Marcil Lavallée

AUGUST 2019

TAX LETTER

IN THIS ISSUE

PROPOSED CHANGES TO EMPLOYEE STOCK OPTION RULES

Under current rules, employee stock option benefits are normally only half taxed. That is, in most cases only half of the benefits are included in the employee's taxable income. The amount of the benefit equals the amount by which the fair market value of the shares when the option is exercised exceeds the price paid for the shares under the option. (If the employee paid something to acquire the option, that would reduce the amount of the benefit.)

In the 2019 Federal Budget, the government announced that it would be restricting the one-half inclusion rule. The Liberal government felt that the rule was not generally warranted for employees of large, mature corporations. As such, the government proposed that only $200,000 worth of stock option grants annually should qualify for the one-half rule. Benefits above the $200,000 threshold would be fully taxable. However, the Budget papers stated that the restriction would not apply to employees of smaller, start-up corporations.

On June 17, 2019, the Department of Finance released draft legislation to implement the proposals. They are scheduled to apply to options granted after 2019 — if the Liberals are re-elected in October.

The draft legislation clarifies that the one-half inclusion rule will not apply to stock option benefits of an employee that reflect more than $200,000 worth of stock annually, the $200,000 value being determined at the time the option is granted. The limitation applies for each year in which the option "vests", which is the year in which the option becomes exercisable. The vesting year is not necessarily the same year as the year of the grant of the option.

For example, if an employee receives an option in 2020 to acquire shares that are worth $400,000 at that time, but the option partially vests in 2021 to acquire half of the shares and the rest of the option vests in 2022 to acquire the remaining shares, the entire benefit will qualify for the one-half inclusion rule. This will be the case regardless of the year in which the option is exercised and the benefit is actually realized. (Obviously, if the option is not exercised, there will be no benefit.)

On the other hand, if the above option fully vested in 2021, only 50% of the benefit (200,000/400,000) will qualify for the one-half inclusion, while the rest of the benefit will be fully included in taxable income.

The draft legislation provides that the limitation does not apply to options granted by a Canadian-controlled private corporation (CCPC), regardless of the size of the corporation.

The upside of the draft legislation is that the amount of benefit for which the one-half inclusion for the employee is denied will be generally deductible for the employer in computing its taxable income. That differs from the current rule, which provides that stock option benefits are not deductible for the employer. However, the deduction for the employer is allowed only if the following conditions are met:

> the employee must deal at arm's length with the employer at the time the option is granted;
>
> the exercise price of the option cannot be less than the fair market value of the share at the time the option is granted; and
>
> the share must be a "prescribed share", which generally includes most common shares and other shares that are similar in nature to common shares.

(The above conditions are the same that must be met in order for the employee to otherwise qualify for the one-half inclusion rule, where it is applicable.)

SHAREHOLDER LOANS

General rule

The *Income Tax Act* has a fairly onerous rule that provides that a shareholder of a corporation that receives a loan from the corporation must include the full amount of the loan in income for tax purposes. This rule also applies to a loan received from the corporation by a person "connected" with a shareholder, which generally includes a person who is non-arm's length with (related to) the shareholder.

Fortunately, there are various exceptions to the rule.

Exceptions to the rule

The rule also does not apply to a shareholder loan that is **repaid within one year** after the end of the corporation's taxation year in which the loan was made. However, the repayment cannot be part of a series of loans and repayments from and to the corporation. This exception allows you to repay the loan almost two years later, depending on when the loan is made.

> Example
>
> The corporation has a calendar taxation year. On January 2, 2019, it makes a loan to a shareholder. As long as the shareholder repays the loan by December 31, 2020 (almost 24 months in total), the loan will not be included in the shareholder's income.

The rule does not apply to a loan received from a corporation which makes the loan in **ordinary course of its business of lending money** where *bona fide* arrangements are made for repayment of the loan within a reasonable time. This exception may apply to loans from banks or trust companies, although loans from any corporation that has a money-lending business can qualify.

Another significant exception applies if you are both a shareholder and an employee of the corporation, but not a "specified employee". You are a specified employee if you and non-arm's length persons (related persons) own at least 10% of the shares of any class of the

corporation. If you are *not* a specified employee, the shareholder loan will not be included in your income if it is reasonable to conclude that you received the loan **because of your employment** and not because of your shareholdings, and *bona fide* arrangements were made for repayment of the loan within a reasonable time.

In addition, even if you *are* a specified employee, another exception exists. In this case, you must use the loan to acquire a home for your family, shares in the employer corporation, or a motor vehicle to be used in the course of your employment. Still, it must be reasonable to conclude that you received the loan **because of your employment** and not because of your shareholdings, and *bona fide* arrangements were made for repayment within a reasonable time. If you meet these conditions, the loan will not be included in your income.

Repayment of loan

If none of the exceptions apply and the full amount of the loan is included in your income, you get an offsetting deduction in a future year in which you **repay the loan**. If you repay only a part of the loan, you get a partial deduction.

Imputed interest benefit where shareholder loan rule does not apply

If one of the exceptions does apply and the full amount of the loan is not included in your income, you may still be subject to an imputed **interest income inclusion.** This will be the case if the loan is made at zero interest or an interest rate that is lower than the "prescribed rate" of interest under the *Income Tax Act* (currently 2% per year). In such case, you must include in your income the difference between the prescribed interest for each year less the interest you paid for the year, either in the year or by January 30 of the following year.

> Example
>
> A shareholder of a corporation receives a $100,000 loan from the corporation on January 1, 2019, at 1% interest. The shareholder pays the 1% interest in the year. The prescribed rate of interest throughout the year is 2%.
>
> In such case, the shareholder will be required to report, and pay tax on, a taxable benefit of (2% –1%) x $100,000, or $1,000.

If you pay the interest for a year after January 30 of the following year, the benefit is not reduced. In other words, if you pay late, you are out of luck.

PERSONAL-USE PROPERTY

There are specific rules that apply to gains and losses from dispositions of personal-use property (PUP). For these purposes, PUP is generally defined as property that is used primarily for personal use by the owner of the property or a related person. PUP includes property such as your personal-use furniture, clothing, jewellery, cars, bicycles, computers, and even your home.

One of the main rules regarding PUP is that a capital loss on the disposition of the property is deemed to be zero (i.e. the loss is denied), unless it is a special category of PUP called "listed personal property" (LPP). Losses from LPP can offset gains from LPP, but not gains from other PUP or other properties.

If there is a net gain from LPP in a year, half is included in income as a taxable capital gain. If there is a net loss in the year, it cannot be used in that year. However, it can be carried back 3 years or forward 7 years to offset gains from only LPP in those years.

> Example
>
> I sell some jewellery (which is LPP) in 2019 at a loss of $3,000. I have a $3,200 gain on a piece of art (also LPP) in 2020. I can carry forward the 2019 loss to 2020, which will leave a net $200 gain. One-half of that, or $100, will be included in my 2020 income as a taxable capital gain.
>
> If the gain in 2020 was from a PUP that was not LPP, the 2019 loss could not offset the gain. In such case, I would have a $1,600 taxable capital gain in 2020.

Definition of Listed Personal Property

As noted, only losses from LPP can be utilized for tax purposes, and only against gains from LPP.

LPP is defined as:

> art, such as paintings and sculptures;
> rare books, manuscripts and portfolios;
> jewellery;
> coins; and
> stamps.

$1,000 threshold

For all PUP, whether LPP or not, there is a general rule that states that the minimum cost and minimum proceeds of PUP for capital gains purposes is $1,000. The rule is meant to alleviate record-keeping and reporting of gains and losses of nominal amounts in respect of PUP.

The rule ensures that you can have a gain on PUP only if the proceeds exceed $1,000, and that you can have a loss on PUP only if the cost is more than $1,000. In some cases, you will neither have a gain or a loss.

> Example
>
> You sell the following PUP, with your cost and sales proceeds as follows:

	Cost	Sales proceeds
Furniture	800	1,200
Bicycle	1,100	700
Painting	800	500

> Because of the $1,000 minimum cost rule, your gain on the furniture will be $200, and half of that will be a taxable capital gain.
>
> Your loss on the bicycle will be $100 (due to the minimum proceeds of $1,000), but it will be denied because it is not LPP.
>
> You will have no loss or gain on the painting (deemed cost and proceeds are both $1,000).

TRANSFER OF DIVIDEND TO HIGHER INCOME SPOUSE

General Taxation of Dividends

Dividends are taxed preferentially relative to most other sources of income. While the highest marginal federal rate of tax is 33%, the highest rate is 24.81% for "eligible dividends" and 27.57% for "non-eligible dividends". When provincial taxes are added, a similar discrepancy exists: the combined Federal and provincial rate of tax on ordinary income is higher than that for eligible dividends.

(In general terms, an "eligible dividend" is paid out of a corporation's business income that is subject to the general (approximately 25%) corporate tax rate. A "non-eligible dividend" is paid out of income that was subject to the small business tax rate for Canadian-controlled private corporations, or investment income that was eligible for a corporate tax refund.)

The way in which you are taxed lower on dividends relative to other income is that you receive a dividend tax credit, which is meant to offset the corporate tax that was paid on the corporation's income from which the dividend was paid. In other words, the intent of the dividend tax credit is to prevent double taxation.

The way it works: When you receive a taxable dividend from a Canadian corporation, you must "gross up" the dividend by a percentage and include that grossed up amount in your income. (Including the gross-up, you add to your income roughly the amount of income the corporation earned before paying corporate tax and then paying you the dividend.) However, you are then entitled to the dividend tax credit, which is roughly meant to credit you for the tax that was paid at the corporate level.

As a result, the gross-up and dividend tax credit mechanism means that taxable dividends are subject to an overall tax rate that is lower than the rate which applies to ordinary income. Eligible and

non-eligible dividends have different dividend tax credit amounts, reflecting the fact they come from corporate income subject to different rates of tax.

The dividend tax credit is not refundable. It can reduce your tax to zero but cannot be used beyond that point. It cannot be carried forward or back to another year. In other words, you generally either use it or lose it. However, in such cases, a "transfer" of the dividend to your spouse or common-law partner may be allowed so that they can use the credit.

Transfer of Dividend to Spouse or Common-law Partner

The transfer of the dividend works as follows. Where a lower-income spouse receives a dividend and cannot fully use the dividend tax credit, the spouses can make an election to have the dividend included in the other (higher-income) spouse's income. However, the election can be made only if including the dividend in the other spouse's income either creates or increases the spousal tax credit that the other spouse may claim.

The regular federal spousal credit for 2019 equals 15% of X, where X is $12,069 minus the lower-income spouse's income for the year. (The dollar amount is increased annually for inflation.)

As such, the higher-income spouse's credit is reduced if the lower-income spouse has any income and is eliminated once the lower-income spouse's reaches $12,069. If the transfer of the dividend from the lower-income spouse creates or increases the credit (since it reduces the lower-income spouse's income), the election can be made. Of course, the election should be made only if it reduces tax overall.

> Simple Example (federal income tax only)
>
> In 2019, Evan has $6,069 of interest income and a grossed-up eligible dividend of $6,000, for total income of $12,069. He is therefore in the lowest federal tax bracket of 15%.
>
> His spouse Lisa has taxable income of $85,000 and is therefore in the 20.5% tax bracket.
>
> They want to know whether they should make the election to transfer the dividend to Lisa.
>
> Result without the election: Evan will pay no tax because his personal credit (15% of $12,069) will fully offset the tax otherwise payable on his income. He cannot use the dividend tax credit.
>
> Lisa will get no spousal tax credit and no dividend tax credit.
>
> **Result with the election**: Evan will still pay no tax because of his personal credit.
>
> Lisa will include the $6,000 grossed-up dividend in her taxable income, bringing her total taxable income to $91,000. This keeps her in the 20.5% marginal tax bracket.
>
> Her initial federal tax on the dividend will be $1,230 (20.5% of $6,000). But she will claim the dividend tax credit, which is 15.02% of the $6,000 grossed-up dividend. That equals $901. So the net tax payable on the dividend will equal $329 ($1,230 minus $901).
>
> Since Evan's income is now below the $12,069 threshold, Lisa can also claim the spousal credit of 15% of ($12,069 minus Evan's $6,069 income), or $900.
>
> As a result, she will save tax of $900 – $329 = $571. Therefore, the election makes sense in this example.

RESERVE FOR UNEARNED INCOME

If you carry on a business, amounts that you receive in advance of providing the goods or services (depending on your business) are included in income, even though they are not yet "earned". In particular, if you receive an amount in one year on account of goods or services provided in a later year, you must nonetheless include the amount in the year of receipt. A similar rule applies to a landlord who receives advance rent in one year on account of future years.

Fortunately, the Income Tax Act generally allows you a "reserve", to defer the recognition of the amount until the year it is actually "earned" (e.g. when you provide the goods or services). The reserve can be deducted in the year of receipt. It is "added back" to income the following year. If the goods or services are provided in that following year, the add-back is permanent. If the goods or services are not yet provided in that year, the reserve can be claimed again, and the process continues until the goods or services are provided.

> Example
>
> In the course of your business, you receive $60,000 in December 2019, for services to be rendered in each of 2020 and 2021 ($30,000 worth of services for each year).
>
> For 2019, you must report $60,000 of income for tax purposes, but can claim the offsetting reserve of $60,000, for a net inclusion of nil.
>
> For 2020, you add back $60,000, but deduct a reserve of $30,000 on account of the services to be rendered in 2021. Net inclusion = $30,000.
>
> In 2021, you add back the $30,000 reserve claimed last year, with no further reserve. Net inclusion = $30,000.

The reserve is optional, so some flexibility is allowed. For example, you might choose to claim no reserve (or less than the maximum reserve) if you have loss carry-forwards to offset the resulting income, or if your tax bracket for the year of receipt is lower than your anticipated tax bracket for the following year.

AROUND THE COURTS

Losses from part-time law practice disallowed

In the recent *Renaud* case, the taxpayer was a lawyer who was employed full-time at a Federal government agency. She also had a part-time law practice of 10 hours a week, from which she ended up losing money every year for many years. She attempted to claim the non-capital losses for tax purposes against her other sources of income. Apparently, her practice consisted of helping clients with low incomes who could not pay her enough for her to make a profit.

The Tax Court of Canada found that Ms. Renaud's practice was not sufficiently commercial, but rather had a significant personal element, and as a result it did not constitute a "source" of income. Her losses were therefore denied.

Ms. Renaud appealed that decision to the Federal Court of Appeal. The Court of Appeal agreed with the Tax Court judge, holding that Ms. Renaud's practice was not clearly commercial in nature and that it was not carried on with a view of making a profit. Thus, her losses were denied.

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.

Marcil Lavallée

OTTAWA
400-1420 place Blair Place
Ottawa ON K1J 9L8
T 613 745-8387
F 613 745-9584

GATINEAU
100-200 rue Montcalm St
Gatineau QC J8Y 3B5
T 819 778-2428
F 613 745-9584

Marcil-Lavallee.ca
Marcil Lavallée, S.E.N.C. | G.P.
Société de comptables professionnels agréés
Partnership of Chartered Professional Accountants