BUCHANAN BARRY LLP
CHARTERED ACCOUNTANTS

TAX NEWSLETTER
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2010 INDEXATION ADJUSTMENTS

Each year, the income tax brackets, certain personal credits, and other amounts in the Income Tax Act are indexed to account for changes in the Consumer Price Index. Some of the notable indexation changes (based on 0.6% increase), as recently announced by the Canada Revenue Agency (CRA), are as follows.

2010 federal tax brackets:

15% tax bracket for first $40,970 of taxable income (up from $40,726 in 2009);
22% tax bracket begins at taxable income above $40,970;
26% tax bracket begins at taxable income above $81,941 (up from $81,452);
29% tax bracket begins at taxable income above $127,021 (up from $126,264).

2010 amounts of federal tax credits:

Basic personal credit: 15% of $10,382 (up from $10,320);
Spousal or common-law partner credit: also 15% of $10,382, and reduced if spouse or common-law partner has income;
Age 65 credit: 15% of $6,446 (up from $6,408) and reduced for net income over $32,506;
Children under age 18 credit: 15% of $2,101 (up from $2,089);
Canada employment credit: 15% of $1,051 (up from $1,044);
Disability credit: 15% of $7,239 (up from $7,196);
Caregiver credit: 15% of $4,223 (up from $4,198), and reduced if dependent's net income exceeds $14,422 (up from $14,336);
Basic medical expense credit: 15% of qualifying expenses exceeding the lesser of 3% of net income and $2,024 (up from $2,011).

The amount at which the **Old Age Security** "claw back" tax starts to apply is increased for 2010 to $66,733 of net income, up from $66,335.

2010 PRESCRIBED AUTOMOBILE AMOUNTS FOR 2010

The federal government also recently announced the 2010 dollar limits and amounts that apply for taxpayers who use automobiles in the course of a business or employment. The various limits and amounts are summarized below.

CCA, interest, and leasing expense limits

As a general rule, you are allowed to deduct car expenses incurred in the course of your business. Similarly, subject to specific requirements under the Income Tax Act, certain employees may deduct their car expenses incurred in the course of employment.

For the 2010 year, the dollar limits for capital cost allowance (CCA) in respect of a car that you own, interest expense incurred on borrowed money used to buy a car, or leasing costs in respect of a car that you lease, remain unchanged from the past several years. In particular, for cars purchased or car leases entered into after 2000 and through 2010, the following limits apply:

- The maximum cost of your car on which CCA that can be claimed is \$30,000 plus GST/HST and provincial sales tax;

- The maximum allowable interest deduction for car loans is \$300 per 30-day period in the year; and

- The general limit on deductible leasing costs is \$800 per 30-day period in the year plus GST/HST and provincial sales tax. However, the deductible lease payments may also be reduced if the manufacturer's list price of your car exceeds \$39,822.

Tax-free car allowances

If you use your own car for employment purposes, your employer can normally pay you a deductible tax-free allowance in respect of the employment use of the car, subject to the certain monetary limits. (That is, the allowance is deductible for the employer and tax-free for you.)

For 2010, the dollar limits remain **52 cents** per kilometre for the first 5,000 kilometres driven in the course of employment and **46 cents** for each additional kilometre driven. For the Yukon Territory, Northwest Territories and Nunavut, the deductible tax-exempt allowance limit remains at 56 cents for the first 5,000 kilometres driven and 50 cents for each additional kilometre driven.

Employee car benefits

If your employer provides you with a car and pays any of your personal operating costs, you are required to include in income an operating expense benefit. For 2010, the prescribed rate used to determine this benefit remains at **24 cents** per kilometre of personal driving, regardless of the amount of expenses actually paid by your employer. For employees who are employed principally in selling or leasing automobiles, the prescribed rate remains at 21 cents per kilometre.

However, if your employment-related kilometres exceed your personal kilometres for the year, you can elect for the operating expense benefit to be one-half of your "stand-by charge" for the year (instead of the per-kilometre benefit described above). The stand-by charge is itself an arbitrary amount, determined by formula, which reflects your benefit in respect of the personal use of the car (aside from the operating cost benefit). This election must be made by notifying your employer before the end of the year.

Note that the operating expense benefit is not included in your income if the personal expenses paid by your employer are fully repaid by you in the year or within 45 days after the end of the year (i.e., by February 14). If you repay only part of the expenses, the benefit is still included but reduced by the amount of your repayment.

EMPLOYEE STOCK OPTIONS

Generally speaking, an employee stock option gives an employee the option to purchase shares in the employer corporation at a set price (called the "exercise price") during a specified period of time. Employee stock option benefits are generally taxed differently from other forms of employment income.

The grant of an employee stock option does not itself give rise to an income inclusion for the employee. However, once the option is exercised such that the shares are acquired by the employee, there is an employment benefit equal to the amount by which the fair market value of the shares at the time they are acquired exceeds the amount paid for the shares under the option (the exercise price) and the amount, if any, paid to acquire the option.

The general timing rule is that the benefit is included in income in the year in which the shares are acquired.

Deferral rule

There are two cases where the inclusion of the benefit is deferred and included in the year in which the shares are disposed of. (Of course, if you acquire and dispose of the shares in the same year, the benefit is simply included in that year.)

The first scenario is where the shares are of an employer corporation that is a Canadian-controlled private corporation (CCPC), or of another CCPC that is non-arm's length with the employer CCPC.

The second scenario occurs where the shares are of the employer corporation (or of a corporation that is non-arm's length with the employer) and are listed on a designated stock exchange. However, the shares must also be "prescribed shares" (normally meaning common shares), the employee must be arm's length with the employer, and the exercise price under the option cannot be less than the fair market value of the share at the time of the grant of the option minus the amount paid to acquire the option, if any. Furthermore, the second scenario applies only in respect of options relating to $100,000 worth of shares (measured at the time of the grant of the option) per taxation year. Lastly, the second scenario is elective, in that it applies only if the employee files an election by January 16 following the year in which the shares are acquired. If the election is not made, the regular timing rule discussed above applies.

One-half deduction

Often, a deduction of one-half of the benefit is allowed in computing taxable income, such that one-half of the benefit is ultimately included in taxable income. As a result, most employee stock option benefits are effectively taxed at capital gains tax rates. The one-half deduction applies if either:

- the shares are "prescribed shares", the exercise price under the option is not less than the fair market value of the share at the time of the grant of the option minus the amount paid to acquire the option, if any, and the employee deals at arm's length with the employer; or

- the shares are CCPC shares and they (or shares they are exchanged for) are held for at least two years prior to their disposition.

Addition to adjusted cost base of share

The full amount of the stock option benefit (before the one-half deduction) is added to the adjusted cost base of the acquired share, to ensure that the amount of the benefit will not be subject to further taxation when the share is sold. However, the sale of the share may generate a capital gain or capital loss.

Example

In January 2009, John was granted an employee stock option which gave him the option to buy 1,000 shares in his employer at a price of $10 per share. He exercised the option in September 2009 when the shares were worth $12 per share, which generated a stock option benefit of $2 per share. He sold the shares in November 2009 for $13 a share.

The $2 benefit is added to the cost of his shares, which becomes $12 per share. Therefore, on the sale of the shares, he has a capital gain of $1 per share ($13 minus $12), or a taxable capital gain of $0.50 per share.

On the other hand, if he sold the shares for $11 per share, he would have a capital loss of $1 per share, or an allowable capital loss of $0.50 per share. Unfortunately, the allowable capital loss could be deducted only against John's taxable capital gains, if any, and not the stock option benefit.

Further deduction for certain charitable donations

If the share acquired under the employee stock option is listed on a designated stock exchange and the share is donated to a registered charity (or certain other "qualified donees"), the other one-half of the benefit may be deducted in computing taxable income, as long as the "regular" one-half deduction discussed above applies. As a result, you will have a nil net inclusion in taxable income in respect of the benefit. For this treatment to apply, the donation must be made within 30 days of acquiring the share and in the same year in which it was acquired.

Furthermore, although the donation is deemed to be made for fair market value proceeds, any capital gain on the share will be deemed to be nil. Accordingly, you will pay no tax in respect of the stock option benefit or a capital gain. However, the fair market value of the share at the time of the donation will qualify for the charitable donations tax credit.

The above treatment can also apply to mutual fund units or shares issued by a mutual fund employer to its employees under an employee option agreement.

ADOPTION TAX CREDIT

Have you adopted a child or are you thinking of adopting? If so, you may want to be aware of the adoption tax credit, which has been available since 2005 to help couples defray the cost of adopting minor children (under 18 years of age at the time the adoption order is issued).

For 2009, the adoption expense credit is 15% of "eligible adoption expenses", on a maximum of $10,909 ($10,975 for 2010) of expenses per adopted child.

The adoption credit can be claimed by one parent or alternatively split between two adoptive parents. However, if both parents make a claim, the combined expenses claimed for the adopted child cannot exceed the maximum $10,975 amount (for the 2010 year).

For the purposes of the credit, "eligible adoption expenses" include:

- fees paid to an adoption agency licensed by a provincial government;
- court, legal and administrative expenses related to an adoption order in respect of the child;
- reasonable and necessary travel and living expenses for the child and the adoptive parents;
- document translation fees;
- mandatory fees paid to a foreign institution;
- mandatory expenses paid in respect of the immigration of the child; and
- any other reasonable expenses required by a provincial government or an adoption agency licensed by a provincial government.

The credit is claimed in the taxation year in which the "adoption period" in respect of the adopted child ends. Generally, the adoption period ends at the later of the time at which the adoption order is issued by, or recognized by, a government in Canada, and the time at which the child begins to permanently reside with the adoptive parent.

The credit can be claimed in respect of both domestic and foreign adoptions.

PREPAID BUSINESS INCOME

If you carry on a business, you are normally required to follow the accrual method in computing your business income for income tax purposes. In very general terms, and subject to certain exceptions, income is included once you have billed and expenses are deductible once they are payable.

However, if you receive an amount in one taxation year that is on account of goods to be delivered or services to be rendered in a later taxation year, a specific provision of the Income Tax Act requires you to include that amount in income in the year of receipt.

Fortunately, you can deduct as a reserve all or a portion of the amount received to the extent that it relates to a subsequent year. The reserve deducted in one year is added back to income in the following year, and if the goods or services are to be provided after that following year, the reserve can be claimed again, up until the year in which the goods or services are actually provided. The reserve effectively allows you to "match" the income inclusion to the year in which you incur the expenses in providing the goods or services.

Since the reserve is optional, it gives taxpayers flexibility in terms of the timing of the inclusion of prepaid income. For example, you might choose not to deduct the reserve if you have losses that can offset the current inclusion of the prepaid income, or if your marginal tax rate in the year of receipt is lower than your anticipated tax rate in the year in which the goods or services will be provided. However, in most other situations, it will be beneficial to claim the reserve and defer the income inclusion. That is, owing to the time value of money, paying tax later is better than paying the same amount of tax now.

MOVING EXPENSES: CRA RATES FOR MEALS AND TRAVEL

In general terms, if you move in order carry on employment or a business, you can deduct your qualifying moving expenses if your new residence is at least 40 kilometres closer to the new work or business location than was your former residence. The qualifying moving expenses include your meal and travel expenses incurred in the course of moving you and your family members to the new residence. They also include meal and accommodation expenses incurred near your old residence or new residence for up to 15 days (e.g. if you have moved out of your old home but your new home is not quite ready to be inhabited).

For the meal and travel expenses, you can claim your actual expenses, and if so, you should retain your receipts. However, the CRA allows an alternative "simplified method" of claiming your meal and travel costs, which involves certain flat rates which the CRA publishes annually. If you use this simplified method, you do not have to keep your receipts or even incur these costs.

The CRA recently announced the flat rates that will apply for moves that occurred in 2009. The deductible flat rate for meal costs remains at $17 per meal per person, to a maximum of $51 per day (i.e. 3 meals a day). The deductible rate for travel costs is based on the number of kilometres driven in the course of the move, and depends on the province from which the travel began. The rates for other provinces can be found at cra-gc.ca/travelcosts.

MANDATORY GST EFILING

In early January, the CRA announced that all GST registrants with annual taxable supplies (including the supplies of associated persons) in excess of $1.5-million must file their GST returns electronically. This requirement is effective July 1, 2010.

As the CRA's policy is developing in this area, please visit http://www.cra-arc.gc.ca/tx/bsnss/tpcs/gst-tps/bspsbch/rtrns/rqrmnts/menu-eng.html for the most up-to-date information.

AROUND THE COURTS

Transfer of house to taxpayer from ex-spouse was not spousal support

In order for a spousal support payment to be included in the income of the recipient and deductible for the payer, the payment must normally be, among other things, "payable on a periodic basis". However, the courts have held that a lump-sum payment made on account of arrears of spousal support, where the support itself was payable on a periodic basis, can qualify as spousal support. (That is, the "periodic" requirement relates to the "payable" nature of the support, not the actual payment.)

In the McDonough case, the taxpayer had divorced her husband, who was required to pay her spousal and child support. However, her husband fell into arrears in respect of the spousal support, and owed about $314,000 in arrears. The parties negotiated that the husband would transfer his house to the taxpayer and that she would in turn renounce her claims to the arrears. The transfer was also intended to provide some long-term financial stability for the taxpayer. The house was worth more than $500,000. The CRA assessed the taxpayer and included the $314,000 amount in her income as spousal support. The CRA took the position that the transfer of the house to the taxpayer was effectively a lump-sum payment and a portion of it, namely $314,000 of the value of house, represented the spousal support that had

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been payable on a periodic basis but had fallen into arrears.

Upon appeal to the Tax Court of Canada, the Court held in favour of the taxpayer and held that the transfer of the home was a tax-free receipt. The Court ruled that the transfer of the house was simply an alternative to the collection of the arrears.

Medical expense credit allowed for certain travel and parking costs

There are numerous medical expenses listed in the Income Tax Act that qualify for the medical expense credit. Reasonable travel expenses can qualify, if, among other things, they are in respect of travel by the patient or someone accompanying the patient to a medical facility that is at least 80 kilometres away from the patient's home, and substantially equivalent medical services are not available in the locality in which the patient lives.

In the recent Bell case, the taxpayer and his wife lived in Nanaimo, British Columbia, and the taxpayer was having hip surgery in Victoria, British Columbia, which is more than 80 kilometres from Nanaimo. The CRA allowed the couple's claim of travel expenses incurred in travelling from Nanaimo to Victoria based on the above criteria, including the fact that the taxpayer was certified as incapable of travelling without an attendant such as his wife.

However, the CRA denied the claim of travel expenses incurred by the taxpayer's wife while she was visiting him during his 18 days in the hospital – in particular, her travel expenses incurred in driving from the hotel in which she stayed to the hospital, and the parking costs at the hospital. The CRA took the position that such expenses were not part of the travel from their home to the hospital, and therefore not part of the qualifying travel expenses as described above.

However, upon appeal to the Tax Court of Canada, the CRA position was overturned. The Court felt that incidental travel expenses incurred during the patient's stay in the hospital should also qualify.

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