

TAX LETTER

July 2014

EMPLOYEE DEDUCTIONS SHAREHOLDER LOANS RRSPs, RRIFs, AND SPOUSAL ATTRIBUTION RULES PRESCRIBED INTEREST RATES AROUND THE COURTS

EMPLOYEE DEDUCTIONS

The employment expenses that can be deducted are quite limited relative to allowable self-employed business expenses. This explains why it is often more advantageous to be considered an independent contractor (that is, running your own business) rather than an employee.

Nonetheless, there are some deductions you can claim as an employee. Some of the main deductible expenses are summarized below. For all expenses, you must keep receipts in case you are audited (though some expenses will be recorded directly on the T4 issued by your employer). The Canada Revenue Agency (CRA) provides Form T777 that can be used to

record your expenses and attached to your tax return.

RPP contributions

If you are a member of an employer-sponsored registered pension plan (RPP), your contributions for the year to the RPP are deductible.

Legal costs to collect wages etc.

If you incur legal costs trying to collect wages or other employment income owed to you by an employer or former employer, you are allowed to deduct the costs. (This includes any income that is taxed as "office or employment" income, such as stock option

benefits or directors' fees.) The deduction is allowed even if you are ultimately unsuccessful in collecting the amounts.

Professional membership or union dues

You can deduct your annual professional membership that are “necessary to maintain a professional status recognized by statute” (e.g. professional fees for doctors, lawyers, accountants), but not voluntary association fees.

If you are required to pay annual union dues (including any special levies, such as to fund a strike), those dues are deductible.

Travel expenses (other than car)

Generally, you are allowed to deduct the cost of employment travel, including airfare, hotels, and meals, if you are ordinarily required to work away from your employer’s location and are required to pay for the travel expenses.

The cost of meals can be claimed only if you are required to be away for at least 12 hours away from the municipality in which your employer is located. Furthermore, only 50% of the cost of meals can be deducted.

You cannot claim the deduction if you receive a tax-free travel allowance, and of course you cannot claim the deduction if your employer pays or reimburses you for the travel costs.

For these travel expenses and the expenses discussed below, you are required to have your employer complete and sign the prescribed **Form T2200**. You do not have to include this form with your tax return, but you must keep it in case the CRA asks to review it.

Car expenses (other than capital cost allowance and interest)

Similarly, you are allowed to deduct reasonable car expenses, if you are ordinarily required to work away from your employer’s location and are required to pay for the car expenses incurred in employment.

The expenses can include car lease payments, oil and gas, insurance, license fees, regular check-ups, minor repairs and maintenance, and car washes. (Lease payments are capped at \$800 per month plus HST/GST and PST, and also can be ground down if the cost of the car exceeds \$35,294 plus HST/GST and PST.) You must pro-rate your expenses based on your employment travel compared to your overall travel. For example, if 40% of your kilometres in the year are driven in the course of employment (not counting driving from home to your employer's place of business or back), you would claim 40% of the expenses.

Again, you cannot claim the deduction if you receive a tax-free car allowance or if your employer pays or reimburses you for the costs.

Additional expenses for commissioned salespersons

If you receive a commission or bonus based on sales or contracts negotiated, you can claim additional expenses that are not available to other employees. They include entertainment and promotional expenses (but only 50% of entertainment expenses), advertising costs, and leasing costs for computers, fax machines, and other equipment. Also, if you qualify for the home office deduction (see below), you can claim a pro-rata portion of your property tax and home insurance. You cannot deduct mortgage interest.

These additional expenses, along with your car and travel expenses described above, are deductible **only** to the extent of your commission or bonus income for the year. Any excess amounts cannot be deducted or carried over to other years.

Home office expenses including “supplies”

If you are required by your employment contract to work from your home office (you can volunteer for an arrangement under which you are "required" to), you can deduct certain employment expenses. But a deduction can be claimed only if the office is where you **principally** carry on your employment duties (e.g., you're a "teleworker" who normally works at home), or if the office is used only for employment purposes *and* you meet clients or customers at home "on a regular and continuous basis". Furthermore, the expenses cannot exceed your employment income for the year, although the excess, if any, can be carried forward and claimed in any later year against the income from the same employment.

The deductible home office expenses include rent if you rent your home, and the cost of supplies. In addition to stationary, stamps, toner cartridges, and so on, “supplies” for this purpose include heat and utilities, and minor repairs and maintenance.

If you are a commissioned salesperson (see above), you may be able to deduct property tax and home insurance.

For expenses that relate to your entire home (e.g. rent, heat, utilities), you must pro-rate the expenses based on the size of your office relative to the house as a whole.

The CRA takes the position that “supplies” also include long distance phone calls, and cell phone air time. The CRA does not allow the deduction of monthly phone costs or the cost of fees for Internet service. Similarly, you cannot deduct fees paid to connect or license a cell phone.

Salary to an assistant

You can deduct salary paid to an assistant, if you are required by your contract of employment to pay for the assistant.

Capital cost allowance for car

If you qualify for the car expense deduction (see above), you can also claim capital cost allowance (CCA) if you own the car. The CCA rate is 30% on a declining basis, generally with only ½ of that allowed in the year in which you acquire the car or start using it in your employment (the “half-year” rule).

If your car cost more than \$30,000, the maximum that qualifies for CCA is \$30,000 plus applicable HST (or GST plus PST). (This \$30,000 threshold is reviewed and adjusted every year, but has been the same since 2001.)

The CCA deduction must be pro-rated, based on your work kilometres driven in the year relative to your total kilometres. Remember that driving to your employer's place of business from home, and back, does not count as "employment-related" driving; it is considered personal driving.

In the case of commissioned salespersons, the deduction is **not** limited to their commission income.

Car loan interest

If you qualify for the car expense deduction, you can deduct interest on a loan used to purchase your car. The deductible interest is limited to \$300 per month (technically, \$300 per 30-day period). Again, you must pro-rate the deduction based on work use versus total use.

Again, this deduction is **not** limited, in the case of commissioned salespersons, to their commission income.

HST rebate

If your deductible employment expenses include GST/HST, you are entitled to get a rebate, which is essentially a refund of the GST/HST you paid on those expenses. The rationale behind the rebate is that this consumption tax is supposed to be paid by the ultimate consumer of goods or services, and when incurring your employment expenses, you are not the ultimate consumer of those expenses. A person carrying on business and registered under the GST/HST system gets an input tax credit for the GST/HST paid on their expenses. But an employee cannot register under the HST system, which is why the rebate mechanism is required.

To get this rebate, you need to complete Form GST370, *Employee and Partner GST/HST Rebate Application*, and file it with your income tax return for the year (i.e., the following spring). The rebate is included in your income for income tax purposes. For example, if you deducted an employment expense with HST in 2013, you will normally receive and be taxed on the HST rebate in 2014. However, if the rebate relates to your CCA expense for your car, the rebate will serve to reduce the UCC (undepreciated

capital cost) in the year of receipt and thus the amount deductible as CCA on the car.

SHAREHOLDER LOANS

Under the shareholder loan rules in the Income Tax Act, if you are a shareholder of a corporation and receive a loan from (or incur debt owing to) the corporation, you may be required to include the **full amount of the loan** in your income. The same rule can apply if you are non-arm's length or affiliated with a shareholder (e.g. the shareholder is your spouse, child, etc.) and you receive a loan from the corporation.

Obviously, the rule can be quite harsh, since loans are typically not considered income. Fortunately, there are various exceptions that apply, as discussed below. Where an exception applies, the principal amount of the loan will not be included in your income. But if the loan is interest-free or below the prescribed rate of interest, you may be required to include an imputed interest benefit (this point is discussed further below).

The main exceptions are as follows.

First exception: In ordinary course of the corporation's business, or money lending business

The shareholder loan rules do not apply if a shareholder debt arose in the ordinary course of the corporation's business, as long as "bona fide" arrangements are made for repayment of the loan within a reasonable time. For example, if a shareholder borrows money or buys property from the corporation, and that type of transaction is in its ordinary business, the exception should apply.

Second exception: Repayment within specified time

This exception applies if you receive a loan and repay it **in full** by the end of the corporation's taxation year following the year that the loan was made. If you only partly repay the loan, this exception does not apply, although as discussed below, you will get a deduction for the partial repayment.

Note that this exception can give you close to two years to repay. For example, if the corporation has a June 30 year and you received a loan in July 2014, you will have to June 30, 2016 to repay it.

This exception does not apply if the repayment was part of a series of loans and repayments – for example, if you borrow and repay and then re-borrow and continue this scenario.

Third exception: Receive loan in capacity of employee

The third main exception applies if you are also an employee of the corporation, and it is reasonable to conclude that you received the loan in your capacity as employee **and not** because of your shareholdings. Furthermore, if you are a “specified shareholder” of the corporation, the loan must be used for one the following purposes:

- 1) to acquire a home in which you will live (not to rent out);
- 2) to purchase treasury shares from the corporation or a related corporation; or
- 3) to acquire a car to be used for employment purposes.

If you are not a specified shareholder, you can use the loan for any purpose.

A “specified shareholder” is basically someone who owns 10% or more of the shares of any class of the corporation (and for these purposes, you are deemed to own any shares owned by relatives or other non-arm's length persons).

Lastly, for this exception to apply, bona fide arrangements must be made for repayment of the loan within a reasonable time.

Repayment of loan

If none of the exceptions applies and you are required to include the loan in your income, you get a deduction in the year in which you repay the loan.

Exception applies but low or no-interest loan

If one of the above exceptions applies so that the loan is not included in your income, you may still be required to include an imputed interest benefit in your income. The benefit will equal the prescribed rate of interest under the Act applied to the outstanding principal amount of the loan during the year, less any interest paid by you in the year or by January 30 of the following year. The prescribed rate is set each quarter, and has been 1% for the first three quarters of 2014. Thus, if you pay at least the prescribed rate of interest, there will be no taxable benefit.

Furthermore, this inclusion rule does not apply if the loan was made at arm's length rate of interest that would have applied if it were made to a non-shareholder (and non-employee) by a corporation in the money-lending business.

RRSPs, RRIFs, AND SPOUSAL ATTRIBUTION RULES

You are allowed to deduct contributions made to either or both of your registered retirement savings plan (RRSP) and that of your spouse or common-law partner. The general deduction limit for a year is the *lesser* of:

- the annual dollar amount (\$24,270 for 2014), and
- 18% of your earned income for the previous year (e.g., 2013, for a deduction for the 2014 year on the return that you file in the spring of 2015)

Unused deduction room can be carried forward indefinitely. Also, your deduction room for a year is reduced by your pension adjustment (PA) for the previous year, which generally takes into account contributions made to or benefits accruing in your registered pension plan, if any.

The deductible contribution to your spouse's RRSP provides obvious income-splitting opportunities. That is, if you are in a higher tax bracket than your spouse in the year of withdrawal, there will be a savings of tax because the withdrawal will be included in your spouse's income rather than in your income.

However, an attribution rule prevents the income-splitting if the withdrawal takes place in the year *during which you made* your contribution or in the following two years. More specifically, if your spouse withdraws an amount from his or her RRSP in a year, the lesser of the withdrawal and the amounts contributed by you to your spouse's RRSP in the year or the two preceding taxation years will be included in

your income. The remaining portion will be included in your spouse's income.

Example

John contributed \$3,000 to his spouse Mary's RRSP in February 2012 (deducting this on his 2011 return), 2013 (for his 2012 return) and 2014 (for his 2013 return). In 2014, Mary withdrew \$15,000 from her RRSP.

John will include \$9,000 in his income for 2014 (3 years x \$3,000). Mary will include the difference of \$6,000 (\$15,000 minus the \$9,000 attributed to John). Note that even though John's first contribution was deducted on his 2011 return, it is attributed back to him because he made the contribution in 2012.

A similar rule applies to withdrawals from a registered retirement income fund (RRIF). Generally, an RRSP can be converted into a RRIF (before the end of the year in which you turn 71) on a tax-free rollover basis. Income earned in the RRIF is exempt from tax while in the plan. No contributions can be made to the RRIF.

Each year, the annuitant under the RRIF must withdraw a minimum amount as set out in the regulations under the Income Tax Act, and that amount is included in income.

However, if your spouse or common-law partner withdraws from his or her RRIF in a taxation year, the lesser of the following amounts will be attributed to you and included in your income:

- Your contributions made to any RRSP of your spouse in the year or in the preceding two years,
- The amount of the withdrawal, and

- The amount of the withdrawal in excess of the RRIF minimum amount, if any, for the year.

Example

In 2012, John contributed \$3,000 to his spouse Mary's RRSP. In 2014, Mary withdrew \$15,000 from her RRIF. The minimum amount that had to be withdrawn in 2014 was \$11,000.

John will include \$3,000 in income in 2014, being the lesser of \$3,000, \$15,000 and (\$15,000 minus \$11,000). Mary will include the net amount of \$12,000 (\$15,000 withdrawal minus the \$3,000 attributed to John).

PRESCRIBED INTEREST RATES

The CRA recently announced the prescribed annual interest rates that will apply to amounts owed to the CRA and to amounts the CRA owes to individuals and corporations. These rates remain unchanged from the first two quarters of 2014 and are in effect from July through September 2014.

AROUND THE COURTS

Most in-vitro fertilization costs did not qualify for medical expense tax credit

In the recent *Ismael* case, the taxpayer had premature ovary failure and therefore attempted to have a child through in-vitro fertilization. She lived in Toronto, where the procedure was available. However, she decided to pursue the treatment first in Syracuse, New York, and subsequently in Ukraine. She made this choice on the grounds that the Canadian clinics had a limited number of donors, particularly in respect to her preferred choice of

East African descent, and that the number of embryos that could be transferred in Canada was limited.

In the taxation years in question, she attempted to claim the cost of the clinic treatments, egg donor fees, transportation costs for her and her spouse including airfare, bus and car rental expenses, along with accommodation and food costs, all as medical expenses for the purposes of the medical expense tax credit. The CRA denied the claim on the grounds that the expenses did not come within the list of qualifying medical expenses under the Income Tax Act.

Upon appeal to the Tax Court of Canada, the Crown conceded that the taxpayer's cost of clinic treatments qualified for the credit. However, the Crown argued that the remaining costs did not since substantially equivalent medical services were available in Toronto, and her husband's expenses were also denied since it was not shown that the taxpayer required assistance to travel.

Lastly, the egg donor fees did not qualify because they were not incurred to locate a "compatible donor" and to arrange for an "organ transplant" (as permitted in the Act). The Court held that an egg donation did not qualify as an "organ transplant". (In an earlier case, surrogate mother expenses had been allowed on the basis that an embryo is an "organ".)

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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.