



TAX LETTER

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CRA UPDATE ON CERTAIN EMPLOYMENT BENEFITS MORE ON THE HOME RENOVATION TAX CREDIT SHAREHOLDER LOANS CAPITAL GAIN ELECTION FOR CANADIAN SECURITIES EMPLOYER-PAID CLUB MEMBERSHIPS AROUND THE COURTS

CRA UPDATE ON CERTAIN EMPLOYMENT BENEFITS

The Canada Revenue Agency (CRA) recently released a “Technical News” publication announcing changes in its administrative positions regarding certain employment benefits. The following is a summary of the more notable changes.

Overtime meals and allowances

The CRA formerly held that free overtime meals or reasonable allowances for such meals were tax-free if the employee worked 3 or more hours of overtime immediately after the scheduled shift, and the overtime was infrequent and occasional in nature. Effective as of 2009, the employee only has to work 2 or more hours either immediately

after or before the shift, and the CRA will consider an allowance of up to \$17 to be reasonable and therefore tax-free. The overtime must still be infrequent or occasional. The CRA states that less than three times a week will generally be considered infrequent or occasional.

Loyalty programs / frequent flyer points

The CRA formerly took the view, supported by some case law, that loyalty points such as frequent-flyer points collected by employees when they charged their employment-related travel expenses on their personal credit cards (and that were then reimbursed by their employers) were taxable benefits when used for personal travel or purchases. Effective as of 2009, the CRA no longer requires frequent-flyer or other loyalty points

to be included as a taxable benefit where the points are collected using the employee's personal credit card. However, the points will be non-taxable only if they are **not** convertible to cash, and the arrangement is **not** indicative of an alternate form of remuneration or for tax avoidance purposes.

Furthermore, if the employer controls the points – for example, where a company credit card is used to charge the expenses and the employer allows the employee to redeem some of its points – the CRA states that a taxable benefit will continue to apply and the fair market value must be reported on the employee's T4 slip.

Employer-provided vehicles (other than automobiles)

Where an employer provides a motor vehicle to an employee that is used to drive from home to work and back, such that the employee takes the vehicle home at night, the employee will have a taxable benefit even if other personal use of the vehicle is prohibited. The benefit reflects the travel between home and work and back, which is considered personal travel.

The CRA has generally determined that the benefit equals 52 cents per kilometre for the first 5,000 personal kilometres (56 cents in the three Canadian Territories) and 46 cents for each additional kilometre (50 cents for the Territories). (Note that these rates are reviewed annually and can increase from year to year.) This rule applies to motor vehicles other than "automobiles" (a defined term in the Income Tax Act), meaning that it applies to vehicles such as delivery vans and trucks, heavy duty vehicles carrying goods or equipment, and emergency vehicles. Employer-provided automobiles give rise to

different benefits, namely a stand-by charge and an operating benefit, as described in last month's Tax Letter.

The CRA will now accept that the lower operating benefit rate of 24 cents per kilometre of personal use (otherwise only applicable to automobiles) will apply to such motor vehicles, as long as the following conditions are met:

- The only allowable personal use of the vehicle is driving from home to work and back. The CRA notes that this condition should be stipulated in writing;
- The employer has *bona fide* business reasons for requiring the employee to take the vehicle home at night, such as where there are security concerns with respect to the employer's tools and equipment otherwise being left at the worksite, or where the employee is on call to respond to emergencies (e.g. a gas utility employee who needs the vehicle to respond to after-hours emergency calls); **and**
- The vehicle is specifically designed or suited for the employer's business and is essential in a fundamental way for the performance of the employment duties.

The 24 cent per kilometre rate applies for 2009, although the rate is reviewed annually and may change next year.

Non-cash gifts and awards

The CRA's current administrative policy is to allow an employee to receive up to two gifts per year tax-free costing \$500 or less in total, for special occasions such as a religious holiday, birthday, or wedding. An

employee is also allowed to receive up to two awards per year tax-free costing \$500 or less in total, for an employment-related accomplishment such as long or outstanding service. If the two gifts (or awards) cost more than \$500 in total, only one of them is tax-free (as long as it cost less than \$500) and the other is fully taxable. This policy continues through the 2009 year. It does not apply to cash or near-cash gifts and awards, which are normally taxable.

However, effective for the 2010 taxation year, the CRA will be changing its policy, which will be as follows:

- Non-cash gifts and non-cash awards to an arm's length employee, regardless of number, will be tax-free to the extent that the total value of all non-cash gifts and awards to the employee is less than \$500 per year. The total value in excess of \$500 will be taxable. Note that gifts and awards are counted together towards the \$500 threshold, in contrast to the current policy which has a separate \$500 threshold for gifts and awards (although for up to two of each only).
- In addition to the above, a separate non-cash long service/anniversary award will be tax-free to the extent that its total value is \$500 or less. The value in excess of \$500 will be taxable. In order to qualify, the award must be for at least five years of service, or at least five years have passed since the last long-service award was given to the employee.
- The above employer gift and award policy will not apply to non-arm's length employees or persons related to such employees.

- Items of an immaterial or nominal value, such as coffee, tea, T-shirts with employer logos, mugs, plaques, and trophies will generally not be taxable benefits.

The CRA's current administrative policy as to the qualifying nature of gifts and awards will remain unchanged. Thus, performance-related rewards such as those relating to sales targets, and cash and near-cash awards such as gift certificates, will continue to be taxable in full.

MORE ON THE HOME RENOVATION TAX CREDIT

As we noted in our March 2009 Tax Letter, the federal government announced a new home renovation tax credit in its January 2009 budget. The credit is based on eligible expenditures incurred for work performed, or goods acquired, in respect of your home or other eligible dwelling after January 27, 2009, and before February 1, 2010, under an agreement entered into after January 27, 2009. The credit can be claimed in your 2009 tax return, when you file it in spring 2010.

Although the credit has not yet been legislated into the Income Tax Act, and draft legislation has not even been released, the Department of Finance and the CRA have provided some details on the credit. The credit can be claimed for renovations and alterations of an enduring nature and that are integral to any eligible dwelling, which is generally a dwelling used for personal purposes such as your home or cottage, and the land that forms part of the property. The credit is 15% of the expenditures in excess of \$1,000 and up to \$10,000, for a maximum credit of \$1,350 (i.e. 15% of \$9,000).

The CRA has published the following list of expenses that it considers eligible for the credit:

- renovating a kitchen, bathroom, or basement
- new carpet or hardwood floors
- an addition, garage, deck, garden/storage shed, or fence
- re-shingling a roof
- a new furnace, woodstove, boiler, fireplace, water softener, or water heater
- a new driveway or resurfacing a driveway
- painting the interior or exterior of a house
- window coverings directly attached to the window frame and whose removal would alter the nature of the dwelling
- new sod on your yard
- swimming pools of a permanent nature, either in-ground and above-ground
- fixtures such as lights and fans
- costs of permits, professional services, equipment rentals, and incidental expenses relating to the above

The CRA indicates that the following expenses are **not** eligible for the credit:

- furniture, appliances, and audio and visual electronics
- tools
- carpet cleaning or house cleaning
- maintenance including furnace cleaning, snow removal, lawn care, and pool cleaning
- financing costs

SHAREHOLDER LOANS

Principal amount of loan

If you are a shareholder in a corporation and receive a loan from it, you may be subject to the shareholder loan provisions in the Income Tax Act. The general rule is that the principal amount of the loan is included in

your income in the year of receipt, although fortunately there are some key exceptions, as noted below.

First, the rule does not apply if you repay the **entire** loan by the end of the corporation's taxation year after its taxation year in which you received the loan. For example, if the corporation has a calendar taxation year and you receive a loan in January 2009, you have until the end of the calendar 2010 year to repay the loan. In order for this exception to apply, the repayment cannot be a series of loans and repayments (e.g. where you borrow an amount one year, repay it the next, and then borrow the amount again).

Second, the rule does not apply if the loan is received in the course of the corporation's money-lending business and there are *bona fide* arrangements for repayment within a reasonable time. This exception normally applies to loan from banks and other financial institutions, although it can also apply to any corporation that has an ordinary business of lending money.

Third, the rule does not apply if the shareholder is an employee, the loan was received because of the employment rather than the shareholding, and there are *bona fide* arrangements for repayment within a reasonable time. However, if the employee is a "specified employee" (generally meaning an employee who owns at least 10% of the shares of any class in the corporation or who is non-arm's length with the corporation), this exception to the shareholder loan rule applies only if the loan is used to buy a dwelling, an automobile to be used in the course of employment, or treasury shares in the corporation.

If the shareholder loan rule does apply, that is, if you do not fall within one of the exceptions, you get a deduction when you repay the loan. The deduction equals the amount of the repayment and is claimed in the year of repayment. However, the deduction is not allowed if the repayment is part of a series of loans and repayments.

Imputed interest benefit

If the shareholder loan rule described above does not apply, but the loan is interest-free or below a reasonable arm's length rate of interest, the imputed interest benefit rule under the Act will normally apply to the loan. Under this rule, the prescribed rate of interest in effect while the loan remains outstanding is included in the shareholder's income, less any interest paid on the loan in the relevant year or by January 30 of the following year. Note that the prescribed rate is adjusted every quarter, and currently (for the third quarter of 2009) stands at an all-time low of 1%.

If the imputed interest inclusion applies, but the loan is used for the purpose of earning income from a business or property, a corresponding deemed interest expense deduction will effectively result in a nil net inclusion.

EXAMPLE

You receive an interest-free loan of \$10,000 from your corporation on January 1 of Year X. We will assume that the regular shareholder loan rule does not apply, such that the imputed interest benefit rule applies. We will further assume that the prescribed rate of interest is 2% throughout Year X, and that you used the loan to purchase an

income-producing property. You did not repay any of the loan by the end of Year X.

You will include 2% of \$10,000, or \$200, in your income in Year X, but will be allowed a corresponding deduction of \$200.

CAPITAL GAIN ELECTION FOR CANADIAN SECURITIES

When you buy and sell securities such as shares and mutual funds, the gain or loss on the sale will normally be a capital gain or capital loss. As such, one-half of the gain will be included in your income as a taxable capital gain, and one-half of any loss will be an allowable capital loss.

However, if the level of your trading activity and organization is significant such that it constitutes a business for income tax purposes (including an adventure or concern in the nature of trade), your gains will be fully taxable as profit, although your losses will be fully deductible against any other sources of income.

If you are concerned that your trading of securities could constitute a business (with fully taxable profits instead of one-half taxable capital gains), you can make an election with respect to your "Canadian securities". When you make the election in your tax return for a year, all of your gains from dispositions of Canadian securities will be taxable capital gains and all of your losses will be allowable capital losses in that year and in all future years, for the rest of your life.

Canadian securities include shares in Canadian resident corporations, units and shares in Canadian resident mutual funds, and bonds and debt obligations issued by

Canadian resident persons. They do **not** include “prescribed securities”, which include shares in non-public corporations the value of which are attributable to real property or resource property, and debt obligations issued by non-public corporations with which you are non-arm’s length.

As noted, the election ensures capital gains treatment for all of your gains from dispositions of Canadian securities. The potential downside is that allowable capital losses are normally deductible only against your taxable capital gains, and are not deductible against your other forms of income. Furthermore, once the election is made, it cannot ever be revoked.

EMPLOYER-PAID CLUB MEMBERSHIPS

The payment or reimbursement of an employee’s fitness or social club dues or membership fees by his or her employer will normally result in a taxable benefit.

However, the CRA takes the position that if the membership is principally for the employer’s advantage, the employee does not receive a taxable benefit. For example, if a social club is used primarily to entertain customers or clients of the employer, the membership will be non-taxable. Also, the employees’ use of the employer’s in-house recreational or physical fitness facility, if any, does not normally give rise to a taxable benefit to the employees. In addition, the CRA has stated that a taxable benefit will not normally be assessed if the employer makes an arrangement with a facility to pay a fee for the use of the facility, the membership is with the employer and not the employee, and the employer allows use of the facility by all employees. The CRA notes that the onus is

on the employer and employee to establish that membership in the facility is principally to the employer's advantage.

If the club membership is principally for the employee’s benefit, there will normally be a taxable benefit even if the employer benefits indirectly from the membership. For example, if the employer pays for an employee’s membership in a fitness club and the main benefit of the membership is to enable the employee to become fitter and healthier, which in turn means that the employee will work better and be sick less often, there will be a taxable benefit even though there is an indirect benefit to the employer, unless the club membership meets a specific employment requirement.

AROUND THE COURTS

Additional spousal support payments not deductible

In the recent *Connor* case, the taxpayer paid his former spouse certain support payments made pursuant to a court order. Furthermore, on the advice of both of their lawyers, he paid certain additional amounts to his former spouse during the 2004, 2005 and 2006 years. Although the amounts were initially paid under an informal agreement only, the taxpayer and his former spouse entered into a formal written agreement in 2008, stating that he agreed to pay those additional amounts as spousal support. He attempted to deduct the additional amount as spousal support payments under the relevant provisions of the Income Tax Act.

The CRA disallowed the deduction, and on appeal the Tax Court of Canada upheld the CRA decision. The Tax Court noted that the Income Tax Act allows a deduction for

spousal support only if it is made pursuant to a written agreement or court order. In this case, although the written agreement in 2008 provided that the taxpayer would pay the (previously paid) additional amounts as spousal support, the relevant provisions of the Act allow a deduction in such case only if the payments are made in the year the agreement is made or in the immediately preceding year. Therefore, the additional amounts, which were paid in 2004 through 2006, did not qualify for a deduction.

The Tax Court stated that it was sympathetic to the taxpayer, especially since the CRA had not informed him of the applicable time limit for making a written agreement. The taxpayer testified that had he been informed of the time limit during the CRA audit of his file, he could have made the agreement on time and the additional amounts would have been deductible. However, the Tax Court held that it did not have the jurisdiction to overrule the CRA decision on these grounds.

Reserve allowed for prepaid services

Under the Income Tax Act, if you carry on a business and receive an amount on account of goods to be delivered or services to be rendered after the year of receipt, or the amount is otherwise unearned at the end of the year of receipt, you are normally allowed to claim a reserve equal to that amount. In other words, although you include the amount in your business income, you are allowed to deduct the reserve, which will result in a nil net inclusion. The reserve can be claimed until the year in which the goods are delivered or the services are performed, at which point the income inclusion occurs without the offsetting reserve.

In the recent *Doteasy Technology* case, a company was in the business of providing

internet website hosting services and domain name registration services. Many of its service contracts extended beyond a year, and the company required full payment for the services at the beginning of the contract. The company claimed a reserve for the amount of the payments that related to services to be rendered after the year of payment, in the manner described above. However, the CRA denied the reserve, largely on the grounds that the payments were non-refundable and that they had the “quality of income” in the year of receipt, meaning, according to the CRA, that they were earned upon receipt and therefore not eligible for the reserve.

However, on appeal, the Tax Court of Canada allowed the taxpayer’s deduction of the reserve. The Tax Court held that the relevant statutory provisions clearly implied that an amount received on account of services to be rendered after the year of receipt was unearned, and therefore eligible for the reserve. It rejected the CRA’s argument that the prepaid amounts, although for services to be rendered after the year of receipt, could be considered earned as a matter of law before the services were actually rendered.

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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.