BUCHANAN BARRY LLP
CHARTERED ACCOUNTANTS

TAX NEWSLETTER
March 2011

- **PRE-2011 STOCK OPTIONS — ELECTION DEADLINE MAY BE MAY 2**
- **CAPITAL GAINS OR INCOME?**
- **HIGH TAXES ON MODEST EMPLOYMENT INCOME**
- **COURT CASES — WHY ARE THEY IMPORTANT?**
- **AROUND THE COURTS**
- **PERSONAL TAX SEASON IS UPON US!**

PRE-2011 STOCK OPTIONS—ELECTION DEADLINE MAY BE MAY 2

If you owned shares in a publicly-traded company that you acquired under an employee stock option plan and which then dropped in value before you sold them, you may need to know about an important filing deadline coming up.

Employee stock options are taxed as an employee benefit when you exercise the option and acquire the shares. (For shares in certain private companies, the tax generally applies only when you sell the shares.) The tax benefit is the difference between what you pay for the shares and what the shares are worth when you acquire them. In some cases there is an offsetting deduction of half of the benefit — generally if the option exercise price was no lower than the trading price at the time you received the option, and the shares are normal common shares.

Under a "deferral" rule introduced in 2000, a deferral was available on up to $100,000 of stock option benefits per year until you sold the shares. This deferral was eliminated as of March 4, 2010, by the 2010 federal Budget.

Amendments to the Income Tax Act enacted in December 2010 (new section 180.01) provide special relief where you used the deferral and the shares dropped in value after you acquired them, so that you sold them for a loss. Normally you could not use a capital loss on the shares to offset the taxable employment benefit from the stock option (because capital losses can only be used against capital gains). The new rule allows you to replace the deferred income inclusion with a deemed capital gain, which can be offset by the capital loss when you sell the shares. You have to give up any actual proceeds you made from selling the shares (the proceeds are payable as a special tax in new section 180.01), so the election is not always beneficial.

This election can be made until 2014. If you claimed the deferral and sold the shares in any year from 2000 to 2010, and had a stock option benefit that could not be offset by your capital losses on the shares, you can make this election for that past year. But **this must be done by your filing deadline for your 2010 return** to be valid**.** For most people, this is **May 2, 2011**. If you (or your spouse or common-law partner) carried on business in 2010, the deadline is **June 15, 2011**.

This election can save you a lot of money, if you had losses from selling shares you acquired under a stock option plan where you had deferred the income inclusion. Because the election was introduced so recently and the deadline for 2000-2010 is looming, it's important to look into this and make sure you don't miss filing the election on time. (Note that as of mid-February, the

CRA web site had not yet been updated with this new information.)

Note that the election can have technical side effects on your income calculations for the years in question, such as affecting your thresholds for medical expenses and charitable donations. However, amendments made to the Income Tax Act ensure that it will not affect entitlement to the GST/HST Credit, Child Tax Benefit or Working Income Tax Benefit or the "clawback" of Old Age Security.

CAPITAL GAINS OR INCOME?

Since capital gains are only half taxed, the distinction between **capital gains** and **income** is very important.

Capital property is property on which any gain is taxed as a capital gain. Only half of a capital gain is included in income in your tax return — the "taxable capital gain". Thus, the effect is that capital gains are taxed at half the rate of ordinary income such as interest or employment income.

Not all gains are capital gains. If you are in the business of buying and selling goods — for example, operating a retail store — then obviously your gains from the goods you sell are business profits, which are fully taxable, and not capital gains.

Some types of gains fall close to the line. The Income Tax Act defines the term "business" — the income from which is fully taxable — as including an "adventure in the nature of trade". This phrase has been interpreted in hundreds of reported court cases.

If what you are doing is a "business" or an "adventure in the nature of trade", then your gain will be **fully taxable** as the sale of inventory. If it is not, then your gain will be only half taxed as a capital gain. On the flip side, business *losses* are fully deductible from income, while capital losses are only half-deductible and normally only against taxable capital gains.

So how do you determine the difference between capital property and inventory? Basically it comes down to **intention**. If you buy a property with the intention of selling it, then you are considered to be in business and the gain will be fully taxed as business profit.

Real Estate

The most difficult issues usually arise with respect to **real estate**. You might build a home to live in (capital), but also with plans to sell it (inventory). You might buy land on which to develop a shopping plaza to lease out (capital), or on which to develop a subdivision of new homes that you will sell (inventory).

The Canada Revenue Agency's Interpretation Bulletin IT-218R, "Profit, Capital Gains and Losses from the Sale of Real Estate" (available at cra.gc.ca) provides the Agency's views on whether the purchase and sale of real estate will be treated as leading to business profits or capital gains. Paragraph 3 of the Bulletin sets out twelve factors that the CRA considers relevant:

(a) the taxpayer's intention with respect to the real estate at the time of its purchase;
(b) feasibility of the taxpayer's intention;
(c) geographical location and zoned use of the real estate acquired;
(d) extent to which intention carried out by the taxpayer;

(e) evidence that the taxpayer's intention changed after purchase of the real estate;
(f) the nature of the business, profession, calling or trade of the taxpayer and associates;
(g) the extent to which borrowed money was used to finance the real estate acquisition and the terms of the financing, if any, arranged;
(h) the length of time throughout which the real estate was held by the taxpayer;
(i) the existence of persons other than the taxpayer who share interests in the real estate;
(j) the nature of the occupation of the other persons referred to in (i) above as well as their stated intentions and courses of conduct;
(k) factors which motivated the sale of the real estate;
(l) evidence that the taxpayer and/or associates had dealt extensively in real estate.

In determining your intention with respect to the property, the Courts have also developed the concept of a "**secondary intention**". If you have an intention of using the property as capital property, but a secondary intention of selling it if the main intention does not pan out, then the property may be considered to be inventory and the gain fully taxable. The CRA's Interpretation Bulletin IT-459 discusses this issue. Of course, just about everyone will sell their property if the right offer comes along, so the secondary intention has to be something more than just a willingness to sell if the price is right. There is often no clear dividing line.

Principal Residence

The prospect of treating your principal residence (your home) as capital property is always attractive. Even better than the regular treatment given to capital gains, the gain on a principal residence is normally **completely exempt** from tax.

However, if you are in the **construction business**, or if you change homes often, watch out! Many small home builders have tried building a home, moving in, then selling it and moving on to another home, repeating the process a few times. If you do this, the CRA will determine that you do not have an exempt capital gain after all. Instead, you are treating each home as "**inventory**" — even though you lived in it — and you will be fully taxed on the gain as business profit. And if you haven't kept all of your receipts for the costs of construction, you might have a hard time proving that your profit was less than the CRA claims it was!

(To make matters worse, if this happens you will also be required to pay GST or HST on the entire value of the new home, including the land, as of the date you moved in. As well, unless you have kept receipts showing GST/HST paid on construction costs, your offsetting input tax credits will likely be denied. Quite a number of small home builders have taken such assessments to the Tax Court of Canada and have lost, on both the GST and the principal residence issues.)

Note that real estate records transfer are permanent and easily available to CRA auditors once they start looking, and in many cases there will be no statute of limitations — e.g. because your return had a misrepresentation attributable to "carelessness

or neglect", or you didn't file a GST return. **The CRA has been known to go after builders even 10, 15 or 20 years after the fact** and assess them for tax, GST, penalties and vast amounts of interest that has accrued over the years. If you are in this situation, consider making a Voluntary Disclosure before the CRA comes calling.

Shares

When it comes to **shares of corporations** and other securities, such as bonds and mutual fund units, the CRA generally accepts that most people hold such securities as capital property, even where the shares are junior stocks that are unlikely to pay a dividend any time soon. However, if you actively trade, buying and selling shares on a regular basis and holding them for only short periods, you might be found to be in business, so that your gains would be fully taxed. (If you have losses, this will be to your advantage.)

You can avoid this situation, with respect to shares in Canadian companies, by filing a "Canadian securities election" (subsection 39(4) of the Income Tax Act), on Form T123, with your tax return. Once you make this election, all Canadian securities you hold are deemed to be capital property, **forever**. (In other words, if you have losses from very active trading in a later year, those losses will be capital losses that have limited use, rather than business losses that you can deduct against other income.)

Note that the Canadian securities election does not apply to all Canadian shares. There is an exclusion for "prescribed shares", listed in section 6200 of the Income Tax Regulations. These include:

- private corporation shares whose value is primarily attributable to real property or resource property;
- debt to a person or corporation with whom you do not (or did not) deal at arm's length;
- shares or debt acquired from a person with whom you did not deal at arm's length (this would include shares you inherited from a deceased family member);
- exploration and development shares;
- shares or debt substituted for any of the above.

HIGH TAXES ON MODEST EMPLOYMENT INCOME

Taxpayers with taxable income of up to about $40,000 pay only 15% federal tax on this level of income (with the first $10,000 or so effectively exempt), plus provincial tax that brings the rate up to about 20-25%, varying by province.

In addition, however, for employees there are substantial employment taxes that increase the tax rate significantly.

Employment Insurance (EI) applies to annual employment income up to $44,200 (for 2011). Employees pay **1.78% EI premiums** on that amount of income in 2011, and this is taken off their paycheque as source deductions. The maximum is $786.76. The employer also has to pay an additional 2.492% "employer's premium" on the same first $44,200 of each employee's income. (The rates for Quebec are somewhat different.)

As well, Canada Pension Plan (CPP) mandatory contributions apply to employment income up to $48,300 for 2011 (the first $3,500 is exempt). Employees pay

4.95% CPP contributions on that amount of income. Again, this is taken off their paycheque as source deductions. The maximum is $2,217.60. The employer also has to pay a matching amount as the "employer's contribution. (In Quebec, the same rates apply for the Quebec Pension Plan.)

For **self-employed** people, there are no EI premiums (since they are not eligible for EI benefits), unless they opt into the system permanently under new rules recently introduced. However, CPP contributions are double — they have to pay both the "employee's" and the "employer's" portions for themselves — so the rate is **9.9%** on the first $48,300 (again, with an exemption for the first $3,500). The maximum is $4,435.20.

For employees with modest incomes, the extra EI premiums and CPP contributions of more than 6.7% add significantly to the 15% federal income tax rate!

COURT CASES — WHY ARE THEY IMPORTANT?

We regularly give you news about tax cases decided in the Courts. Why are they important?

First, you need to understand the legal basis on which our tax system operates. Tax is imposed by the Income Tax Act, which is legislation passed by Parliament. The Department of Finance drafts and proposes changes to the Act (including in the annual federal Budget), but the changes do not become law until Parliament passes them.

But the Income Tax Act is very complex — about 2,000 pages of difficult and sometimes unintelligible language. It takes a lot of interpretation, and its application in many situations is unclear.

The Canada Revenue Agency publishes extensive materials to help us interpret the Act. Most of this material can be found on its Web site, at cra.gc.ca. CRA publications include Interpretation Bulletins, Information Circulars, guides, pamphlets and other documents. These can be used by taxpayers and their advisers in deciding how the Income Tax Act will apply to any given situation. They are also used by CRA assessors, auditors and appeals officers in deciding how to assess or reassess taxpayers in any given situation.

However, the CRA **does not make the law**. As noted above, the law is made by Parliament. The CRA merely *interprets* the law. **Its interpretations are not legally binding.** There are many situations where taxpayers (and their advisors) disagree with CRA interpretations. (See the *Genier* case discussed under "Around the Courts" below for an example.)

This is where the Courts come in. Any taxpayer who disagrees with an assessment or reassessment can file a Notice of Objection within 90 days of the date on the Notice of (Re)Assessment. The matter is then considered by a CRA appeals officer; this is a purely administrative process, very informal, with telephone discussions and correspondence but no formal hearing.

If after discussing the case with the taxpayer or the taxpayer's representative, the appeals officer believes that the assessment was correctly based on the rules in Income Tax Act, the appeals officer will "confirm" the assessment.

BUCHANAN BARRY LLP
CHARTERED ACCOUNTANTS

At this point, a taxpayer who still wants the assessment changed has to go to Court. Appeals of income tax (and GST) assessments are filed in the **Tax Court of Canada**.

The Tax Court of Canada is an excellent Court, well run, efficient, humane and friendly, especially to taxpayers who do not have a lawyer and are appealing a relatively modest amount of tax. Where the amount of federal tax does not exceed $12,000 (likely to be changed to $25,000 soon), an income tax appeal can be filed under the Tax Court's "Informal Procedure". (The same goes for any GST appeal, regardless of the amount at stake, though a $25,000 limit may be introduced.) The process is still a formal Court hearing that follows the rules of Court, but the judge is able to bend the rules of evidence and to be more flexible in reaching his or her decision. At the end of the day, however, the decision must still be based on the rules in the Income Tax Act, and the Tax Court will *not* allow a taxpayer's appeal merely because the result is otherwise unfair. There has to be a **legal basis in the Act** for allowing the appeal.

For larger appeals, the Court's General Procedure is used. While individual taxpayers are allowed to represent themselves, it is highly advisable to retain a tax litigation lawyer to deal with the procedures, which include formal pleadings, Lists of Documents, discoveries, Status Hearings and various other procedural steps, as well as organizing the evidence and making the correct legal arguments.

If you are not happy with the Tax Court's decision, you can appeal to the Federal Court of Appeal, but normally only on a question of law. Any findings of fact reached by the Tax Court are binding (unless you can show that no judge could possibly have reached that conclusion based on the evidence presented — a "palpable and overriding error"). You are not normally allowed to bring any new evidence to the Federal Court of Appeal — the decision is based on the written record of the evidence at the Tax Court trial.

If you win at the Tax Court, the CRA can appeal to the Federal Court of Appeal, under the same rules as above.

From the Federal Court of Appeal, an appeal is possible to the Supreme Court of Canada, but only with "leave" of that Court. Either side can file an "Application for leave to appeal". Leave is granted only when the issue is of "national importance". Only a very few tax cases a year are heard by the Supreme Court.

AROUND THE COURTS

Business shutdown costs are deductible

In the recent *Genier* case, Mrs. Genier opened a retirement home for seniors in Cochrane, in northern Ontario. The business did not succeed — apparently due to "whispered rumours" because Mrs. Genier also ran a funeral home!

With only three tenants for 14 rooms, Mrs. Genier shut down the business in 2001 and listed the property for sale. The property was difficult to sell; she started with an asking price of $450,000, and despite her actively trying to sell it for years and reducing the price periodically, it still had not sold by June 2010, though there was a conditional offer for $175,000 at that time.

Mrs. Genier claimed expenses in the business during these years, as the

BUCHANAN BARRY LLP
CHARTERED ACCOUNTANTS

property still cost money to hold and maintain (interest, property taxes and utilities). She also rented out space in the property a few times, when she could. This led to annual claims for businesses losses of $25,000 to $30,000.
The CRA disallowed the losses for 2003, 2004 and 2005, and Mrs. Genier appealed to the Tax Court of Canada. (Presumably her later losses were also disallowed, but they were not included in this appeal.)

The Tax Court judge allowed Mrs. Genier's appeal, and excoriated the CRA for not allowing her the losses.

PERSONAL TAX SEASON IS UPON US!

If you have not already done so, it is now time to assemble your personal income tax information for preparation of your personal tax return. Personal tax returns are due May 2, 2011 (because April 30 falls on a weekend), unless you or your spouse are self-employed, in which case the return must be filed by June 15, 2011 (although the tax is due April 30, 2011).

If you expect to have a tax balance owing, but do not have the funds to pay the tax by April 30, you should still file your return on time. Late-filed returns are subject to a penalty calculated by reference to the balance owing. If you file on time, you will not be subject to a penalty – rather you will be subject only to interest on the outstanding tax debt.

Our Personal Tax Organizer is available to help you get organized. If you have not received a copy, it is located on our website at http://www.buchananbarry.ca/resource-centre/rates-and-tools.html. Alternatively please contact our offices and we will send you a copy.

* * * * * *

Buchanan Barry LLP has served the Calgary business and non-profit community since 1960. We are a full-service chartered accounting firm providing accounting, audit, assurance, advisory, tax and valuation services to clients in the oil and gas sector, the service industry, real estate, the retail and wholesale trade, the manufacturing industry, agriculture, the non-profit sector and professionals.

Should you have any questions regarding the foregoing or other tax matters, please contact our tax group at (403) 262-2116.

Buchanan Barry LLP
Chartered Accountants
800, 840 – 6th Avenue SW
Calgary, Alberta T2P 3E5

Tel (403) 262-2116
Fax (403) 265-0845
www.buchananbarry.ca

This letter summarizes recent tax developments and tax planning opportunities. We recommend that you consult with an expert before embarking on any of the opportunities in this letter, which may not be appropriate to your own specific circumstances.