



TAX LETTER

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HOME OFFICE EXPENSES CAPITAL GAIN RESERVE TAX CREDITS FOR SUPPORTING AN INFIRM PERSON RESPS “TRANSFER” OF DIVIDEND TAX CREDIT TO SPOUSE AROUND THE COURTS

HOME OFFICE EXPENSES

General requirements

Self-employed persons carrying on a business and certain employees are allowed to deduct their home office expenses if they meet the conditions set out in the Income Tax Act. The general requirements are as follows:

First, the office must be either

- 1) the place where the person primarily carries on the business or the duties of employment (generally meaning more than 50% of the time); **or**
- 2) used exclusively for business or employment purposes, and used on a regular and continuous basis in the course of the

business or employment for meeting clients or customers.

Secondly, the home office expenses cannot create a loss. However, any excess expenses can be carried forward and deducted in the subsequent taxation year, subject to the same income limit.

In the case of employees, they must have the prescribed form T2200 signed by their employer, certifying that they have met the statutory requirements under the Act. Furthermore, they must be required to incur the expenses under the contract of employment (which can be a written or oral contract).

Qualifying home office expenses

In terms of the types of home office expenses, employees are allowed to deduct rent and supplies. For these purposes, “supplies” includes items such as heat, utilities, computer expenses and minor repairs.

Employees who are commissioned salespersons can also normally deduct their property tax and home insurance premiums.

In addition to the above items, self-employed persons can deduct their mortgage interest.

Expenses that relate to the entire home must be pro-rated, based on the size of the office relative to the size of the home (normally measured by square feet or by number of rooms).

If the office is also used for other purposes (that is, you fall within the “primarily” category under 1) above), the expenses must be further pro-rated based on the employment or business use relative to the other use.

EXAMPLE

In 2009, you are self-employed and incur \$5,000 of expenses consisting of mortgage interest, property tax, home insurance, and heat and utilities. Your home office is used 75% of the time for business purposes, and the office constitutes 10% of the size of your home.

Your \$5,000 of expenses should be multiplied by 10% (\$500) and by a further 75%, resulting in \$375 of deductible expenses.

Although self-employed persons can also normally deduct a pro-rata portion of capital cost allowance (depreciation for tax purposes) in respect of their homes, this deduction is

generally not advisable because it can affect their principal residence exemption and potentially lead to recapture (income) when they sell their homes.

CAPITAL GAIN RESERVE

If you sell property and realize a capital gain but some or all of the proceeds are due after the year of sale, you are generally allowed to deduct a capital gain reserve in computing your gain for the year. The reserve is optional, and if it is claimed, it is added back into your capital gains next year, in which case another reserve may be available if proceeds are due after that year.

One-half of the net gain (i.e. the gain net of the reserve) is included in your income for the relevant year as a taxable capital gain.

There are two limits on the amount of the reserve that is allowed in a year. The reserve cannot exceed the lesser of:

- 1) the gain multiplied by [proceeds due after the year / total proceeds]; and
- 2) the following amount, depending on the year:
 - Year 1 (year of sale): 4/5 of the gain
 - Year 2: 3/5 of the gain
 - Year 3: 2/5 of the gain
 - Year 4: 1/5 of the gain
 - Year 5 and subsequent years: nil.

As a result of the second limitation above, no reserve can be claimed after the fourth year, even if some proceeds are still due after that year. As a result, the gain can be spread out over a maximum of five years.

EXAMPLE OF RESERVE

In 2009, you sell some land and realize a capital gain of \$100,000. 60 % of the sale proceeds are received in 2009 and the other 40% is due in 2010.

For 2009, you can deduct a reserve equal to 40% of the \$100,000 gain, which is \$40,000 (this is the lesser of the two amounts described above). Accordingly, your gain will be \$60,000, and one-half of this amount, or \$30,000, is included as a taxable capital gain in 2009. For 2010, you must include the \$40,000 reserve (claimed in 2009) in a capital gain. No further reserve is available because no further proceeds are due after 2010.

Note that if the property is a small business corporation share or a qualified farming or fishing property sold to a child (or grandchild or great-grandchild), the reserve applies for up to 10 years including the year of sale.

Lastly, the reserve is not allowed in a year if you are non-resident at the end of the year or at any time in the immediately following year, or if the purchaser of the property is a corporation controlled by you or a partnership of which you are a majority-interest partner.

TAX CREDITS FOR SUPPORTING AN INFIRM PERSON

If you support a person who is dependent upon you for support by reason of mental or physical infirmity or impairment, there are certain income tax credits that you may claim. Note that the credits generally require that the dependant be a relative, and certain relatives will not qualify (e.g. cousins do not qualify).

Wholly dependent person credit

If you are unmarried and not in a common-law relationship, **or** do not live with your spouse (or common-law partner) and are not supported by and do not support your spouse, you can normally claim the “wholly dependent person” credit in respect of one infirm dependant. In general terms, the dependant must live with you and be related to you. For 2009, the credit is 15% of the amount by which \$10,320 exceeds the dependant’s income.

Caregiver credit

If one or more dependants are 18 years or older and live with you, you may be able to claim the “caregiver credit” for each. Generally, the dependant must be related to you and dependent upon you for support because of a mental or physical infirmity.

The credit is not available if the wholly dependent credit is claimed in respect of the dependant, although a “top-up” credit is allowed generally to the extent that the caregiver credit otherwise determined exceeds the wholly dependent person credit claimed.

Infirm dependant credit

If a dependant is 18 years or older and related to you, you may be able to claim the “infirm dependant” credit. The credit can be claimed in respect of more than one dependant. The dependant does not have to live with you but must be dependent upon you for support. The credit cannot be claimed if you can claim the caregiver credit in respect of the dependant.

For 2009, the infirm dependant credit is 15% of the following amount: \$4,198 minus the dependant’s income in excess of \$5,956. It cannot be claimed if the wholly dependent

person credit is claimed in respect of the dependant, but a “top-up” credit is again available to the extent that the infirm dependant credit otherwise determined exceeds the wholly dependent person credit.

Transfer of disability credit

If the dependant qualifies for the disability tax credit, the credit may be transferred to you to the extent that he or she cannot use the credit. The disability tax credit is 15% of \$7,196. An additional “supplemental” credit may be available if the dependant is under 18 years old; this credit is a maximum of 15% of \$4,198.

If you are **not** the spouse or common-law partner of the dependant, the disability tax credit cannot be transferred to you if the dependant’s spouse or common-law partner claims one of the above-noted credits or certain other credits in respect of the dependant.

Medical expense credit

You can claim the regular medical expense tax credit in respect of qualifying medical expenses that are paid for you, your spouse or common-law partner and minor children, regardless of whether they are infirm.

In addition, you can claim a credit for medical expenses paid in respect of a person dependent upon you for support who is 18 years or older. Generally, the person must be related to you. For 2009, this additional credit is 15% of the amount by which the medical expenses paid by you in respect of the dependant in any 12-month period ending in the year exceeds the lesser of \$2,011 and 3% of the dependant’s net income for the year. The maximum credit

for this additional medical tax credit is 15% of \$10,000, or \$1,500.

RESPS

General rules

A registered education savings plan (RESP) allows you (as the “subscriber”) to contribute funds to the plan that can grow tax free for the post-secondary education of the beneficiary of the plan. Although plans are typically set up for a child, they can in fact be set up for anyone as a beneficiary, including the subscriber. Although the funds earn tax-free income while in the plan, the contributions to the RESP are not deductible.

The income earned in the plan, when withdrawn by the beneficiary for educational purposes, is included in the beneficiary’s income. The income of the plan can be paid to the beneficiary for either full-time or part-time studies in a post-secondary institution. If the beneficiary is your child and in a lower tax bracket than you, the RESP is an effective vehicle to split income and therefore save even more tax.

The contributions to the plan can be withdrawn free of tax, by either the subscriber or the beneficiary.

Although there is no annual limit to the amount of contributions, there is a lifetime limit of \$50,000 per beneficiary.

The time limits in which contributions are allowed, and in which the RESP must be wound up, were increased effective for 2008 and subsequent years. Those limits are as follows:

For regular RESPs, contributions are allowed in the 31 years following the year in which the plan was set up, and the plan must be wound up by the end of the 35th year following the year the plan was set up.

For a “specified” RESP, contributions are allowed in the 35 years following the year the plan was set up, and the plan must be wound up by the end of the 40th year following the year it was set up. A specified RESP is generally a plan under which the beneficiary is eligible for the disability tax credit in the beneficiary’s taxation year that ends in the 35th year following the year the plan was set up.

Family plans

RESPs can be set up for an individual beneficiary, or as a family plan which allows multiple beneficiaries who are related to the subscriber by adoption or blood relationship. For family plans, each beneficiary must normally become a beneficiary before he or she turns 21 years old, and contributions in respect of each beneficiary can normally be made only before the beneficiary turns 31 years old. The main benefit of a family plan is that if a particular beneficiary does not pursue post-secondary education, the plan can still pay out its income to any other beneficiary that pursues post-secondary education.

Beneficiary not pursuing post-secondary education

If the beneficiary does not attend a post-secondary institution (or all of the beneficiaries of a family plan do not attend), the income of the plan can be paid out to the subscriber of the plan in the following circumstances:

- It is paid out after the 9th year following the year the plan was set up, and each

beneficiary is at least 21 years old and not pursuing post-secondary education;

- It is paid out in the year that the plan must be terminated (see above); or
- Each beneficiary is deceased.

The CRA may waive the first two conditions above if it is reasonable to expect that a beneficiary under the plan will not be able to pursue post-secondary education because he or she suffers from a severe and prolonged mental impairment.

The income paid to the subscriber is included in regular income, and is subject to an additional 20% tax (12% in Quebec), basically to account for the previous deferral of tax. However, up to \$50,000 of the income can be contributed to the subscriber’s RRSP or a spousal RRSP (to the extent of available RRSP contribution room), in which case the additional tax is not levied on that income.

Canada education savings grant (CESG) and Canada learning bond (CLB)

A further benefit of setting up an RESP is that the federal government will assist in the funding of the plan if the beneficiary is a child.

For all RESPs, the government will pay a CESG grant equal to 20% of your annual contributions to the plan in respect of each beneficiary, to a maximum grant of \$500 per year and a lifetime maximum of \$7,200 per beneficiary. The grant is provided for each year of contributions up to the year in which the beneficiary turns 16 years old. This encourages you to contribute at least \$2,000 per year for each beneficiary to maximize the

grant. For low-income families, additional CESG amounts are available.

For families entitled to the National Child Benefit (NCB) supplement for the child beneficiary, the CLB provides an initial \$500 to the RESP if the child was born on or after January 1, 2004. The CLB pays an additional \$100 each year that the family is eligible for the NCB supplement in respect of the child, for up to another 15 years.

“TRANSFER” OF DIVIDEND TAX CREDIT TO SPOUSE

The dividend tax credit results in a reduction of tax payable on dividends received from taxable Canadian corporations to recognize the fact that the corporation has already paid tax on the same income. However, the dividend tax credit cannot always be used by low-income individuals if their other credits effectively result in little or no tax otherwise payable. There is some relief, however, if the individual’s spouse (or common-law partner) could otherwise use the credit.

Generally speaking, the spouse (transferee) of the individual who receives the dividend (transferor) can elect to have the dividend included in the transferee spouse’s income. If the election is made, the dividend in turn is not included in the transferor’s income. The election can be made only if the spousal tax credit for the transferee spouse either becomes available or is increased as a result of the election.

Of course, the election should be made only if it results in a reduction in the total tax payable by both spouses. The example below illustrates such a situation. For the sake of simplicity, only federal tax is

computed and it is assumed that only the basic personal tax credit and spousal tax credit are applicable.

EXAMPLE

In 2009, John has \$70,000 of taxable income otherwise determined and is therefore in the 22% federal tax bracket. His spouse Ming has \$5,000 of actual dividends received from public corporation shares and no other income. Note that such dividends require a “gross-up” of 45% that is also included in income before the dividend tax credit is computed. (Also note that John is the transferee spouse, Ming is the transferor.)

To determine whether the election is beneficial, we can compute the tax savings, if any, that would result from the election.

Without election:

Ming’s taxable income is $\$5,000 \times 1.45$ (the gross-up amount) = \$7,250, and with the basic personal credit, she would pay no tax.

John’s spousal tax credit: $15\% \times (\$10,320 - \$7,250) = \$460$

With election:

Ming would have no income and no tax.

John’s spousal tax credit: $15\% \times \$10,320 = \$1,548$; therefore there is a \$1,088 increase in the spousal credit.

John’s initial increase in tax on the grossed-up dividend: $22\% \times \$7,250 = \$1,595$

John’s dividend tax credit: $11/18 \times \$2,250$ (the gross-up) = \$1,375

Total reduction in tax with election: Credits of \$2,463 (\$1,088 spousal credit increase plus \$1,375 dividend tax credit) minus \$1,595 tax in respect of the dividend, equals \$868.

Therefore, the election would be beneficial.

AROUND THE COURTS

Settlement received after wrongful dismissal non-taxable

In the recent *Severe* case, the taxpayer's employer was closing its Montreal office and opening a new office in Toronto. The taxpayer was offered a position in the Toronto office, which he accepted, and proceeded to move himself and his family to a new home in Toronto. However, shortly after the move, he was dismissed from employment. He sued the employer for wrongful dismissal, including damages for mental distress, certain financial losses, and a reimbursement of his expenses incurred in moving.

The taxpayer and his employer eventually agreed upon an out-of-court settlement of about \$14,400. The CRA assessed and included the amount as income, as either a taxable benefit or a retiring allowance.

On appeal to the Tax Court of Canada, the taxpayer argued that the settlement amount was essentially a reimbursement of his expenses, and the Tax Court agreed and allowed the appeal.

Travel expenses claimed by self-employed author not deductible

In the recent *Henrie* case, the taxpayer was an author who had written many French literary works. The taxpayer traveled extensively

in 2004 and 2005 both overseas and across Canada. He attempted to deduct his travel expenses on the grounds that they helped to "enrich his experiences and expand his mind", which in turn helped him write various novels, stories and memoirs during his travels. To back up this assertion, the taxpayer noted that his written works contained references to and examples of his travel experience.

The CRA allowed a deduction of 25% of the travel expenses, but denied the other 75% on the grounds that they were personal and not for the purpose of earning income from his business as an author. Upon appeal to the Tax Court of Canada, the Court agreed with the CRA. They found that even though the expenses provided the taxpayer with inspiration and enhanced his ability to write and therefore earn income, the expenses were capital in nature and not deductible. The Court lastly indicated that the 25% deduction allowed by the CRA was fairly generous, and that the CRA could have completely disallowed the deduction.

Note that in some cases travel expenses may be deductible. For example, if you are a self-employed author writing a non-fiction book that requires travel to do your research, you may be allowed to deduct a reasonable portion of your travel expenses if you can show that they were necessary for the purpose of writing the book.

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.