TAX LETTER

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TWO RDTOH ACCOUNTS STARTING IN 2019
ACCELERATED CAPITAL COST ALLOWANCE: RESPONSE TO U.S. CORPORATE TAX CUTS
RE-ALLOCATION OF PROCEEDS ON SALE OF LAND AND BUILDING
CAPITAL DIVIDENDS
AROUND THE COURTS

TWO RDTOH ACCOUNTS STARTING IN 2019

In our November 2018 Tax Letter, we discussed the refundable Part IV tax that can apply to a Canadian-controlled private corporation ("CCPC") on certain dividends that it receives from another corporation.

In general terms, the 38 1/3% Part IV tax applies to dividends that a CCPC receives from a corporation where the CCPC owns 10% or less of the shares of the corporation (based on either votes or fair market value). These dividends are often referred to as "portfolio dividends".

The Part IV tax can also apply if the CCPC receives dividends from another corporation that are not portfolio dividends (that is, where the CCPC owns more than 10% of the other corporation), if the other corporation receives a dividend refund on the payment of the dividends to the CCPC.

The Part IV tax is added to a notional account called the refundable dividend tax on hand (RDTOH) account.

The CCPC then receives a refund of the Part IV tax equal to 38 1/3% of the taxable dividends it pays to its shareholders, to the extent of its RDTOH account. (Examples were provided in the November Letter.)

However, there are two types of dividends that the CCPC can pay to its shareholders: *eligible* dividends and *non-eligible* dividends. Eligible

dividends are generally paid out of the CCPC's income that was subject to the general corporate tax rate. Non-eligible dividends are generally paid out of the CCPC's active business income that was eligible for the small business deduction, or investment income where the tax is refundable, such as the refundable Part IV tax.

A shareholder receiving an eligible dividend receives a dividend tax credit that is more generous than the dividend tax credit in respect of a non-eligible dividend. The more generous dividend tax credit for eligible dividends reflects the fact that the general corporate tax rate for a CCPC is higher than the rate that applies to business income that qualifies for the small business deduction, and higher than the rate that applies to investment income after the refund of the refundable tax on such investment income.

Under the pre-2019 rules, a CCPC could receive a refund of Part IV tax whether it paid eligible or non-eligible dividends, as long as it had enough of a balance in its RDTOH account. Apparently, the Department of Finance felt that this result was not always appropriate, since a CCPC could receive a refund of its Part IV tax even though the shareholder received an eligible dividend and therefore the more generous dividend tax credit.

As a result, in the 2018 Federal Budget, the Department addressed the situation, and amended the rules **to split up the RDTOH account into two accounts**: the *eligible* RDTOH and the *non-eligible* RDTOH.

The *eligible* RDTOH account of a CCPC will include the Part IV tax payable on eligible portfolio dividends it receives, plus the Part IV tax payable on other dividends it receives to the extent the corporation paying the dividends receives a refund of tax out of its eligible RDTOH.

A CCPC's *non-eligible* RDTOH account will generally include the Part IV tax payable on any other dividends that the CCPC receives.

When the CCPC in turn pays eligible dividends to its shareholders, it can receive a refund of its Part IV tax out of its eligible RDTOH account. Furthermore, under the ordering rule noted below, the payment of non-eligible dividends can generate a refund out of the eligible RDTOH account.

When the CCPC pays a non-eligible dividend, it can receive a refund of its Part IV tax out of its non-eligible RDTOH account.

An ordering rule provides that upon the payment of a non-eligible dividend, a refund is first taken out of the non-eligible RDTOH account, and any remaining amount of the dividend can generate a refund out of the eligible RDTOH account.

These new rules apply to taxation years that *begin* after 2018, so if your corporation has a December 31 year-end, then the rules are already in force for it, for the year beginning January 1, 2019. A transitional rule splits up the pre-existing RDTOH of the CCPC for its first affected taxation year. In general terms, the lesser of the RDTOH balance at the end of the previous year and 38⅓ per cent of the CCPC's "general rate income pool" (basically, income that was subject to the general corporate tax rate), is allocated to the CCPC's eligible RDTOH account. Any remaining balance is allocated to its non-eligible RDTOH account.

ACCELERATED CAPITAL COST ALLOWANCE: RESPONSE TO U.S. CORPORATE TAX CUTS

On November 21, 2018, the Department of Finance announced income tax measures to

address recent corporate tax changes made in the United States. The new measures focus on accelerating the claim for capital cost allowance ("CCA" – tax depreciation), for most capital properties acquired after November 20, 2018.

The changes are intended to keep Canada's corporate tax system competitive with that of the United States. However, unlike the recent changes in the United States, the new measures do not reduce Canadian corporate income tax rates. Despite that, the Department of Finance states the new accelerated CCA measures "will give businesses in Canada the lowest overall tax rate on new business investment in the G7, significantly lower than that of the United States".

Depreciable capital property is divided into Classes, and each Class is a pool of assets on which CCA is claimed each year. For example, computers generally go into Class 50. When depreciable property is purchased (e.g., a new computer), its purchase price is added to the "Undepreciated Capital Cost" (UCC) of the Class. Each year, a percentage of the UCC for the class (55% for Class 50) can be deducted as CCA, and the UCC for that Class is reduced by the amount deducted.

Under existing rules, the CCA for the year the property is acquired is subject to the so-called "half-year" rule. Basically, for the year of acquisition, a taxpayer can claim CCA on only half of the amount added to the Class for that property. The other half remains in the UCC pool for the Class, so it can be deducted in future years, based on the percentage rate for the Class.

The new CCA measures replace the detrimental half-year rule with beneficial rules, as discussed below.

New rules for "accelerated investment incentive property"

The half-year rule is effectively eliminated for most depreciable capital properties, which are referred to as "accelerated investment incentive property" ("AII property").

AII property acquired after November 20, 2018 and before 2024 will qualify for an accelerated CCA deduction in the year of acquisition (technically, in the year in which the property becomes "available for use"). In that year, an additional 50% of the cost of acquired property is added to the Class, which means that CCA can be deducted on 150% of the cost of the property in that year. After the year of acquisition, the CCA applies as usual to the balance in the Class.

The Department of Finance provides the following example (we have made some modifications):

Example

X spends $100 to purchase AII property included in Class 10 (30% CCA rate) in 2019, and it becomes available for use in that year. X may deduct $45 instead of the $15 that would previously have been allowed in the first year due the half-year rule, as calculated below:

Regular UCC at the end of the year:	$100
50% addition:	$50
Adjusted UCC:	$150
CCA rate:	30%
First year CCA deduction ($150 x 30%)	$45
UCC pool for next year after CCA deduction	$55

In the following year, assuming no new acquisitions, the taxpayer may deduct 30% of the $55 UCC and no additional amount for accelerated investment incentive property.

For AII acquired after 2023 and before 2028, the 50% addition does not apply in the year of acquisition, but the half-year also does not apply. In other words, CCA will be allowed at the percentage rate for the Class, on the full cost of the property in the year of acquisition.

Similar rules with an accelerated upfront deduction apply to specific types of AII, such as the cost of leasehold interests, and the cost of patents, franchises, or concessions or licenses for a limited period.

There are some exceptions, where property does not qualify as AII. For example, AII does not include property previously owned or acquired by the taxpayer or by a person or partnership with which the taxpayer did not deal at arm's length.

Immediate write-off for certain AII

The new measures provide that in the year of acquisition, the full cost of machinery and equipment used in the manufacturing and processing of goods (Class 53) and specified clean energy equipment (Classes 43.1 and 43.2) may be deducted as CCA. (The normal CCA rates are 50% for Classes 53 and 43.2, and 30% for Class 43.1.)

This immediate 100% write-off applies to property acquired before 2024.

For Classes 53 and 43.1, an enhanced deduction, but less than a full write-off, is allowed in the year of acquisition of the property for 2024-2027 (although Class 53 will be effectively replaced by Class 3 after 2025). For Class 43.2, a 75% write-off is allowed if the year of acquisition is 2024.

RE-ALLOCATION OF PROCEEDS ON SALE OF LAND AND BUILDING

Buildings used to earn rental income or for business purposes are considered depreciable property. As such, tax depreciation, or CCA as discussed above, can be claimed on a building. Land is not depreciable.

When CCA is claimed on a building, the amount claimed reduces the undepreciated capital cost ("UCC") in respect of the building. If the building is subsequently sold, the proceeds of disposition (to the extent of the original cost of the building) in excess of the UCC at that time is treated as "recapture" and is fully included in income. On the other hand, if the building is sold for proceeds less than the UCC, the remaining UCC pool can be fully deducted from income as a "terminal loss".

Any gain on the sale of the land on which the building is situated will be a capital gain, only half of which is included in income (assuming the land is capital property – if it was bought for the purposes of resale, then these rules do not apply and any gain is taxed as business income).

Historically, the government has been concerned about situations in which the sale of a building would generate a terminal loss, while the sale of the land would generate a capital gain. The government is not keen on you claiming a full deduction for the building terminal loss while only including half of the gain on the land in your income. An extreme example would occur if you demolished the building and therefore generated a terminal loss, and sold the land at a capital gain.

Accordingly, the Income Tax Act has a rule that **re-allocates the proceeds of disposition** when you sell a building with a terminal loss and the related land at a capital gain. Basically, the proceeds from the land are re-allocated to the building to bring the terminal loss from the building down to zero. But the re-allocation is limited to the amount of the capital gain from the land.

Example 1

You own a building with an original cost of $200,000 and UCC of $100,000, and you sell it for $80,000. You sell the land on which the building is situated and realize a capital gain of $30,000. In the absence of the re-allocation rule, you would have a terminal loss of $20,000 on the building, and a taxable capital gain of $15,000 from the land (one-half of the $30,000 capital gain).

Because of the re-allocation rule, $20,000 of the proceeds from the sale of the land will be shifted to the proceeds of the building, so you will have no terminal loss. Your capital gain on the land will be reduced to $10,000, one-half of which will be included in your income as a taxable capital gain.

Example 2

You own a building with an original cost of $200,000 and UCC of $100,000, and you sell it for $80,000. You sell the land on which the building is situated and realize a capital gain of $12,000. In the absence of the re-allocation rule, you would have a terminal loss of $20,000 on the building, and a taxable capital gain of $6,000 from the land (one-half of the $12,000 capital gain).

Because of the re-allocation rule, $12,000 of your proceeds on the sale of the land will be shifted to the proceeds of the building, so that your terminal loss will be reduced from $20,000 to $8,000. Your capital gain on the land will be reduced to zero.

CAPITAL DIVIDENDS

If you receive a dividend from a corporation, the dividend is normally included in your income.

However, a *capital* dividend is not included in your income. In other words, it is received free of tax.

In general terms, a private corporation can pay capital dividends to the extent of its "capital dividend account". Public corporations cannot pay capital dividends.

The capital dividend account includes certain amounts that are tax-free to the private corporation, and that are allowed to pass tax-free to the shareholders. For example, one-half of capital gains are not subject to tax. Therefore, if a corporation earns net capital gains (capital gains in excess of its capital losses), one-half of that amount is added to the corporation's capital dividend account and can be paid out as a tax-free capital dividend. In addition, the corporation's capital dividend account includes:

- Most life insurance proceeds received by the corporation on policies where it was the beneficiary; and
- Capital dividends that the corporation received from other corporations.

The capital dividend account is computed immediately before the earlier of the time that the capital dividend became payable and

the time it was paid. (It is usually payable at the time indicated by the directors of the corporation in the corporate resolution declaring the dividend.) Furthermore, the corporation must elect that the dividend is a capital dividend. This election must be filed with the CRA by the earlier of the two times indicated above.

The election is made on Form T2054, including a schedule showing the calculation of the capital dividend account balance immediately before the election. The CRA T2 Schedule 89 (Form T2SCH89, *Request for Capital Dividend Account Balance Verification*) can be used to ask the CRA to confirm the balance.

Late filing of the form T2054 may be allowed, but with a monetary penalty.

What if the dividend exceeds the capital dividend account?

A corporation declaring a capital dividend should have a capital dividend account equal to or greater than the capital dividend.

If the corporation makes a mistake, and pays a dividend that exceeds its capital dividend account, but still makes the election in respect of the dividend, the dividend will remain non-taxable to the recipient shareholder as a capital dividend. However, the corporation will be subject to a penalty tax equal to 60% of the excess, plus interest to the date of payment. The recipient shareholder will be jointly and severally liable with the corporation to pay the penalty.

As an alternative to the penalty, the corporation can elect to treat the excess amount as a *taxable* dividend, meaning that the shareholders will include that excess amount in income as a taxable dividend rather than a capital dividend. The shareholders must agree to this election.

CHILD CARE EXPENSES

If you incur child care expenses because you are employed, carrying on a business, or attending school, you will normally be allowed to deduct some or maybe all of those expenses in computing your income.

The deduction for a taxation year is the lowest of the three following amounts:

1) Your actual child care expenses for the year. This includes amounts paid for baby-sitting, nanny costs, and day care. A limited amount is allowed for boarding camps and schools, as discussed below.
2) The total of the annual child-care limits for the year. These amounts are $8,000 for each child you have under age 7 at year-end, and $5,000 for each child you have that is 7 through 16. (The expenses aren't limited for each child; this limit is a total, so if you spend $13,000 on your baby and nothing on your 12-year-old, the $13,000 can be deductible.) The annual child care limit is $11,000 for children who are disabled and eligible for the disability tax credit.
3) Two-thirds of your earned income for the year, which includes your gross income from employment, your business income (after expenses) for the year, and your disability pension under the Canada Pension Plan or the Quebec Pension Plan.

For boarding camps and schools (for example, a summer overnight camp), the expenses for the purposes of item 1) above are limited to the following: $200 per week per child under the age of 7 at year-end; $125 per

child age 7-16; and $275 per child eligible for the disability tax credit.

If you are married or in a common-law partner relationship, the **lower income spouse** (or partner) is normally the only one who can claim the deduction. Thus, for example, if the lower income spouse has no earned income (per #3 above), then no deduction will be allowed. If you are single, you can claim the entire deduction.

Example

John and Isabel are married and have two healthy children, aged 5 and 12. They incurred $15,000 of child care expenses in the year. They also sent the 12-year to a summer camp for 3 weeks during the year, and spent $1,000 on that.

John is the lower income spouse. His earned income for the year is $30,000. His child care expense deduction will equal the lowest of:

1) $15,000 actual child care expenses + ($125 x 3 summer camp weeks) = $15,375
2) Total annual child care amounts of $8,000 + $5,000 = $13,000
3) Two-thirds of John's $30,000 earned income = $20,000.

John can deduct $13,000.

In certain cases, the higher income spouse (or partner) may claim a limited deduction in a taxation year. Basically, this occurs if the lower income spouse (or partner) is either is in school during the year; is physically or mentally infirm and incapable of caring for the children; or is in prison for at least two weeks in the year.

AROUND THE COURTS

Spousal support payments were "periodic" and therefore deductible

Spousal support payments are deductible for the payer of the support if certain conditions are met. For example, the payments must be made pursuant to a court order or written agreement, and normally they must be made "on a periodic basis".

In the recent *Ross* case, the taxpayer made payments to his former spouse. Although most of the conditions for deductibility were met, the CRA denied the deduction on the grounds that the taxpayer's payments were not made on a periodic basis.

The taxpayer made five instalments payments to his former spouse: a lump sum of $20,000 on the signing of their separation agreement in November 2015; the transfer of a car (a payment-in-kind) worth $20,000 in December 2015; and three further payments in December 2016 of $4,000, $3,000 and $3,000. Apparently, the reason the payments were all made near the end of the years, rather than throughout the years, was because Mr. Ross did seasonal work as a lobster fisherman. His income generally peaked in the fall and early winter.

On appeal to the Tax Court of Canada, the Tax Court judge held that the CRA misapplied the meaning of "periodic basis" to the facts. There were a series of payments made over two years as set out in the separation agreement, and therefore could qualify as being periodic.

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