



GEIB & COMPANY
PROFESSIONAL CORPORATION
CHARTERED PROFESSIONAL ACCOUNTANTS

INSIDE THIS ISSUE

PG. 1 CARRYOVER OF TAX LOSSES

PG. 2 ESTATES AND THE “PIPELINE”
STRATEGY

PG. 5 TUITION TAX CREDIT

PG. 8 AROUND THE COURTS



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TAX NEWSLETTER

CARRYOVER OF TAX LOSSES

Under the Income Tax Act, if you have a net loss for the year rather than positive net income, you might not have any other income against which to use that loss in that year. Fortunately, there are “carryover” provisions that allow you to carry the loss back or forward to other taxation years.



NON-CAPITAL LOSSES

If you have a loss from employment, a business or property in a taxation year, the losses will reduce your other sources of income in the same year. However, your overall net income cannot be negative. Therefore, your losses from these sources in excess of your positive income from all sources cannot be used in that year. Such losses are called “non-capital losses”.

Non-capital losses can be carried back 3 years or forward 20 years, to offset all other sources of income for those years. If you carry back the losses, there is a special form T1A that is filed to amend the previous tax year’s tax return.

NET CAPITAL LOSSES

One-half of your capital losses are called “allowable capital losses” (ACL) and one-half of your capital gains are “taxable capital gains” (TCG). ACLs in a taxation year reduce your TCGs for the year, but only down to zero net TCGs. Any excess ACLs cannot reduce other sources of income in that year.

The excess ACLs for the year, called “net capital losses”, can be carried back 3 years or forward indefinitely, to offset TCGs in those other years. Unfortunately, they normally cannot offset other sources of income. One exception is described immediately below.

ALLOWABLE BUSINESS INVESTMENT LOSS (“ABIL”)

An ABIL is a type of allowable capital loss that arises on the disposition of shares or debt in a small business corporation. (Various conditions apply.) Unlike regular ACLs, an ABIL can reduce all sources of income, not just TCGs.

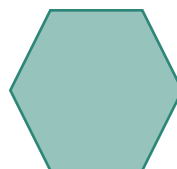
Unused ABILs in a year can be carried back 3 years or forward 10 years to offset all sources of income in those years. After the 10-year carry-forward period, unused ABILs convert to regular ACLs and therefore can only offset TCGs in years beyond that.

LISTED PERSONAL PROPERTY LOSSES

There is a general rule that says capital losses from the disposition of personal-use property are deemed to be nil and are therefore not recognized for income tax purposes.

However, if the loss is from the disposition of a “listed personal property” (LPP), the loss can offset gains from disposition of LPP in the same year. If there is a net gain, one-half is a TCG included in income in that year. If there is a net loss, the excess loss can be carried back 3 years or forward 7 years to offset gains from LPP in those years (but not gains from other properties).

LPP includes works of art; rare books, folios, and manuscripts; jewelry; stamps; and coins.



ESTATES AND THE “PIPELINE” STRATEGY

When a person dies, they are deemed to dispose of most of their capital properties at fair market value. This deemed disposition may trigger capital gains or losses, depending on the tax cost of the properties relative to their current fair market value.

The person who acquires the property as a result of the person’s death, which can include the deceased’s estate, acquires the property at a tax cost equal to that fair market value.

(However, if the deceased's spouse or common-law partner inherits the property, a tax-free rollover is available.)

As a result, there is normally no double taxation in respect of any accrued gains on the property. For example, if the estate sells the property, it will have a stepped-up tax cost so that there will be no further capital gain, except to the extent that the property has increased in value since the time of death.

However, a potential double tax problem can occur where the property is shares in a corporation, and where the corporation's cash or other assets are subsequently distributed to the estate. In this case, there may be a deemed capital gain for the deceased, and a subsequent deemed dividend for the estate.

Fortunately, there are some ways to avoid this double tax problem.

First, there is a rule in the Income Tax Act that allows an estate's capital losses in its first taxation year to be carried back to the deceased's final taxation year. Those capital losses can be used to offset the deceased's capital gains at death that arose under the deemed disposition rule.

Example 1

X died, owning all the shares in a corporation "Xco". X's adjusted cost base of the shares was \$1,000, the paid-up capital of the shares was \$1,000, and their fair market value at the time of death was \$500,000. (The paid-up capital of the shares, which involves a fairly technical calculation, generally reflects the after-tax capital that was originally used to acquire the shares.)

X will have a deemed disposition of the shares for proceeds of \$500,000, which will result in a capital gain of \$499,000 (\$500,000 proceeds minus the \$1,000 adjusted cost base). One-half of that gain will be included

in X's income as a taxable capital gain. The capital gains exemption does not apply.

In the estate's first taxation year, Xco distributes \$500,000 to the estate upon the redemption of the shares. The estate will have a deemed dividend of \$499,000 (\$500,000 minus the \$1,000 paid-up capital of the shares). However, under the share redemption rules in the Income Tax Act, the estate will have a corresponding capital loss of \$499,000, which can be carried back to X's final year to offset the capital gain in the year of death.

Result: The estate is taxed on the deemed dividend of \$499,000, but X has a net capital gain of zero so that there is no double taxation.

Although this strategy is normally effective, it comes with at least a couple of potential issues.

First, if the deemed dividend is sufficiently large, as in the above example, the tax on the dividend for the estate will normally be greater than the tax on the deemed capital gain at death that would otherwise be payable for the deceased. If so, although double taxation is avoided, the procedure comes with some additional tax cost.

Second, if Xco has assets with accrued gains, and those assets are distributed to the estate as part of the dividend, Xco may be subject to tax on those accrued gains. As well, the estate will be subject to tax on the dividend. Although there is a mechanism that may reduce Xco's tax when it pays the deemed dividend (using a corporation's so-called the corporation's "refundable dividend tax on hand"), the mechanism does not always completely alleviate the potential double tax problem.

If the foregoing issues are problematic, a "pipeline" and / or "bump-up" strategy can be employed.

Under the pipeline strategy, the estate incorporates a new corporation (“Newco”) and transfers the Xco shares to Newco on a tax-free basis, assuming the value of the Xco shares has not increased since the death. But even if the Xco shares have increased in value, a tax-free transfer can be implemented using a “section 85 election”. The estate would receive at least one share in Newco and a promissory note reflecting the value of the shares.

NEXT, THERE ARE A COUPLE OF OPTIONS

First, to the extent Xco’s assets have a high tax cost (or are cash), it can distribute those assets to Newco as a tax-free inter-corporate dividend. Since the assets have a high tax cost (little accrued capital gain), Xco should pay little or no tax on the payment of the dividend. Newco will then use the assets to pay off the promissory note to the estate, which should result in no further tax.

Example 2 (Regular Pipeline)

Assume the same facts as Example 1. The assets in Xco have a high tax cost and/or consist of cash. The estate incorporates Newco and transfers its shares in Xco to Newco, taking back consideration consisting of one common share and a promissory note for \$500,000.

Xco distributes its assets, including the cash, to Newco as a tax-free inter-corporate dividend. Newco pays off the \$500,000 promissory note by distributing the assets to the estate. Little or no further tax should be payable. The only significant tax that may be payable by X, the deceased, is in respect of the capital gains resulting in the year of death.

Alternatively, if the assets in Xco have a low tax cost relative to their fair market value, and therefore have significant accrued gains, Xco could be wound up into Newco or amalgamated

with Newco. This can be done on a tax-free basis. Furthermore, under a special rule in the Income Tax Act, the tax cost of Xco’s non-depreciable properties can often be “bumped up” to their fair market value (this is a very general description, as there are various technical issues to be considered). Then, when the properties are distributed to the estate for the payment of the promissory note, Newco should incur little or no tax. The estate also should incur no tax on that payment. Unfortunately, the bump-up does not apply to depreciable properties, so that if their fair market value exceeds their tax cost, there may be some tax payable on their distribution.

Example 3 (Pipeline with Bump-Up)

Assume the same facts as in Example 1, except in this case the non-depreciable assets in Xco have a low tax cost and therefore have accrued gains. As with Example 2, the estate incorporates Newco and transfers its shares in Xco to Newco, taking back consideration consisting of one common share and a promissory note for \$500,000.

After some time, Xco is wound up into, or amalgamated with, Newco. Under the special rule discussed above, the tax costs of the assets of Xco will normally be bumped up to their fair market value (although there may be some limitations). Then, Newco pays off the \$500,000 promissory note by distributing the assets to the estate. As with Example 2, little or no further tax should be payable.

THE POTENTIAL PROBLEM

The potential problem involves subsection 84(2) of the Income Tax Act, which may apply to pipeline strategies. Under this provision, where funds or property of a corporation have been distributed to or for the

benefit of a shareholder of the corporation on the winding up, discontinuance, or reorganization of its business, there is a deemed dividend for the shareholder, generally equal to the value of the funds or property in excess of the amount that the paid-up capital of the shares is reduced on the distribution. If the provision applies, the estate in the pipeline examples might be subject to tax on a deemed dividend.

The Canada Revenue Agency (CRA) has issued favourable rulings or opinions on pipeline transactions, but they generally require at least a 12-month wait period before the funds or assets are distributed to the estate. The CRA has stated:

“...in the context of certain post-mortem pipeline strategies, some of the additional facts and circumstances that in our view could lead to the application of subsection 84(2) and warrant dividend treatment could include the following elements:

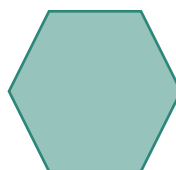
The funds or property of the original corporation [Xco in the above examples] would be distributed to the estate in a short time frame following the death of the testator.

The nature of the underlying assets of the original corporation would be cash and the original corporation would have no activities or business (“cash corporation”).

Where such circumstances exist, resulting in the application of subsection 84(2) and dividend treatment on the distribution to the estate, we believe that double taxation at the shareholder level could still be mitigated with the implementation of the subsection 164(6) capital loss carryback strategy [that used in Example 1 above], provided the conditions of the provision would apply in the particular facts and circumstance.

Accordingly, in cases where we have issued favourable rulings [on pipelines strategies], the particular taxpayer’s facts and proposed transactions, amongst other things, did not involve a cash corporation and contemplated a continuation of the particular business for a period of at least one year following which a progressive distribution of the corporation’s assets would occur over a period of time. Consequently, one or more of the conditions in subsection 84(2) were not met.” (emphasis added).

Although the CRA’s views are not binding law, it is usually prudent to follow their guidelines to avoid potential assessments and tax litigation.



TUITION TAX CREDIT

The federal tuition tax credit equals 15% of eligible tuition fees payable in respect of a taxation year. It applies to tuition payable by students to most universities and colleges in Canada, as well as to other educational institutions providing courses at a post-secondary school level.

Included in the tuition credit amount are mandatory ancillary fees, such as for lab work, materials or computer services. For fees that are not mandatory, up to \$250 qualifies if the student chooses to pay the fees.

The credit is also available for students who are developing or improving skills in an occupation and the educational institution (other than at a university level) has been certified as providing such skills by the Minister of Employment and Social Development Canada. The CRA takes the position that the phrase “to improve the student’s skills in an occupation” means that the

student already possesses sufficient skills to enable the student to work at an occupation and the course or program must be capable of improving those skills. An occupation is considered “a profession, vocation, trade, or other particular employment.”

Each province has a corresponding tuition credit, which varies depending on the province.

Students may claim the federal credit for tuition paid to universities outside of Canada. Generally, the credit is available only if the student is enrolled full-time in a program leading to a degree and the course is at least three weeks in length. The CRA provides the following guidelines in terms of what constitutes a university outside of Canada:

“We will accept that an educational institution is a university outside Canada for purposes of the tuition credit if it meets all of the following conditions:

- it has the authority to confer academic degrees of at least the bachelor level (bachelor’s degree or equivalent) according to the education standards of the country it is located in
- it has an academic entrance requirement of at least secondary school matriculation standing
- it is organized for teaching, study and research in the higher branches of learning.”

For universities in Commonwealth countries, the CRA will also accept an eligible educational institution “that is part of the Association of Commonwealth Canada if the institution can grant degrees of at least the bachelor level.” For institutions in the United States, the CRA will accept “an accredited degree-granting institution currently recognized by the Institute of Education Sciences National Center for Education Statistics or Council for Higher Education Accreditation (CHEA) in a university

outside Canada, provided that the institution can grant degrees of at least the bachelor level.”

A list of foreign qualifying universities can be found on the CRA website at Recognized universities and higher educational institutions outside Canada - Canada.ca.

In addition, if the student lives near the Canada-United States border, tuition fees paid to an educational institution in the United States that is a university, college or other educational institution providing courses at a post-secondary school are eligible regardless of whether the courses lead to a degree.

In terms of filing requirements, the student must fill out and file Schedule 11 with their tax return. They also must receive a form from the educational institution: Form T2202 from an institution in Canada, Form TL11A from a foreign institution, or Form TL11C for students commuting to attend an institution in the United States.

The credit is often claimed by the student. However, if the student has no remaining tax payable in the taxation year, the student can transfer up to \$5,000 of the tuition to their parent, grandparent, spouse or common-law partner, who can then claim the credit on that amount on their tax return.

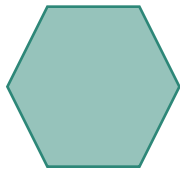
Alternatively, the student can choose to carry forward the credit indefinitely to a future taxation year, where the student can claim the credit in that future year.

The credit cannot be carried forward to a future year to transfer to one of the individuals described above. In other words, the tuition in a taxation year can only be transferred in that year.

Example

Student has \$9,000 tuition payable for year 1. Student has some tax payable (before the tuition tax credit) but uses \$3,000 of the tuition for the credit in year 1 to reduce their tax to zero.

The remaining \$6,000 can be carried forward for Student. Alternatively, up to \$5,000 can be transferred to one of the above individuals in year 1, and any remaining amount can be carried forward to future years for Student.



AROUND THE COURTS

FOREIGN SOURCE TAX DEDUCTIONS DO NOT REDUCE CANADIAN TAX INSTALLMENT REQUIREMENTS

In the recent Bhachu case, the taxpayer was a resident of Canada who worked for a petroleum company in Egypt in the taxation year at issue. As a Canadian resident, he was liable to pay income tax on his worldwide employment income. He was also liable to pay tax to the government of Egypt for his employment income earned in Egypt.

The taxpayer was assessed by the CRA and charged interest for not making tax instalments in Canada. Generally, an individual must pay quarterly instalments in a taxation year if their non-withheld tax for the year and one of the two preceding years exceeds \$3,000.

In the year in question, the Egyptian company withheld tax for Egyptian tax purposes but not for Canadian tax purposes, such that it seemed

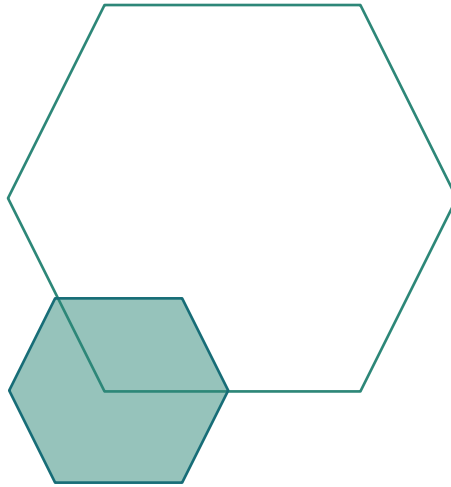
that Mr. Bhachu was liable to pay instalments in Canada. He did not, which is why the CRA charged instalment interest.

The taxpayer appealed the CRA assessment. The taxpayer argued that the withheld tax for Egyptian tax purposes should have relieved him from paying Canadian instalments. The Tax Court judge disagreed, and held that the Canadian tax rules do not take into account foreign withholding taxes in determining whether instalments are to be made in Canada.

Upon further appeal to the Federal Court of Appeal, that Court agreed with the Tax Court judge and dismissed the taxpayer's appeal. The taxpayer had also argued that a provision in the Canada-Egypt income tax treaty absolved him from being required to pay the Canadian instalments. The Federal Court rejected this argument as being a misinterpretation of the Treaty provision.

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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.



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