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TAX LETTER

December 2017

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A WILD OCTOBER

On July 18, 2017, the federal government announced wide-ranging income tax proposals affecting private corporations. In the Economic Statement of October 24, 2017, they backed down from the original proposals, though some will remain. Here's a quick overview of the current status of the July 18, 2017 proposals:

- **Small business deduction:** The federal tax rate on Canadian-controlled private corporations (on active business income) for the first $500,000 of income per year, currently 10.5%, will drop to 10% January 2018 and to 9% starting January 2019. However, the related "gross-up" and dividend tax credit on dividends paid by private corporations to individual shareholders will also be reduced, so that once dividends are paid out, the effective total tax on the corporation and the shareholders will be the same as before.

- **Income sprinkling:** The proposals to prevent income splitting by imposing a high tax rate on dividends or salary paid to family members will proceed, but not in the form proposed on July 18. Adult family members who have contributed to the business will not be subject to the new rules. We won't have specifics until the draft legislation is released, likely in mid-December. However, the new rules might still take effect starting January 1, 2018.

- **Lifetime capital gains exemption:** The proposals to limit the exemption in various ways have been dropped.

- **Converting income to capital gains (dividend stripping):** These very technical proposals to amend section 84.1 and add new section 246.1 to the Income Tax Act have been dropped.

- **Passive income:** The proposal to tax a private corporation's passive income (investment income) at high rates, with insufficient offsetting dividend tax credit, will proceed, but will not apply to the first $50,000 of a corporation's passive income each year. The effect will be to subject any additional passive income at rates well over 70% in many cases, once dividends are paid out to shareholders. However special exceptions will be made for venture capital and "angel" investors who fund growing businesses. Again, we won't have specifics until the legislation is released, likely in mid-December.

It remains to be seen, when the revised legislation is released in December, what the details of the changes are and how they impact businesses. The government said the legislation will be released "later this fall", so we will likely see it on December 20 (the last day of fall).

CRA DROPS PLANS TO REGISTER TAX PREPARERS

In January 2014, the Canada Revenue Agency (CRA) began consultations on whether to introduce a system that requires anyone who prepares tax returns for a fee to be registered with the CRA. (Some other countries, including the United States, already have such a requirement.) We reported on this in our March 2015 Tax Letter.

The CRA now says it's "considering other options that would serve to implement the objectives of the proposed Registration of Tax Preparer Program (RTPP) through existing CRA programs and initiatives at lower costs."

Note that a form of registration is already effectively required. Any tax preparer who prepares more than 10 individual returns or 10 corporate returns is subject to a penalty if those returns are not filed electronically. And filing electronically requires the preparer to register for the CRA's "E-File" system. However, there are no training or qualification requirements, other than not having been involved in offensive or fraudulent tax activities.

CHANGE TO MARKET SETTLEMENT RULE AFFECTS YEAR-END TAX SELLING

For many decades, the rule when selling stocks on the market was that "settlement" — actual completion of the sale — would happen in three days. This rule came into place long before there was computerized trading and electronic delivery of shares.

Since September 5, 2017, settlement of a share purchase or sale now takes place in **two business days**. This change applies to markets in both Canada and the U.S.

This affects year-end selling done for tax purposes. If you are selling shares to trigger a capital loss to use for 2017, or to trigger a capital gain to use up other losses, make sure to finalize your trade no later than **December 27, 2017**. Since December 28 and 29 are Thursday-Friday, your trade will then "settle" on December 29. As the following two dates are Saturday and Sunday, a trade on December 28 will not settle until January 1, and will not count for your 2017 tax return.

YEAR-END PLANNING

It's December, and time to think of some tax planning ideas. If you wait until your tax return is due next April or June, it will generally be too late to change your tax situation for this year.

1. Private Companies — Pay out Dividends before the Tax Cost Goes Up

The so-called "gross-up" and dividend tax credit apply when you receive dividends from a Canadian corporation. The purpose of these rules is to put you in the same position as you would be if you earned directly the income earned by the corporation — taking into account that the corporation has already paid corporate income tax. The **"gross-up"** brings into your income an amount that theoretically reflects the pre-tax income earned by the corporation to pay you the dividend, and the **dividend tax credit** then gives you a credit for the corporate tax that the corporation theoretically paid on that income. This so-called "integration" is often not exact, especially when varying provincial tax rates are taken into account.

As noted above in "A Wild October", the federal corporate tax rate on small business active business income (up to $500,000 per year for most Canadian-controlled private corporations) will drop from 10.5% to 10% in 2018 and 9% in 2019, and the gross-up and dividend tax credit will be reduced to match.

This means that the effective personal tax rate on dividends from private corporations will increase a little bit for 2018 and again for 2019.

Other things being equal, if you are planning to have your corporation pay out dividends in the near future, do it before the end of 2017. Your personal income tax on the dividend will be a little lower than in 2018. The top *federal* rate on dividends will increase from 26.3% to 26.64% in 2018 and 27.57% in 2019. The effect of provincial tax will add to the amount you save.

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Of course, this is not a very large saving, and you need to take other factors into account as well. For example, if your personal income will be lower in 2018 so that you will be in a lower tax bracket than in 2017, it will be much better to postpone the dividend until 2018.

2. Income Sprinkling

The new rules for income sprinkling (see "A Wild October" above) may take effect in 2018, although the details are not yet known. If you have the option of having your corporation pay dividends to family members who are not involved in the business, and who have not contributed significantly to the business, consider paying those dividends before year-end for income-splitting purposes. Starting 2018, such dividends may be taxed at the highest rate that can apply, if the "tax on split income" applies.

Of course, if the shareholders are children under 18, this "tax on split income" already applies to them, until the year in which they turn 18.

3. Charitable Donations

Charitable donations must be made by December 31 to be counted for this year.

Charitable donations receive special tax assistance. Donations that exceed $200 per year give you a tax credit calculated at the highest marginal rate. If your taxable income for 2017 (after all deductions) exceeds $142,353, the charitable donation credit is generally worth the same as a deduction (sometimes a little less, depending on the province). If your taxable income is lower, then the donation credit is *better* than a deduction, usually around 45%. (In Alberta and Nova Scotia, a special high credit for donations brings the value of the donation up to 50-54%.)

In fact, if you are not in the top tax bracket, you can benefit by receiving income and donating the excess to a charity. This may be possible if you already volunteer for a charity. **If the charity pays you for your volunteer work**, and you donate the income back to the charity, your tax bill will go down.

For example, suppose you are in a 30% tax bracket (including provincial tax), and you have already made over $200 in donations this year. If the charity pays you $10,000 for work you have done for it, your tax bill will go up $3,000 (maybe a bit higher, if you move up to the next bracket). If you donate the same $10,000 back to the charity, your tax bill will go down about $4,500 (varying slightly by province). The net is a saving of about $1,500 after tax.

Of course, the income has to represent real work you have done for the charity, and your donation must be voluntary. The charity also has to determine whether you are an employee or an independent contractor. If you are an employee, the charity must issue you a T4 and may have to withhold some tax at source. If you are an independent contractor, you may be able to deduct expenses from your "business income", providing you with further tax savings; and if your total business revenues for the year exceed $30,000 you may need to charge GST or HST. Professional advice may be useful in addressing these issues.

An even simpler technique is to have the charity reimburse you for expenses you have incurred this year as a volunteer (e.g., travel and parking costs). Such reimbursements, provided they are reasonable, are not taxable to you. You can then donate the reimbursed amount back to the charity and get a tax credit.

Another idea to consider is donating publicly-traded shares or mutual fund units to a charity. If you do this, you do not pay tax on any capital gain on the securities, but the donation is valued for tax purposes at its current fair market value. If you are considering making a donation to a charity, and you have some securities that have gone up in value, donating the securities will be very tax effective.

You can claim charitable donations up to 75% of your "net income" for tax purposes. Net income is basically your income after most deductions, but before claiming the capital gains deduction (capital gains exemption) or any loss carryovers from other years.

In cases, make sure to get a tax receipt from the charity that meets all of the conditions specified in the Income Tax Regulations, or you will not be entitled to the credit.

Note that donations of property are valued at your cost of the property, if you acquired the property within the past 3 years or if you acquired it for the purpose of donating it.

(This rule does not apply to publicly-traded securities or certain other property.) This prevents the so-called "gifting" schemes which used to attract many taxpayers, who would purchase art or other goods for less than their appraised value and then donate the art to a charity for a high-value tax receipt.

Finally, if you (or perhaps a child of yours who is over 18) have not claimed any donations for years after 2007, a special bonus "super credit" or "stretch credit" of an extra 25% is available for the first $1,000 of donations, significantly reducing the cost of the donation. This year, 2017, is the last year that this bonus credit can be used. It can only be used once, so if you already used it since it was introduced in 2013, you cannot use it again.

4. RRSP contributions

If either you or your spouse are not yet 71 this year, then you can normally make contributions to a registered retirement savings plan (RRSP) and deduct them from your income for tax purposes. Your RRSP contribution limit for 2017 is based on your 2016 "earned income" as well as your pension adjustment (reflecting future pension credited to you in 2016 from your being a member of a company pension plan).

Your available RRSP contribution room should be printed on the Notice of Assessment that you received from the CRA after you filed your 2016 return in the spring of 2017. Your maximum contribution room for 2017 is:

18% of your 2016 earned income
(maximum $26,010 if your 2016 earned income exceeded $144,500)

minus

your pension adjustment

plus

any contribution room from earlier years since 1991 that you have not yet used up.

Your deadline for contributions for 2017 is **March 1, 2018**. However, if you have excess cash, you should consider making your 2018 contribution early in 2018. You can make that contribution any time from January 1, 2018 through March 1, 2019. Putting funds into an RRSP will allow them to grow tax-free, rather than you having to pay tax on any interest or investment income that you earn during the year. (You can also put money into a tax-free savings account, or TFSA, for which you get no deduction but interest or investment income will not be taxable. As of 2017, your lifetime TFSA contribution limit is $52,000 if you were born before 1992.)

Consider also a contribution to a **spousal RRSP**. (This also applies to a common-law spouse or same-sex partner who meets the Income Tax Act's definition of "common-law spouse", even if you are not legally married.) Your maximum deductible contribution is the same regardless of whether you contribute to your RRSP or your spouse's, or some combination of the two. If your spouse is likely to have lower income than you in future years, then a spousal RRSP contribution will allow your spouse to take the income out down the road (once the last year during which you make any spousal contributions has passed, plus two more years). Your spouse will then pay tax on that income at a lower rate than you would if you withdrew the funds from your own RRSP.

A spousal RRSP is also useful if you are already over 71 but your spouse is younger. Once you reach the year in which you turn 71, you cannot contribute to your own RRSP and must convert your RRSP to an annuity or a registered retirement income fund (RRIF) from which you draw income every year. However, you can still make contributions to a spousal RRSP if your spouse is under 71 at year-end.

5. Trigger capital losses

Capital gains are half-taxed; that is, half of the gain is included in your income as a taxable capital gain. Capital losses can be claimed only against capital gains (and can be carried back three years and forward indefinitely against such gains).

If you have capital gains this year — for example, from selling some shares for a gain earlier in the year — you may wish to trigger capital losses by selling securities that have gone down in value.

Make sure the transaction is completed by December 27, in time for it to settle before the end of the year. As noted in the article "Change to Market Settlement Rule" above, the settlement date for most stock trades in Canada is now two business days.

You should also ensure that you are not caught by the "superficial loss" rules. If you (or an "affiliated person", which includes a corporation you control) acquire the same (or identical) securities within 30 days of selling them, then your capital loss will be disallowed.

There are numerous other special rules for capital gains and losses. This is just a general overview.

6. Pay your instalments

If you have instalments to pay for the year, and you have not been paying them as per the notices you receive from the CRA during the year, now would be a good time to catch up. If you wait until next April, you will owe four months' additional interest, and possibly penalties, on the late instalments.

To avoid interest applying, instalments should be paid on March 15, June 15, September 15 and December 15. Prepaid or "early" instalments earn credit (called "offset interest") against interest that applies to late instalments for the same year.

You are allowed to calculate instalments based on any of three methods, without interest applying. The instalments can total your tax payable (on income from which tax is not withheld at source) for this year, or for last year, or based on the amounts that the CRA advises you. The CRA's notice to you for March and June is based on the total taxes you paid two years ago, and then for September and December the suggested instalments are adjusted so that the total for the year equals the amount you paid last year.

If you have not been paying your instalments, you should estimate as best as you can the tax that will be owing for the year on your self-employment and investment income (and other sources from which tax is not withheld), or use the numbers for 2016 (whichever is lower). You should then make a catch-up instalment payment as soon as possible, to reduce interest charges.

Where interest does apply to late instalments, it is calculated at 5% compounded daily, a rate that varies quarterly but has been largely unchanged since 2009. You do not get

interest on overpaid instalments, other than as an offset to late instalments for the same year as explained above. But any interest you are required to pay is non-deductible.

AROUND THE COURTS

Orthodontist denied GST/HST input tax credits

Most businesses can claim a full "input tax credit" (ITC) to recover all the GST/HST they pay on their expenses. That way, the real cost of the GST and HST is imposed only on consumers.

However, businesses that make "exempt" supplies cannot claim ITCs, though they do not charge GST/HST on their services. Thus, the GST/HST is a real cost to such businesses. This includes physicians, dentists, and most other regulated health care providers.

Orthodontists provide dental services (which are exempt), but also sell braces, which are "zero-rated" as medical devices. No tax applies to a zero-rated supply, but the business is allowed to claim ITCs for its costs of making such sales.

Because orthodontists provide both exempt services and zero-rated goods, the CRA has since 1992 an administrative policy allowing orthodontists to claim 35% of their ITCs.

However, in a recent case, *Dr. Brian Hurd Dentistry Professional Corp. v. The Queen*, the Tax Court of Canada held that this policy is wrong.

The Court ruled that what an orthodontist provides is a "single supply": the dental services and braces cannot be separated, since neither can usefully be supplied without the other. Under the law developed by the Courts over the past 20 years, a "single supply" has only one status for GST or HST purposes: that of the dominant element.

The Court found that the dominant element was the dental services. Thus, the orthodontist's sales were all exempt, and he was unable to claim *any* ITCs.

This case will cause serious problems for orthodontists if the CRA decides to follow it and revise its administrative policy to disallow all ITCs. Since the decision was issued under the Tax Court's Informal Procedure, it is not a binding precedent, and the CRA may chose to ignore it; but given the Court's ruling, the CRA may feel that it should re-evaluate its policy to reach the correct legal result.

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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.