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# TAX LETTER

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## HOW ARE OPTIONS TAXED?

An option to *purchase* a property, as the term implies, provides the holder of the option an optional right to purchase the property. The option is referred to as a **call option**. The purchase price under the option is sometimes called the exercise price or strike price.

Conversely, an option to *sell* a property provides the holder of the option an optional right to sell the property. The option is called a **put option**. The sales price under the option is also called the exercise or strike price.

If you purchase or acquire an option, there are generally no immediate tax consequences for you. Instead, the amount you paid for the option becomes your cost or "adjusted cost base" of the option.

The person granting the option ("grantor") will include the amount they received for the option as proceeds of disposition, which will result in a capital gain (or, if they are in the business of granting or selling options, their profit will be business income). The grantor's adjusted cost base of the option is deemed to be nil, such that the entire proceeds will constitute the capital gain, one-half of which is included as a taxable capital gain.

However, if the option is exercised, the tax consequences become more significant.

**Exercise of call option**

If you exercise a call option and acquire the property subject to the option, the amount you paid for the option will be added to your adjusted cost base of the property, plus of course whatever you paid for the property under the exercise price.

The grantor of the call option will add the amount paid to them for the option to their proceeds of disposition of the property. Since the amount paid to them for the option was initially a capital gain (see above), if the option is exercised in a subsequent year, the CRA can re-assess the grantor's previous year to make the appropriate adjustments and effectively reverse that initial capital gain. (If the option is exercised in the same year in which it was granted, the adjustments are simply made in the return for that year.)

EXAMPLE 1

In year 1, John buys a call option from Sally for $5,000. The option gives John the right to purchase a property from Sally at an exercise price of $100,000 over the next two years. In year 2, John exercises the option and purchases the property for $100,000.

Results:

John's adjusted cost base of the property becomes $5,000 plus $100,000, or $105,000.

In year 1, Sally initially reported $5,000 as a capital gain, half of which was a taxable capital gain included in her income. However, since the option was exercised in year 2, that initial capital gain will be reversed. Instead, Sally has proceeds of disposition for the property in year 2 of $105,000. She will have a capital gain or loss in year 2, depending on her cost of the property.

## Exercise of put option

If you exercise a put option and sell the property under the option, you deduct your cost of the option from your proceeds of disposition of the property.

The purchaser of the property deducts the amount you paid for the option from their cost of the property. Since the amount paid to them for the option was initially a capital gain, if the option is exercised in a subsequent year, the CRA can re-assess the purchaser's earlier year to make the appropriate adjustments.

EXAMPLE 2

In year 1, Bela pays Ahmed $5,000 for a put option. The option gives Bela the right to sell a property to Ahmed for $100,000 over two years. In year 2, Bela exercises the option and sells the property to Ahmed for $100,000.

Results:

Bela's proceeds of disposition of the property are reduced by her $5,000 cost of the option, to $95,000. She will have a capital gain or loss, depending on her cost of the property.

In year 1, Ahmed will report $5,000 as a capital gain. However, since the option was exercised in year 2, that initial capital gain is effectively reversed. Instead, the $5,000 reduces his cost of the property in year 2, which becomes $95,000.

## Option expires

If you have an option and do not exercise it so that it expires, there is a deemed disposition at the time it expires. Since you will have nil proceeds of disposition (since the option simply expired and so you got nothing for it), you will have a capital loss, which will equal your cost of the option.

EXAMPLE 3

Assume the same facts as Example 2, except that Bela's option expires at the end of year 2.

In such case, since she has nil proceeds on the expiration, but since her cost of the option was $5,000, she will have a capital loss of $5,000, half of which will be an allowable capital loss claimable against her taxable capital gains.

On a final note, there are different rules that apply to *employee* stock options.

## DONATIONS UNDER YOUR WILL OR BY YOUR ESTATE

The charitable donation credit is one of the more generous credits under the Income Tax Act.

People often provide for charitable donations under their will. Sometimes the provision is explicit, and sometimes they give the executor or liquidator (trustee of their estate) discretion in terms of making charitable donations.

When claiming the charitable donation credit, there are a few significant tax rules that come into play when your estate makes the donation.

First, when a charitable donation is made under an individual's will or otherwise by their estate, it is deemed to be a donation made (and valued) at the time it is given to the charity (rather than on the date of death). A similar rule applies where the donation to charity is made because of a designation under the individual's life insurance policy, RRSP, RRIF, or TFSA.

Despite this deeming rule, if the donation is made by the estate within 60 months after the death, the credit can optionally be claimed by the deceased for the year of death or the immediately preceding year. (Technically, the estate must otherwise qualify as a "graduated rate estate", which is normally the case, but there are certain conditions that must be met.)

Alternatively, the estate can claim the credit in the year the donation is made. If it is made within 36 months after the death, the estate can claim the credit in a previous taxation year of the estate. (Again, the estate must qualify as a "graduated rate estate".)

As another alternative, the estate can carry forward the credit for up to 5 years and claim it in any one of those years (up to 10 years if the donation qualifies as an "ecological gift"). Obviously, the estate would still have to be in existence in those future years. If the estate is wound up relatively soon after the death, the carry-forward will be of limited use.

Donations made by the estate can be split up under the above rules, so, for example, part of the credit could be claimed by the deceased and part by the estate. The decision on where to claim the credit will depend on the facts, and in particular the tax otherwise payable by the deceased and the estate in the relevant year.

Another issue relevant to the deceased is the increase in the amount of donations that can qualify for the credit. Normally, most donations up to 75% of an individual's net income for the year qualify for the credit in that year. In the year of death and the preceding year, the limit is increased to 100% of the individual's net income for the year. But in any case, the credit should be claimed in any given year only to the extent of tax otherwise payable, because the credit is not a refundable credit.

EXAMPLE

Josh died in December 2020. His income in 2020 was $150,000. His estate makes $200,000 of cash donations to various charities in 2022.

Possible alternatives:

His executor could choose to use up to $150,000 of the donations as a credit for Josh in 2020. However, as noted above, it would make sense to use the credit only to the extent of Josh's tax otherwise payable in 2020. If the donation would generate a 50% credit (the exact rate will depend on Josh's province of residence, among other things), and his 2020 tax will only be $45,000, then it won't make sense to claim more than $90,000 of the donation of his 2020 return.

The remainder of the credit can be claimed by the estate in 2021 or 2022. Or it could be carried forward for up to five years after 2022 (assuming the estate is still in existence). Or the estate could claim the entire credit in any of those years (provided it has tax to pay) and not claim it on Josh's tax return.

Obviously, there are various options here. For example, depending on Josh's income and tax otherwise payable for 2019, some of the credit could be claimed in his final tax return for that earlier year.

## CAPITAL DIVIDENDS

Most dividends are taxable to the recipient shareholder. Taxable dividends are included in the shareholder's income. However, if they are received from a Canadian corporation, they qualify for the dividend tax credit, which results in a lower tax rate for the shareholder compared to most other forms of income (though the amount initially included in income is actually higher than the dividend received, as it is "grossed up" to equal the corporation's theoretical pre-tax income represented by the dividend).

But if you receive a **capital dividend**, it is completely tax-free.

What is a capital dividend? Basically, it is a dividend paid by a private corporation (so not publicly listed corporations) out of its "capital dividend account" (CDA). Although the calculation of the account can be complex, it basically consists of certain amounts that are not otherwise taxable to either the corporation or an individual.

The basic element of the CDA is one-half of net capital gains realized by the corporation. Only half of capital gains are included as taxable capital gains for any taxpayer, meaning the other half is tax-free and this "untaxed half" goes into the CDA. Another common component is life insurance proceeds received by the corporation on the death of an individual, which are also tax-free for all taxpayers.

The corporation must elect for the dividend to be a capital dividend, using a particular prescribed form (form T2054) no later than the time the dividend becomes payable. A late election is allowed, with payment of a penalty (maximum $8,000).

## ELECTION FOR DIVIDENDS WITH YOUR SPOUSE

Normally, you include in your income, for tax purposes, any dividends that you receive in the year. You cannot generally shift your dividends into your spouse's income, or vice versa.

However, an election under the Income Tax Act allows this in certain cases.

Generally, this may be allowed where your spouse (or common-law partner) receives a dividend but is in a low tax bracket.

More specifically, if your spouse receives a dividend in a taxation year, you can elect in your tax return for the year to have it included in your income rather than your spouse's income. You can make the election only if it would increase your spousal tax credit, which is available if your spouse has relatively little or no income. That is, if the shift of the dividend into your income brings your spouse's income low enough for you to claim or increase your spousal tax credit, you can make the election. For federal tax purposes for 2021, your spousal credit will be phased out as your spouse has income up to $13,808 and eliminated at or above that amount, or $16,103 if they are infirm (lower thresholds apply if you are in one of the two highest tax brackets). If your spouse has no income, you get the full spousal credit.

The dividend tax credit for dividends received is not refundable, which means it can bring an individual's tax down to zero, but

the individual does not get a refund if the credit is greater than the tax otherwise payable. So, if your spouse or partner has little or no income, they might not to be able to use the dividend tax credit, in which case it may make sense for you to make the election and claim the dividend and the dividend credit, subject to the comments below.

In terms of whether you should make the election, you would also have to weigh the increase in the spousal tax credit for you versus the increased tax that you would pay by including the dividend in your income after accounting for the dividend tax credit. If the increased spousal credit is more than the tax on the dividend, you would likely make the election. If it were the other way around, you would likely not make the election.

## TRUSTS: ALLOCATING INCOME TO BENEFICIARIES BUT TAXED TO TRUST

If a trust (or estate or succession) earns income, it will generally be included in either the trust's income or the income of a beneficiary of the trust.

The basic rules are as follows: If any of the trust's income is payable in a taxation year to a beneficiary, that amount is deductible in computing the trust's income for year. The amount payable is then included in the beneficiary's income. As a result, there is normally no double taxation (since there is a deduction for the trust, and inclusion for the beneficiary).

"Payable", in this context, means that the income is either *paid out* to the beneficiary, or the beneficiary is "entitled in the year to enforce payment of it".

EXAMPLE

In year 1, a trust earns $50,000 of interest income. Half of that is payable to a beneficiary in the year, and the other half is retained by the trust.

Result: $25,000 is included in the trust's income and the other $25,000 is included in the beneficiary's income.

In essence, the income of the trust is "flowed out" to the beneficiary when it is payable to beneficiary. In addition, the character of the income (interest, dividends, taxable capital gains) generally can remain the same in the hands of the beneficiary, if the trust makes the appropriate designation in its tax return.

On the other hand, losses of a trust cannot be flowed out to a beneficiary and therefore can be claimed only by the trust.

Fortunately, there is a mechanism that allows a trust to carry forward losses from previous years to offset current year gains or profit, which then can be paid out to beneficiaries free of tax.

Basically, to use this mechanism, the trust can carry forward non-capital (ordinary) losses or net capital losses to offset income or taxable capital gains in the current year, but it can do this only if it brings the trust's taxable income for the year down to zero. This means the trust will pay no tax, and the amount of its net income (before the carry forward) can be paid out to the beneficiaries free of tax.

EXAMPLE

In year 1, a trust had a net capital loss of $20,000. In year 3, it has a net capital gain and taxable income of $15,000.

During year 3, the trust can pay the $15,000 to its beneficiaries and make a special designation in its year 3 return, so that the $15,000 will remain part of the trust's net income and not be included in the beneficiaries' income. As a result, the beneficiaries

will not pay tax on that amount. The trust will use $15,000 of the loss carried forward from year 1 to bring its taxable income down to zero, so that it also will pay no tax.

The remaining $5,000 of the trust's year 1 net capital loss can be carried forward to future years.

## SELF-EMPLOYED? YOU PAY DOUBLE CPP or QPP PREMIUMS

From an income tax perspective, it is generally beneficial if you can structure yourself as a self-employed independent contractor, rather than an employee. Of course, you are not always able to do so, as the firm to which you provide services may insist on you as being an employee or the facts of your relationship with the firm may not support the claim that you are an independent contractor.

If you are self-employed, you can normally deduct more expenses than can an employee. As a result, your net income should be lower, resulting in less tax. That is probably the main advantage.

One downside is that you will have to pay double the amount of Canada Pension Plan (CPP) or Quebec Pension Plan (QPP) premiums relative to an employee. (Another is that you generally don't qualify for Employment Insurance, though in some cases you can opt in to the EI system for certain purposes; and the September 2021 Liberal election platform proposes to allow EI for all self-employed persons.)

In an employment situation, the employee and employer both pay CPP or QPP premiums.

If you are self-employed carrying on your own business, there is no third-party employer. As a result, the CPP/QPP legislation generally requires you to pay both the regular *employee* premiums and the regular *employer* premiums. Hence, you pay twice as much as you would if you had been an employee.

For income tax purposes, half of the CPP/QPP premiums paid by a self-employed individual generate a tax credit. This is likely because employees get a credit for their premiums. The other half of the premiums are deductible in computing the self-employed individual's net income, likely because "regular" employers get a similar deduction.

(A deduction is more beneficial if you are not in the lowest tax bracket. This is because the credit is calculated using the lowest tax rate, while the deduction will save you tax at the rate of your higher tax bracket.)

## AROUND THE COURTS

**Lending money was not a business; losses on loans were not deductible**

In the recent *Kallis* case, the taxpayer was a businessman who founded and ran a pipeline business. After the business became financially successful, he decided to use some of the surplus funds to make loans to various third parties.

Unfortunately, two of the borrowers became bankrupt and could not repay their loans. As a result, the taxpayer incurred losses on those loans. He argued that his lending activities constituted a business such that the losses were fully deductible against other sources of income. The CRA disagreed, and held that his losses were capital, and therefore only one-half deductible (and usable only against capital gains). The taxpayer appealed to the Tax Court of Canada.

The taxpayer did not keep detailed books or records of the loans and did not actively solicit potential borrowers. He stated that he tried to stay "under the radar" because he was not trying to compete with banks.

Unfortunately for Mr. Kallis, the lack of proactive business activity was his undoing at the Tax Court. The Court found that he was not in the business of lending, so his losses were capital losses. The Court noted that the taxpayer's success as a self-made businessman was admirable, and that his losses on the loans were very unfortunate. However, the Court held that it "cannot find that he was in the business of lending money during the years under appeal because the positive [indications] of a business were either absent or minimally present".

*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.*

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