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TAX LETTER

November 2012

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CHANGES TO EMPLOYEE PROFIT SHARING PLAN RULES

In general terms, an employee profit sharing plan (EPSP) is a plan under which an employer shares some of its profits with its employees.

Under an EPSP arrangement, the employer contributes some of its profits to a trust which invests the funds for the employees' benefit. The employer's contributions to the trust are deductible in computing the employer's income. The trust must allocate each year to its employees the employer contributions, investment income from the property, capital gains and losses, and certain other amounts. The employees include these allocated amounts in their income.

The Department of Finance and Canada Revenue Agency have been concerned that EPSPs of some private businesses and corporations have been used to divert business profits to members of the business owners' families to reduce or defer tax on these profits.

As a result, in its 2012 budget, the Department of Finance introduced a new penalty tax on a specified employee's "excess EPSP amount". This amount equals the employer's contributions in a year to the EPSP that are allocated in the year to the specified employee, in excess of 20% of the employee's gross income from employment for the year (not including "regular" EPSP allocated amounts included in income, or stock option benefits).

A "specified employee" includes an employee who does not deal at arm's length with the employer or who owns at least 10% of the shares of any class of the corporate employer.

The penalty tax is payable by the specified employee.

The penalty tax is imposed at the top federal rate of 29% plus the top provincial rate for the province of the employee's residence (other than Quebec, which administers its own provincial income tax and thus can choose to impose a parallel penalty tax). If the employee is not resident in any province or territory, the second rate is 14%. The excess EPSP amount is deducted in computing the employee's income so as to prevent double taxation of that amount (since otherwise it would also be taxed as regular income).

The new penalty tax applies to contributions made after March 28, 2012. However, in the case of contributions to an EPSP pursuant to an agreement entered into before March 29, 2012, the tax applies only to contributions made beginning in 2013.

TRANSFERRING PROPERTY TO YOUR CORPORATION

Special rules in the Income Tax Act allow you to transfer property to your corporation on a tax-free basis. This is called a "section 85 rollover". However, certain conditions apply.

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First, in consideration for the property, you must receive at least one share in the corporation.

You must make a joint election with the corporation. The election must be filed with the Canada Revenue Agency (CRA) by the earlier of your tax-filing due date and that of the corporation for the taxation year of the transfer.

You must specify an "elected amount" in the election, which will be your proceeds of disposition on the property. Therefore, if you elect an amount equal to your cost, there will be no gain or tax payable on the transfer. The elected amount also becomes the corporation's cost of the property.

The elected amount is subject to the following conditions:

- It cannot exceed the fair market value of the property transferred to the corporation.
- It cannot be lower than the fair market value of any non-share consideration (e.g., cash or debt) that you receive back from the corporation.
- It cannot be lower than the lesser of your tax cost of the property and its fair market value.

The transferred property must be "eligible property", which includes the following:

- Capital property (other than land owned by a non-resident – but see below)
- Eligible capital property (e.g. goodwill, customer lists)
- Inventory other than land
- Land that is capital property owned by a non-resident if it is used by the non-resident in a business carried on in Canada; however, the non-resident must transfer all or substantially of the business assets (generally, 90% or more in value) to the corporation.

Your cost of any non-share consideration received back from the corporation will be its fair market value. Your cost of the shares received from the corporation will equal the elected amount minus the value of any non-share consideration received from the corporation.

Example

You transfer land (which is capital property to you) to a corporation in exchange for 100 common shares and a promissory note of $10,000. Your cost of the land was $50,000 and its fair market value is $200,000.

Assuming you elect $50,000, you will have no gain or tax payable on the transfer. The corporation's cost of the land will be $50,000, for purposes of calculating any gain or loss when it eventually sells the property.

Your cost of the promissory note received from the corporation will be $10,000. Your cost of the 100 common shares will be $40,000 (the $50,000 elected amount minus the $10,000 promissory note, which is non-share consideration).

As indicated earlier, the elected amount does not have to equal your cost of the transferred property. For example, if you have some capital losses available from the current year or past years, you might elect an amount that is higher than your cost so as to generate a gain on the transfer to your corporation. You could then use the accrued losses to offset the gain. This would result in a higher cost base for the corporation on the property and the shares you receive on the transfer.

Unfortunately, in many cases it does not make sense to elect an amount that generates a loss. Your loss will usually be denied (or at least deferred) under certain "stop-loss" rules in the Income Tax Act, if you and the corporation are "affiliated" (e.g., you or your spouse controls the corporation).

ALLOWABLE BUSINESS INVESTMENT LOSSES

A business investment loss is a capital loss incurred on certain dispositions of debt or shares, as described below. One-half of a business investment loss is an allowable business investment loss (ABIL), which, unlike ordinary allowable capital losses, is deductible against all sources of income and not just taxable capital gains.

A business investment loss includes a loss from the disposition to an arm's length person of

- a share of the capital stock of a small business corporation, or
- debt in a Canadian-controlled private corporation (CCPC) that is
  - o a small business corporation,
  - o bankrupt and that was a small business corporation at the time it became a bankrupt, or
  - o a corporation that was insolvent and a small business corporation at the time a winding-up order was made in respect of the corporation.

A CCPC is generally a Canadian private corporation that is not controlled by non-residents or public corporations or any combination thereof.

In addition to losses incurred on actual dispositions, a loss on a "deemed disposition" of the above-noted debt or shares can qualify as a business investment loss. A deemed disposition will occur if you make an election in your tax return for a year in respect of

- a debt owing to you at the end of a taxation year that is a "bad debt" (basically meaning that it is uncollectible) in the year, or

- a share in a corporation where
  - o the corporation has during the year become a bankrupt, or
  - o the corporation is insolvent and being wound up, or
  - o the corporation is insolvent; neither the corporation nor a corporation controlled by it carries on business; the fair market value of the share is nil; and it is reasonable to expect that the corporation will be dissolved or wound up and will not commence to carry on business.

As noted, an ABIL can be used to offset all sources of income in a year (e.g., employment income or business income). If there are unused ABILs in a year, they can be carried back 3 years or forward 10 years to offset all sources of income in those years (for losses incurred in taxation years that end before March 23, 2004, the carry-forward period is 7 years). After the 10th forward year (or 7th, as the case may be), the ABIL becomes an ordinary allowable capital loss and therefore deductible only against taxable capital gains.

ABIL reduced by capital gains exemption previously claimed

The amount of your business investment loss is reduced to the extent that you sheltered capital gains in a previous year under the capital gains exemption. That exemption allows you to receive tax-free capital gains of up to $750,000 ($375,000 taxable capital gains) during your lifetime from disposition of certain types of property such as qualified small business corporation shares. You might also have used the more general $100,000 exemption which was available until 1994.

Although the business investment loss is reduced in this manner, the reduced loss remains a capital loss, one-half of which is an allowable capital loss that can be deducted against taxable capital gains.

EMPLOYER-PAID TUITION AND RELATED COSTS

If your employer pays for your tuition or related costs of education, there normally will be no taxable benefit if the education primarily benefits your employer. However, if the education primarily benefits you, there will be a taxable benefit included in your income.

In this regard, the CRA sets out the following general guidelines (Income Tax Technical News No. 13).

Specific Employer-Related Training

If you take courses for maintenance or upgrading of employer-related skills, where it is reasonable to assume that you will resume your employment for a reasonable period of time after completion of the courses, the payment by your employer for the course will be non-taxable.

In this regard, fees and other associated costs such as meals, travel and accommodation that are paid for courses leading to a degree, diploma or certificate in a field related to your current or potential future responsibilities in the employer's business will not result in a taxable benefit.

General Employment-Related Training

Payments for other business-related courses, although not directly related to the employer's business, will generally be considered non-taxable.

Examples include courses on stress management, employment equity, first-aid skills and language skills. In-house training will not normally be considered a taxable benefit.

Personal Interest Training

Employer payments for courses for personal interest or technical skills that are not related to the employer's business are taxable benefits.

CAPITAL COST ALLOWANCE (TAX DEPRECIATION)

If you carry on a business or earn rental income from property, you are likely aware that you can deduct capital cost allowance (CCA) in respect of depreciable property used to earn that income. The CCA is the tax version of depreciation or amortization, and it takes precedence over financial accounting depreciation, which is not allowed for income tax purposes.

Depreciable property includes tangible items such as machinery and equipment, furniture, electronic equipment, motor vehicles, and buildings. It also includes certain intangible properties such as patents and licenses. It does not include land.
Each depreciable property goes into a specific “class” set out in the Income Tax Act. You can then claim CCA (deduct it from your business or rental income) on the property in the class. In most cases, there is a set percentage assigned to the class, and that is the maximum amount you can deduct in respect of the class (you can always choose to deduct less or nothing, deferring the claim to later years).

The amount you deduct each year reduces the cost “pool” in the class, which is technically called the undepreciated capital cost (UCC) of the class. Every time you add a property to the class, the cost of the property is added to the UCC, and every time you sell a property of the class, the proceeds of disposition reduce the UCC. The CCA you can claim for a taxation year is, in most cases, a percentage of your UCC pool for each class at the end of the year.

In most cases when you acquire or add a property of a class, only half of the net additions to the class are eligible for the CCA deduction in the year of acquisition.

The half-year rule applies regardless of when you acquire the property in the year. Therefore, other things being equal, it often makes sense to acquire depreciable property late in the year rather than early in the year, because the CCA deduction is the same.

Recapture

If you sell a property in a class and the proceeds of disposition exceed your UCC of the class before the disposition, such that your UCC is negative at year end, you will have "recapture". You are required to include the recapture (the negative amount) in your income for the year. The recapture essentially means that in previous years your CCA deductions exceeded the decrease in the economic value of the property, such that upon its sale you realized an amount greater than the UCC of the class.

Example of recapture

You had one property in a class used in your business. Its original cost was $10,000, and the UCC at the beginning of the year was $7,000, meaning that you had previously deducted $3,000 in CCA. You sell the property for $8,000, and no other properties are left in the class at year end.

In this case, you will have $1,000 of recapture ($7,000 − $8,000 is the negative amount), which will be included in your income for the year. Effectively, you previously depreciated the property down to a UCC of $7,000, which turned out to be less than its actual economic value of $8,000, hence the $1,000 income inclusion.

If, in the above example, you sold the property for more than its original cost, say $12,000, the $2,000 excess over that original cost would be a capital gain and not recapture. One-half of that gain would be a taxable capital gain. However, you would still have recapture of $3,000, being the difference between your original cost and the UCC.

Terminal loss

In the converse situation, where you sell a property and the proceeds of disposition are less than the UCC of the class, you will have a terminal loss if there are no properties left in the class at year end. In this case, the terminal loss essentially means that in previous years your CCA deductions were less than the decrease in the economic value of the property, such that upon its sale you realized an amount less than the UCC of the class. The terminal loss is fully deducted in your computing your income.

Example of terminal loss

You had one property in a class used in your business. Its original cost was $10,000, and the UCC at the beginning of the year was $7,000. You sell the property for $6,000, and no other properties are left in the class at year end.

In this case, you will have a $1,000 terminal loss ($7,000 − $6,000). It is fully deductible in computing your business income for the year.

EMPLOYEE GIFTS AND AWARDS

If you receive a gift or award from your employer, it may be tax-free. The CRA has an administrative position that allows tax-free gifts or awards in the following circumstances.

First, it must be a non-cash gift or award. Cash or near-cash gifts or awards such as gift certificates are normally taxable.

The CRA provides that the first $500 of non-cash gifts or awards in a year is not included in your income. Any excess above $500 will be taxed (and also reported on your T4 and subject to payroll withholding at source).

In addition, the CRA provides that a separate non-cash long service or anniversary award will be non-taxable to the extent its total value is $500 or less. The value in excess of $500 will be taxable. In order to qualify as non-taxable, the award must be for at least five years of service, or five years must have passed since the last award was given to the employee.

The CRA policy does not apply to non-arm's length employees or persons related to non-arm's length employees.

Lastly, the CRA policy provides that items of an immaterial or nominal value "such as coffee, tea, T-shirts with employer logos, mugs, plaques, trophies etc." will not be considered a taxable benefit to employees.

The CRA provides the following example (we have made slight modifications).

Jeffrey's employer has given him the following gifts and awards during the year:

T-shirt with employer logo	$15 cost
Birthday gift	$75 gift certificate
Reward for meeting sales performance target	$400 weekend holiday
10-year anniversary award	$275 print
Wedding gift	$300 crystal vase
Innovation and excellence award	$250 Toronto Blue Jay tickets

Tax consequences:

The T-shirt is tax-free as it is of an immaterial/nominal value.

The gift certificate is a near-cash gift, so it is included in Jeffrey’s income.

The $400 weekend holiday for meeting the sales performance target is not eligible for the gift and award policy, and therefore is fully included in his income.

The $275 10-year anniversary award is eligible under the long service/anniversary award policy and therefore is tax-free.

The total value of the wedding and innovation and excellence gifts is $550. Jeffrey will include $50 in income ($550 – $500). The employer will be required to report this amount on Jeffrey's T4.

AROUND THE COURTS

Hot tub for severely disabled person not eligible for medical expense credit

In the recent *Johnston* case, the taxpayers attempted to claim a medical expense tax credit for the cost of a hot tub used as a hydrotherapy pool for their adult daughter who was severely disabled with cerebral palsy-related spastic quadriplegia and other conditions. Their daughter’s doctors recommended daily hydrotherapy in a hot tub pool to assist with her muscle stimulation and relaxation, breathing and blood circulation, to relieve her pain and suffering, and to enhance her muscle mobility and flexibility. It was accepted that the use of the hot tub greatly improved the daughter’s health and mobility.

However, the CRA denied the claim and on appeal, the Tax Court upheld the CRA decision. The Tax Court judge ruled that the hot tub was of the type that ordinary, healthy persons would normally use, and so it did not qualify for the credit. Therefore specially designed tubs or structures could qualify.

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