

TAX LETTER

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EMPLOYEE STOCK OPTIONS FOREIGN EXCHANGE GAINS AND LOSSES CAREGIVER AND INFIRM DEPENDENT CREDITS MAKING TAX INSTALMENTS EARNED INCOME FOR RRSP PURPOSES AROUND THE COURTS

EMPLOYEE STOCK OPTIONS

In general terms, an employee stock option is an option granted by a corporate employer to an employee to purchase shares in the corporation (or a related corporation). The option gives the employee the ability to purchase shares at a preset price (the exercise price) over a set period of time (the term of the option). Typically, the employee will exercise the option at a time when the value of the shares is greater than the exercise price, so that the employee will make a gain or profit on the exercise.

Employee stock options are normally taxed preferentially under our income tax system. As discussed below, they are typically only

half-taxed; more precisely, only half of the stock option benefit is included in taxable income.

The grant of a stock option by an employer to an employee is not itself a taxable benefit. Instead, the Income Tax Act employs a “wait and see” approach, under which the amount of the employment benefit is determined when the option is exercised and the underlying shares are acquired – or, in some cases, where the shares are later sold.

At the time of exercise, the amount of the benefit is the value of the acquired shares at that time in excess of the option exercise price. If the employee paid an amount for

the option (this is rare), that amount reduces the benefit.

The amount of the benefit is added to the adjusted cost base of the shares, to prevent double taxation on a later sale of the shares.

Example

John exercises an employee stock option with an exercise price of \$10 per share, when the shares are worth \$15 per share. His employment benefit is \$5 per share (\$15-\$10). The \$5 is added to the cost of the shares along with the \$10 purchase price, so that his adjusted cost base becomes \$15 per share. Thus, if he subsequently sells the shares for, say, \$17 per share, he will have a capital gain of \$2 per share (rather than \$7 per share, which would occur if the benefit were not added to the cost of the shares).

Note that the full \$5 benefit is added to the cost of each share, even if John qualifies for the one-half deduction in computing taxable income, described below.

In most cases, the benefit is included in employment income in the year of the exercise of the option and acquisition of the shares. However, if the employer is a Canadian-controlled private corporation (CCPC), the benefit is deferred and instead included in the year in which the shares are sold. (This recognizes that the value of the shares is not known at time of exercise, because the shares are not publicly traded.) In general terms, a CCPC is a private corporation that is resident in Canada that is not controlled by any combination of non-residents or public corporations.

As noted, typically only half of the benefit is included in the employee's taxable income.

This is done by including the full benefit as income and therefore in "net income", and then deducting half of the benefit under section 110 of the Income Tax Act, in computing "taxable income". This deduction is available in either of two scenarios:

- 1) Generally, if the shares are prescribed shares (common shares or certain shares with similar attributes), the value of the shares at the time the option was granted was not greater than the exercise price under the option, and the employee deal's at arm's length with the employer; or
- 2) In the case of a CCPC, the shares are held for at least two years by the employee (or if the employee dies within the two years still owing the shares).

Applied to the above example, assuming John qualifies under criterion 1) or 2) above, he will include in taxable income only \$2.50 per share. His capital gain on the sale of the shares for \$17 each would remain \$2 per share (only half of which is included in income).

Stock option "cash-outs"

In some cases, an employer may agree to "cash out" an employee's stock options. Typically, this means the employee will give up the stock options for a cash payout without ever acquiring shares in the corporation.

In this case, the employee does not normally qualify for the one-half deduction in computing taxable income. However, if the employer elects that it will not claim a deduction for the cash payment made to the employee, then the employee is eligible for the one-half deduction in computing taxable income, if the criteria under 1) above are met.

FOREIGN EXCHANGE GAINS AND LOSSES

There are several possible ways that you can realize a foreign exchange gain (or loss) for income tax purposes.

For example, suppose you buy a property using foreign currency, and later sell it for foreign currency proceeds. For Canadian income tax purposes, the cost of the property must be converted into Canadian dollars (C\$) at the time of the purchase. Similarly, you must convert the proceeds into C\$ at the time of the sale. As a result, you may have a gain or loss due to the fluctuation of the C\$ against the foreign currency, even if the value of the property does not change in terms of the foreign currency.

Example

You bought some US real estate for \$200,000 using US dollars, when the US and Canadian dollars were at par. So your adjusted cost base is C\$200,000. You sell the property for US\$200,000, when the exchange rate is US\$1 = C\$1.10. Therefore, your proceeds for Canadian income tax purposes are C\$220,000.

Even though there is no gain in US dollar terms, you will have a capital gain of \$20,000 for income tax purposes. This is a foreign exchange gain. Like other capital gains, only one-half is included in your income as a taxable capital gain.

You can also realize a foreign exchange gain or loss if you incur a debt in foreign currency and repay the principal amount of the debt when foreign exchange rates have changed. If the C\$ has increased relative to the foreign currency when you repay the debt, you will have a foreign exchange gain. If the C\$ has declined, you will have a

foreign exchange loss. Again, only half of such a gain is included in your income for Canadian income tax purposes, and the loss can be used only as a capital loss.

Of course, you can also realize a foreign exchange gain or loss simply by converting Canadian dollars into foreign currency and then re-purchasing Canadian dollars.

Example

You bought US\$10,000 when the US and Canadian currencies were trading at par. Subsequently, you sell the US\$10,000 back into Canadian dollars, when the exchange rate is US\$1 = C\$1.10. So you receive C\$11,000. The extra \$1,000 is a foreign exchange gain.

However, there is a special rule in the Income Tax Act that provides that the first \$200 of net foreign exchange gains or loss per year on the disposition of foreign currency are ignored. Thus, for income tax purposes you would report an \$800 gain, and half of that would be a taxable capital gain. The \$200 rule applies to individuals only but not to other taxpayers.

CAREGIVER AND INFIRM DEPENDANT CREDITS

The caregiver and infirm dependant credits are similar, in that they are available to an individual on whom an infirm adult is dependent upon support. However, there are some circumstances in which they differ.

Basically, the caregiver credit can be claimed by an individual in respect of an adult relative 18 years of age or over who lives with the individual in the year and who is dependent upon the individual for support. The relative must either be physically or

mentally infirm, or, in the case of the individual's parent or grandparent, 65 years or age or older. The federal credit for 2015 is 15% of \$6,701 (of \$4,608 if the parent or grandparent is not infirm), but is reduced if the dependant's income exceeds \$15,735.

The infirm dependant credit similarly can be claimed by an individual in respect of an adult relative who is dependent on the individual for support by reason of physical or mental infirmity. However, there is no requirement that the relative live with the individual. Also, a parent or grandparent 65 or over can qualify only if they are infirm. The federal infirm dependent credit for 2015 is 15% of \$6,701, reduced if the dependant's income exceeds \$6,720.

So the two maximum credits for infirm dependents are equal, although the caregiver credit has a higher income threshold for the dependant and is therefore potentially more valuable.

In some cases you will be eligible for only one of the credits. For example, if your dependant is your senior parent or grandparent who is not infirm, you can claim the caregiver credit but not the infirm dependent credit. On the other hand, if your infirm dependant does not live with you, you can claim the infirm dependent credit but not the caregiver credit.

But since the credits overlap somewhat, you may qualify for both. If you qualify for both credits in respect of the same dependant, you must claim the caregiver credit for that dependant. As noted, this credit is potentially higher in any event because of the different income threshold for the dependant.

However, either credit can be claimed in respect of more than one dependant in one

taxation year, assuming the criteria are met for each dependant.

If you are single or separated

If you are single or separated from your spouse or common-law partner, you can claim the spousal equivalent credit (also called the wholly dependent person credit) in respect of an infirm relative who resides with you. This credit is 15% of \$13,420 (but reduced if the dependent has any income), and therefore may be greater than both the caregiver and infirm dependent credit.

If you qualify for both the spousal equivalent credit and one of the above credits in respect of the same dependant, you can claim only the spousal equivalent credit. If you also qualify for the caregiver credit and it is greater (owing to the income threshold applicable to that credit), the excess can be claimed as a "top-up" credit.

You can only claim one spousal equivalent credit per year.

Potential transfer of disability credit

If you are eligible to claim one of the above-noted credits in respect of a dependant and that person qualifies for the disability tax credit, the dependant may be able to transfer some or all of that credit to you. Generally, they can transfer the unused portion of the disability credit to you, but only once their tax is otherwise down to nil. In other words, if they can use the disability credit, they must use it before transferring it to you.

MAKING TAX INSTALMENTS

Many individuals are not required to make tax instalments. For example, if employment income is your main source of income,

income taxes are withheld from your salary or wages by your employer and remitted to the government on their behalf. If you have little or no other sources of income, you likely will not have to pay instalments.

On the other hand, if you have significant income from sources where there is no withheld tax, such as dividends, interest, capital gains, business income, or rental income, you may have to make quarterly instalments of tax.

Generally speaking, you are required to make quarterly instalments in a taxation year (current year), if, in the current year **and** one of the two preceding years, you have federal and provincial net tax owing of more than \$3,000 (**not** including tax withheld at source such as from your pay cheque). For Quebec residents, the same rules apply but the threshold is \$1,800 of federal tax owing.

The instalments are due quarterly, on the 15th day of March, June, September and December of the year. Late or insufficient instalments are subject to interest charges. However, if you "prepay" or overpay instalments, the amount you have overpaid earns "contra interest" or "offset interest" at the same rate as interest on late instalments, so you can avoid interest charges on late instalments by making other instalments early. If instalment interest charges exceed \$1,000 for the year, you may be subject to a monetary penalty.

Remember that the tax instalments are essentially a "down payment" of your actual taxes owing for the year, which are due in full on April 30 of the following year. If your actual tax liability exceeds your instalments (and any tax withheld) for the year, you will be required to pay the excess by April 30. On other hand, if your instalments (and any

tax withheld) exceed your tax liability for the year, you will get a refund.

Assuming you are required to pay quarterly instalments, they can be calculated in one of three ways, and you are entitled to choose the method that leads to the lowest instalments.

Method 1:

Each quarterly instalment equals $\frac{1}{4}$ of your estimated tax owing for the current year.

Method 2:

Each quarterly instalment equals $\frac{1}{4}$ of your net tax owing for the preceding year.

Method 3:

The first two instalments equal $\frac{1}{4}$ of your net tax owing for the second preceding year. The last two instalments each equal $\frac{1}{2}$ of (preceding year net tax owing minus the first two instalments that were based on the second preceding year). Put more simply, the last two instalments are what is needed to make your total instalments equal your tax owing from the preceding year.

The third method is sometimes called the CRA instalment method because it is the method the CRA uses when they send instalment reminders to taxpayers. However, you are not obligated to follow this method and may choose whichever method you wish.

If you have late or insufficient instalments, interest will be charged relative to the method that provides the least amount of

instalments (and therefore the least amount of interest charged).

Example of 3 methods

Mary had the following amounts of net tax owing (net of tax withheld):

2013: \$12,000

2014: \$24,000

2015: Expected to be \$30,000

Under method 1, in 2015 she would remit \$7,500 each quarter ($\$30,000/4$).

Under method 2, she would remit \$6,000 each quarter ($\$24,000/4$).

Under method 3, she would remit \$3,000 for each of the first two quarters ($\$12,000/4$). For each of the last two quarters, she would remit \$9,000, being one-half of ($\$24,000$ minus $\$6,000$), and totalling \$18,000, which added to the \$6,000 paid for the first two quarters equals her 2014 tax of \$24,000.

Methods 2 and 3 end up with the same total amount of instalments (in this example, \$24,000). However, Mary might prefer method 3 because the first two instalments are lower and the last two instalments “catch” up to make the difference. That is, because of the time value of money, you would usually want to delay paying your tax.

EARNED INCOME FOR RRSP PURPOSES

One of the limitations on making deductible contributions to a registered retirement savings plan (RRSP) is your “earned income” for the preceding taxation year. Basically, the calculation of your contribution limit for the

current year begins with the lesser of the set dollar amount for the year (\$24,930 for 2015) and 18% of your earned income for the preceding year. Unused RRSP room from previous years will add to your current year’s room. If you are a member of a registered pension plan, your RRSP room will be reduced by your “pension adjustment” for the preceding year.

For RRSP purposes, “earned income” includes

- Net income from employment,
- Net income from business, including from a partnership,
- Net rental income from real estate,
- Canada Pension Plan or Quebec Pension Plan disability pensions, and
- Spousal support payments include in your income;

Minus:

- Losses from businesses and rental real estate, and
- Deductible spousal support paid by you.

(There are certain other components to earned income as well.)

Significantly, earned income does not include most forms of passive investment income, such as interest, dividends, and capital gains.

In most cases, there isn’t much you can do in terms of maximizing your earned income for these purposes. However, if you own a corporation in which you are an employee, there is some flexibility in this regard. You can decide on any mix of dividends or salary to be paid to you in a particular year. The salary will be earned income for RRSP purposes, while the dividends are not. Of

course there may be other reasons for choosing dividends, so the RRSP deduction rule should not be your only consideration.

AROUND THE COURTS

Corporations carried on “personal services business” – small business deduction denied

A Canadian-controlled private corporation (CCPC) is generally eligible for the small business deduction on the first \$500,000 of its active business income each year. However, an anti-avoidance rule in the Income Tax Act provides that if the corporation carries on a “personal services business”, it is not eligible for the small business deduction, and its deductions from income are significantly restricted. (As well, since 2011, it pays a much higher tax rate than even large corporations.)

In general terms, your company carries on a personal services business if you perform services on its behalf for another entity, and but for the existence of the company, you would be considered an employee of that other entity. (For these purposes, the rule can apply if you, combined with any close relatives, own at least 10% of the shares of any class of the company.) This rule is aimed at preventing someone who would otherwise be an employee of a firm from carrying on employment-like duties for the firm through a CCPC, thus attempting to claim the small business deduction.

In the recent case of *9016-9202 Québec Inc. et al*, a garbage collecting firm (EBI) previously hired numerous individuals as employees to perform the collection duties. However, the firm came up with a plan to convert the employment structure to one involving independent contractors. The individuals each

set up a CCPC (EBI handled all the mechanics for them), and the CCPCs then entered into new contracts with EBI to perform the various garbage collection duties (the individuals carried out those duties on behalf of the CCPCs). The CRA assessed the CCPCs and denied the small business deduction on the grounds that they were carrying on personal services businesses.

On appeal to the Tax Court, the CRA assessments on this issue were upheld. The Court compared the previous duties of the employees to the duties performed by the CCPCs and found that they were very similar. Significantly, the CCPCs were required to use the same garbage collection trucks and equipment provided by EBI, and EBI supervised and monitored the activities of the CCPCs in much the same manner as it previously did for the employees. The Court concluded that, but for the existence of each CCPC, each individual shareholder of the CCPC (a former employee) would have been considered an employee of EBI, and therefore carried on a personal services business.

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.