example where this year Ashley disposes of two boats that she has owned for many years.

| | Boat A | Boat B |
|---|---|---|
| **Facts** | | |
| Original cost | $750 | $1,500 |
| Actual selling price | $1,600 | $850 |
| **Calculation** | | |
| Proceeds of distribution | $1,600 | $1,000[1] |
| Adjusted cost base | $1,000[2] | $1,500 |
| Capital gain (loss) | $600 | ($500) |

[1] Deeming rule bumps the proceeds of disposition from $850 to $1,000

[2] Deeming rule bumps the ACB from $750 to $1,000

The resulting taxable capital gain on the disposition of Boat A is included in the taxpayer's reportable income. The capital loss realized on the disposition of Boat B is not deductible against the taxpayer's income nor is the capital loss netted against the capital gain realized on Boat A.

The general theory is that the majority of personal-use properties do not typically appreciate because they are often property that is consumed and tend to depreciate over time such as a car or furniture.

A subset of personal-use property is classified as listed personal property (LPP). The main difference between regular personal-use property and LPP is that there is an investment element associated with LPP and its value is not necessarily consumed through the taxpayer's enjoyment.

The rules in respect of capital losses realized on LPP are modified from regular personal-use property. Specifically, capital losses realized on LPP can be netted against capital gains realized in the same year on LPP. Net capital losses realized on LPP can be carried back three years and claimed against capital gains on other LPP. Alternatively, net capital losses realized on LPP can be carried forward seven years and claimed against capital gains realized on other LPP in those years.

The definition of LPP is very specific because each type of property classified as LPP is defined specifically in the *Income Tax Act*. LPP includes:

**a.** A print, etching, drawing, painting, sculpture, or other similar work of art;

**b.** Jewellery;

**c.** A rare folio, rare manuscript, or rare book;

**d.** A stamp; or,

**e.** A coin.

Consider the example of Martin who sells two paintings from his art collection in the same year.

| | Painting A | Painting B |
|---|---|---|
| **Facts** | | |
| Original cost | \$800 | \$1,500 |
| Actual selling price | \$1,200 | \$500 |
| **Calculation** | | |
| Proceeds of distribution | \$1,200 | \$1,000[1] |
| Adjusted cost base | \$1,000[2] | \$1,500 |
| Capital gain (loss) | \$200 | (\$500) |

[1] Deeming rule bumps the proceeds of disposition from \$500 to \$1,000

[2] Deeming rule bumps the ACB from \$800 to \$1,000

The \$500 capital loss on Martin's disposition of Painting B will fully offset the capital gain realized on the disposition of Painting A. The difference of \$300 (\$500 loss on B less \$200 gain on A) can be carried back three years or forward seven years and claimed against any net capital gain realized on the disposition of other LPP in those years.

This is an area that is often overlooked because taxpayers must self-report these transactions as there is no T-slip associated with personal-use property. However, a taxpayer is obligated to report the capital gain realized on the disposition of personal-use property and failure to do so could result in penalties and interest. Capital losses realized on LPP should be reported because they may be able to offset capital gains realized on the disposition of other LPP.

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