



## TAX LETTER

July 2010

### 100% WRITE-OFF FOR COMPUTERS CHILD CARE EXPENSES REDUCING YOUR TAX DEDUCTIONS AT SOURCE CAPITAL GAINS EXEMPTION ALLOWABLE BUSINESS INVESTMENT LOSSES EMPLOYEE STOCK OPTION “CASH-OUTS” AROUND THE COURTS

#### 100% WRITE-OFF FOR COMPUTERS

If you use a computer for business purposes, it is considered depreciable property and subject to the capital cost allowance (CCA) provisions of the Income Tax Act. CCA is basically depreciation for income tax purposes. Depreciable property is usually depreciated over time, and the rate of depreciation depends on the class of the property (different annual CCA rates apply to the various classes).

A special rule, first announced in the 2009 federal budget, provides that the cost of computer hardware and systems software for computers is eligible for a 100% CCA rate if acquired after January 27, 2009 and before

February 2011. Furthermore, the “half-year rule” that normally applies to depreciable property (limiting the deduction to one-half of the normal deduction in the first year) does **not** apply. In other words, the entire cost of the computer and systems software can be deducted in the year of acquisition.

(In contrast, for computers and systems software acquired after March 18, 2007 and before January 28, 2009, the CCA rate is 55% and the half-year rule applies.)

It is not known whether the 100% CCA rate will be extended beyond the current purchase deadline of January 31, 2011; the 2009 federal budget described the 100% CCA rate as “temporary”. As a result, if you

are thinking of buying a computer for business purposes, you might want to act by that deadline.

Employees cannot normally deduct the cost of computers used for employment purposes. An exception applies to an employed salesperson whose income is comprised at least partly of a commission or bonus based on sales or the negotiation of contracts (and subject to certain other criteria). Computers for such salespersons are eligible for the same 100% deduction as described above.

### **CHILD CARE EXPENSES**

As many readers know, child care expenses are deductible in computing income, although the deduction is subject to various limitations. Some of these limitations are described below. Generally speaking, deductible child care expenses are expenses incurred to provide care for your child, which enables you or your spouse (or common-law partner) to carry on employment or a business, or to attend school. The expenses include those incurred for daycare, nannies, babysitters, and a boarding school or camp.

The maximum deductible amount per year is \$7,000 times the number of children under the age of 7 at the end of the year, \$4,000 times the number of children from 7 to 16 years old, and \$10,000 times the number of children eligible for the disability tax credit. (In the latter case, the child must either be 16 years old or less, or dependent upon you or your spouse.)

However, the total deductible amount is also limited to 2/3 of your “earned income” for the year, which includes your employment income and business income and certain

disability pension income under the CPP or QPP.

In the case of married persons or common-law partners, the deduction can normally be claimed only by the lower income-earner. An exception, where the higher income-earner can claim a deduction, occurs if the lower income-earner is:

- a student in a qualifying post-secondary or secondary institution,
- incapable of caring for the children because of a mental or physical infirmity and confinement for at least two weeks in the year or because of an indefinite infirmity,
- in prison for at least two weeks in the year.

In each of the above cases, the higher income-earner can deduct child care expenses in accordance with the above-noted limits, but the deduction is further limited to the number of weeks in the year that the other person is in school, incapable of caring, or in prison, as the case may be, multiplied by

- \$100 per week times the number of children from age 7 to 16,
- \$175 per week times the number of children under the age of 7, and
- \$250 per week times the number of children eligible for the disability tax credit.

(If the lower income-earner is attending school on a part-time basis, the above amounts are multiplied by the number of months rather than weeks.)

### **Example**

John and Jane are married. They have a 4 year-old son and a 9 year-old daughter.

During 2010, they incurred \$10,000 of eligible child care expenses in respect of the children (it does not matter how much was paid for each child). John is the lower income-earning spouse, and he also attended university on a full-time basis for 26 weeks during the year. John's earned income was \$30,000, and Jane's earned income was \$90,000.

Jane's claim is the least of:

$\frac{2}{3}$  of her \$90,000 earned income = \$60,000;  
\$7,000 (4-year old) + \$4,000 (9-year old) = \$11,000; and  
26 weeks x (\$100 + \$175) = \$7,150

Therefore Jane can deduct \$7,150.

The remaining \$2,850 (\$10,000 - \$7,150) can be deducted by John, because it does not exceed the lesser of  $\frac{2}{3}$  of his \$30,000 earned income (\$20,000) and the \$11,000 limit for the two children as noted above.

Note that if the child care expenses are fees for boarding school or camp, the deductible portion of the fees is limited to \$100 per week for children age 7 to 16, \$175 per week for children under the age of 7, and \$250 per week for children eligible for the disability tax credit.

Child care expenses do not qualify for the deduction if they are paid to one of the parents, a related person under the age of 18, or to a person in respect of whom a personal tax credit is claimed. However, they will normally qualify if paid to a related person 18 or older (e.g. an adult sibling of the child) or a grandparent or other relative of the

child. Of course, in such case the care-taker must include the amount received in income.

## **REDUCING YOUR TAX DEDUCTIONS AT SOURCE**

If you are an employee, your employer must normally withhold or deduct tax (and CPP contributions and EI premiums) from your employment income and remit it to the Canada Revenue Agency (CRA) on your behalf. The amount of tax the employer must withhold is calculated under the Income Tax Regulations, and depends largely on the amount of your employment income. However, the amount of tax to be withheld under the Regulations does not take into account things such as your registered retirement savings plan (RRSP) contributions, your employment-related expenses, your child care expenses, and so on.

As a result, in certain cases, the tax that must be withheld from your pay cheque can exceed the tax you will ultimately owe for the year (in which case you will get a refund after you file your tax return). However, you can apply to have the withheld tax reduced by making a request to the CRA using Form T1213, "Request to Reduce Tax Deductions at Source". The CRA has published a list of reasons that may qualify for a reduction in withheld tax (this list is not exhaustive):

- the employee is making charitable donations;
- the employee has employment-related expenses;
- the employee pays child care expenses; or
- the employee is contributing to an RRSP.

If the CRA agrees with your request, it will send you a letter of authorization which you can give to your employer, after which your

employer can begin to reduce the withheld tax for the year. The CRA notes that it takes about 4-6 weeks to process your request.

If your employer takes a portion of your remuneration and contributes it directly to a registered pension plan or RRSP (that is, the employer contributes the amount on your behalf), those contributions will automatically reduce the amount of tax that your employer must withhold. You are **not** required to make the Form T1213 request in these cases. However, in the case of direct contributions to your RRSP, the CRA notes that your employer must “have reasonable grounds to believe that the contribution can be deducted by the employee for the year” – in other words, that you will have sufficient RRSP deduction room.

## **CAPITAL GAINS EXEMPTION**

Every individual resident in Canada is eligible for the capital gains exemption, which exempts from taxation up to \$375,000 of taxable capital gains (\$750,000 of capital gains) during one’s lifetime. The exemption is actually a deduction from "net income", in computing "taxable income".

The capital gains that qualify for the exemption include a gain from a disposition of a qualifying small business corporation share (QSBC share). In general terms, a share will qualify as a QSBC share if the following conditions are met:

- the share is of a corporation that is a “small business corporation” (described below),
- throughout the 24 months preceding the disposition of the share, it was not owned by anyone other than you or a related person, and

- throughout the 24 months preceding the disposition, the share was of a Canadian-controlled private corporation (CCPC), and throughout that time more than 50% of the fair market value of the CCPC was attributable to assets used principally in an active business carried on primarily in Canada (or to shares or debt in certain other CCPCs that met similar fair market value tests).

A “small business corporation” is a CCPC, all or substantially all of the fair market value of the assets of which are attributable to assets that are used principally in an active business carried on primarily in Canada, or to shares or debt in other small business corporations. The CRA takes the position that “all or substantially all” for these purposes means 90% or more.

A CCPC is generally a private corporation resident in Canada that is not controlled by non-residents, public corporations, or a combination thereof.

The capital gains exemption that can be claimed in a taxation year is reduced by the amount of your allowable business investment losses (ABILs) for the year. (ABILs are discussed in next section of this letter.) Furthermore, the exemption that can be claimed in a year is reduced by your cumulative net investment loss (CNIL) at the end of the year, which is generally the total of your investment expenses in excess of your investment income for the year and all preceding years (going back to 1988).

The capital gains exemption also applies to gains from dispositions of qualified farm property and qualified fishing property. These properties include real property used in the business of farming or fishing, a

fishing vessel used in a fishing business, shares in a family farm or fishing corporation and interests in a family farm or fishing partnership. These properties must meet certain holding-period tests and farming or fishing business-use tests, somewhat similar in nature to those imposed on qualifying QSBC shares.

The \$375,000 lifetime exemption for taxable capital gains (\$750,000 of capital gains) applies collectively to all qualifying properties; in other words, there is not a separate monetary limit for each type of property. Therefore, for example, any exemption you claim in respect of QSBC shares will reduce the lifetime amount available for qualified farm property, and vice versa.

## **ALLOWABLE BUSINESS INVESTMENT LOSSES**

An allowable business investment loss (ABIL), which is one-half of a “business investment loss”, is deductible against all forms of income. In this way, an ABIL differs from an allowable capital loss, which is normally deductible only against taxable capital gains. Therefore, from a tax perspective, an ABIL is preferable to an allowable capital loss. An ABIL can occur on an actual disposition or a “deemed” disposition of certain types of shares or debt, as described below.

### **Actual disposition**

A business investment loss includes a capital loss from an arm’s length disposition of a share of a “small business corporation” (described in the section above on the capital gains exemption). However, a special rule applies for the purposes of the business

investment loss rules, and provides that a corporation is a small business corporation at the time of the disposition of the share if it was a small business corporation **at any time** within the 12 months before the disposition.

A business investment loss also includes a loss from disposition of a debt of a Canadian-controlled private corporation (CCPC) that is either a small business corporation at the time of the disposition, bankrupt and was a small business corporation when it became bankrupt, or insolvent and in the process of being wound up and was a small business corporation when the winding-up order was made.

### **Deemed disposition**

As noted, a business investment loss can occur on a “deemed disposition” of a share or debt, such as a bad debt, or insolvency of the small business corporation. The deemed disposition is elective. The election is made in your tax return for the relevant taxation year.

### **ABIL reduced by prior capital gains exemption**

Lastly, your ABIL for a taxation year is reduced to the extent you claimed the capital gains exemption in an earlier year. More particularly, your business investment loss is reduced by the amount of capital gains that were subject to the exemption in previous years, which generally means that your ABIL (1/2 of business investment loss) is reduced by the amount of taxable capital gains (1/2 of capital gains) that were previously exempt under the exemption. (A fractional adjustment is required if the previous year had a capital gains inclusion

rate that differed from the current one-half rate.)

## **EMPLOYEE STOCK OPTION “CASH-OUTS”**

In most cases, one-half of an employee stock option benefit is deductible in computing taxable income, meaning that only half of the benefit is included in the employee’s taxable income. As such, employee stock options are taxed similarly to capital gains. (Details were provided in our February 2010 Tax Letter.)

The benefit normally arises when you exercise the option and acquire the share. A special rule in the Income Tax Act prevents the employer corporation from deducting the amount of the benefit.

Until recently, if you “cashed out” your stock option, that is, you chose to forfeit the option to the corporation in exchange for cash, you would similarly include only one-half of the benefit in taxable income. However, the above restriction regarding the corporation’s deduction did not apply, meaning the corporation could deduct the amount of the cash-out. As a result, the cash-out situation was more beneficial from a tax perspective than exercising of the option.

The Department of Finance was evidently not pleased with this discrepancy. It announced in the 2010 federal budget that these types of cash-outs will be fully included in the employee’s taxable income (i.e. the one-half deduction will not apply). The employer corporation will still be able to deduct the amount of the cash-out.

However, if the corporation elects to forego its deduction, the employee can qualify for

the one-half deduction so that only half the benefit will be included in the employee’s taxable income. The employer must file the election with the CRA, provide written notice to the employee of the election, and the employee must file that notice with the CRA with the employee’s tax return for the year.

### **Summary of new rules for employee stock-option cash-outs**

Regular rule: Employee fully includes, employer fully deducts

Elective rule: Employee includes one-half in taxable income, employer gets no deduction

The new rules apply to cash-outs occurring after 4 pm EST, March 4, 2010.

## **AROUND THE COURTS**

### **Damages for breach of contract for future employment not taxable**

In the recent *Schewe* case, the taxpayer was a dean for several years at a university, which subsequently terminated his position. However, under his contract with the university, the taxpayer was allowed the option of continuing employment with the university as an instructor. The taxpayer notified the university that he intended to take up the instructor position, but the university refused to further employ him. The taxpayer sued the university and received \$90,000 as damages for breach of contract.

The CRA assessed the taxpayer to include the \$90,000 in his income as a “retiring allowance”. The definition of “retiring

allowance” in the Income Tax Act includes, among other things, an amount received “in respect of a loss of an office or employment of a taxpayer”. The issue in the case was whether the \$90,000 was received in respect of the taxpayer’s loss of employment as dean, in which case it would have been a taxable retiring allowance, or an amount received in respect of the future employment, in which case it would not be taxable.

The Tax Court of Canada held in favour of the taxpayer and ruled that the damages were in respect of the future instructor position. Essentially, the Court held that the dean and instructor positions were separate forms of employment. Since the damages related to the breach regarding the future instructor position, which the taxpayer never held, it could not be said that they were in respect of a “loss” of office or employment. Therefore, the damages did not constitute a retiring allowance and were not taxable.

### **Deduction allowed for moving expenses**

Under the Income Tax Act, you are allowed to deduct moving expenses incurred in respect of an “eligible relocation” when moving for employment or business purposes. Among other requirements, the eligible relocation must be from one residence at which you “ordinarily resided” to a new residence at which you “ordinarily resided” after the relocation.

In the recent *Myles* case, the taxpayer had lived in Abbotsford, B.C., and accepted a new job in Victoria, B.C. in 2006. In September 2006, he and his wife moved to Victoria and rented a small apartment for 7 months. While renting the apartment, the couple searched for a permanent home in Victoria to purchase, which they did in April

2007. The taxpayer attempted to deduct certain moving expenses incurred in 2007 in respect of the move to the permanent home, but the CRA denied the deduction. The CRA took the position that the 2006 move to the small apartment was the “eligible relocation”, rather than the 2007 move to the new permanent home.

The main issue in the case was whether the taxpayer first “ordinarily resided” in the small apartment or the permanent home. The Tax Court of Canada found that the taxpayer did **not** ordinarily reside in the apartment, such that he first ordinarily resided in the permanent home after the relocation. Accordingly, the 2007 move to the permanent home was the eligible relocation, and the expenses incurred in respect of that move were deductible as moving expenses.

### **Erratum**

In the June Tax Letter, we provided a chart in the section dealing with the HST, which indicated types of property eligible for a “point of sale rebate” in the participating provinces. That chart should have indicated that the rebate for prepared food up to \$4 applies in Ontario, rather than in B.C. We regret the error.

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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.