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PERSONAL TAX

55(1)

MEDICAL EXPENSE - NURSING HOME

The Income Tax Act permits a *medical expense* for the full-time care in a *nursing home* of a patient who has been *certified* by a medical practitioner to be a person who, by reason of lack of normal mental capacity, is and in the foreseeable future will continue to be, dependent on others for the patient's personal needs and care. This extends to *physical or mental* handicaps where special equipment, facilities or personnel are required.



However, in a *Federal Court of Appeal* case, the Court did *not accept* the doctor's certificate which simply said that:

"This person requires a supervised setting since January 31, 1995 due to medical illness. This person requires a twenty-four hour companion."

The certificate *must at least specify* the mental or physical handicap and the equipment, facilities or personnel that the patient requires in order to obtain the care or training needed to deal with the handicap.

In a *Tax Court* case, the taxpayer was *permitted* a medical expense for the *total occupancy charges* of \$26,009 paid to a

retirement home in the 1998 taxation year. CCRA had disallowed the medical expenses for a few reasons including the fact that it was a retirement home, not a nursing home.

In *allowing* the medical expense the Court noted that:

1. A *medical doctor certificate* explaining the taxpayer's progressively worsening medical problems was presented to the Court.
2. This retirement home *provides*, among other things, 24 hour emergency response, medication supervision, bathing and hygiene, regular nutritionally balanced meals, mobility assistance, a nurse call system and a staffed nursing station.
3. The taxpayer *required* the facilities and personnel because of her special needs.

INTEREST ON STUDENT LOANS

In a *Technical Interpretation*, CCRA note that to obtain a tax credit for *interest on a student loan*, the loan must be made under the Canada Student Loans Act, the Canada Student Financial Assistance Act or a law of a province governing the granting of financial assistance to students at the post-secondary level. Once an eligible loan is *replaced* with a new "ineligible" loan, the interest is *not eligible* for the tax credit.

DISABILITY TAX CREDIT (DTC)

In a *Tax Court* case, the Court permitted a

IN THIS ISSUE

PERSONAL TAX
EMPLOYMENT INCOME
BUSINESS INCOME
CAPITAL GAINS
MARRIAGE BREAKDOWN
REGISTERED RETIREMENT SAVINGS PLAN (RRSP)
CHARITABLE DONATIONS
FARMING
GST
DID YOU KNOW

DTC for the taxpayer's two daughters who had *significant food allergies* which required *time-consuming* preparation of special diets and the use of an Epi Pen syringe and a syringe of glucagon.

The Court permitted the DTCs because a person's activities of daily living are *markedly restricted* if the person requires an *inordinate amount of time* to prepare special food.

Also, in another *Tax Court* case, the Court permitted a *DTC* for a person suffering from *celiac disease* - no cure is available and the only control/treatment is a specific *gluten-free diet*.

The Court noted that the taxpayer was *markedly restricted* in a basic activity of *daily living* - feeding oneself. The prepara-

Tax Tips & Traps

ration of gluten-free meals involves *additional time* expended including label reading, checking with manufacturers to ensure no cross-contamination, adapting recipes, separation of products and additional preparation and cooking time. This constitutes an *inordinate amount of time* to feed oneself and qualifies for the DTC.

EMPLOYMENT INCOME

55(2)

EMPLOYER-PROVIDED COMPUTERS AND INTERNET ACCESS

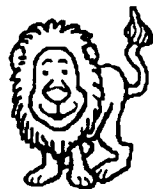
In an *Advance Income Tax Ruling*, CCRA Ruled that the provision of *computer and internet services* to an employee, where the primary beneficiary is the company, would *not* be a *taxable benefit* to the employee.

In this Ruling, the company is providing a *computer, a printer and unlimited internet access* to employees to achieve its goal of company-wide computer literacy and to accelerate the technological capabilities of its employees, develop their computer skills, link them closer to the customers and open a new communicational channel with its employees. However, each participating employee must pay a *nominal fee* to cover their incidental *personal use*.

Other aspects of the policy include that where an employee *leaves the company* before the end of a prescribed period, they must keep the hardware and software and make *pro-rata payments* for the *full cost* of the computer and internet access fees. However, after the period, the employee will have *unrestricted ownership* of the computer.

PHANTOM STOCK PLAN

There are a number of *Advance Income Tax*



Tax Tips & Traps

Rulings where CCRA concludes that *directors' fees* paid in the form of "*deferred share units*" would *not be taxable* until cash is received for the units - usually on ceasing to be a director. For example, in one case, each director has a right to be a member of the plan and receive his/her annual retainer/fee either as cash, one-half in deferred share units and one-half in cash or, entirely in deferred share units.

A deferred share unit is a *unit equivalent* to the value of a common share of the corporation. The purpose of the plan is to promote a greater alignment of interest between the directors and the shareholders through stock appreciation.

In another *Ruling*, the *deferred share unit plan* was used by a *public corporation* to provide *bonuses* to certain of its *officers and key employees* so as to attract and retain talented individuals and to promote a greater alignment of interest between these employees and the shareholders.

Again, tax is not payable until cash is paid on the deferred share unit at which time the employee will be required to include this amount as employment income.

EMPLOYEE STOCK OPTIONS

GENERAL

Under the Income Tax Act, an employee who acquires a share under an *employee stock option agreement* is deemed to have received, in the year the security is acquired, a *benefit* from employment equal to the excess of the fair market value of the security over the amount paid.

CANADIAN CONTROLLED PRIVATE CORPORATION (CCPC)

However, an *exception* provides that where the share is acquired under an option granted to an arm's length employee of a *CCPC*, the employment benefit is reported in the year the employee *disposes* of the security if the share is held for more

than two years.

PUBLICLY-TRADED SECURITY

Another *exception* provides that where an employee acquires a security after *February 27, 2000* under an option granted by a corporation (*other than a CCPC*) or by a mutual fund trust, the employment benefit is reported in the year the employee *disposes* of the security.

Some of the features include:

1. This deferral is available only on shares listed on a Canadian or foreign prescribed *stock exchange*.
2. The amount paid by the employee to acquire the security must not be less than the *fair market value* of the share when the option was granted and, the employee must deal at arm's length, immediately after the option was granted, with the employer, the entity that granted the option, and the entity whose securities could be acquired.
3. If the security is a share, it must be an ordinary *common share*.
4. The deferral is not available if the employee was, immediately after the option was granted, a specified shareholder (a *10% share ownership* of any class test) of the employer, the corporation that granted the option or the corporation whose shares could be acquired under the option.
5. The deferral is subject to an *annual limit of \$100,000*.
6. The employee must *file an election with the entity* that is involved in the option agreement.

For example, in 2001 Mr. J exercises an option to acquire a share of the capital stock of his employer. The exercise price is \$10, which was the fair market value of the share when the option was granted. At the time of acquisition, the share is worth \$100.

Mr. J files an election to defer recognition of the \$90 employment benefit. Mr. J sells the share in 2003, when the share is worth \$300. On Mr. J's T4 Slip for 2001, the employer just makes a note of the *deferred* employment benefit of \$90 (\$100 - \$10).

In filing his tax return for 2003, Mr. J actually reports the \$90 benefit as employment income (subject to a \$45 deduction in computing taxable income), as well as the taxable capital gain of \$100 (\$300 - (\$10 + \$90) @ 50%).

EMPLOYER-PROVIDED PARKING

In a *Technical Interpretation*, CCRA notes that there is *no taxable benefit* when the employer provides employees with *free parking* and the employees are *regularly required to use* their vehicles in their *employment*.

This is consistent with a *Tax Court* case which found that the *employer* was the *primary beneficiary* of the benefits derived because the employees were required to use their vehicles for business purposes.

BUSINESS INCOME

55(3)

RESERVE ALLOWED

The Income Tax Act permits a *reserve* deduction in respect of *goods and services* that have to be delivered *after the year end* related to business sales. However, this does not include a reserve in respect of guarantees, indemnities or warranties.

In a *Tax Court* case, the taxpayer provided an extended power train warranty (five years or 5,000 hours) on new graders. However, the taxpayer also *agreed to carry out*, on a semi-annual basis, an inspection of the graders and *deducted a reserve* based on costs of \$5,000 per grader

per year to do these inspections.

The Court *permitted* the estimated costs as a *reserve* because this did not constitute a warranty, indemnity or a guarantee. Also, the estimated cost of \$5,000 per grader was reasonable.

PRIVATE HEALTH SERVICES PLAN (PHSP) - PROPRIETORSHIPS

In a *Technical Interpretation*, CCRA note that the Income Tax Act provides a deduction for *PHSP* premiums payable by a *proprietor* in respect of himself/herself, a spouse and members of the household.

Exceptions to the normal \$1,500/yr./adult and \$750/yr./child deduction apply where the business *employs* one or more persons on a *full-time* basis, each of whom has accumulated three months of service and deals at arm's length with the proprietor. The exceptions are based on "equivalent coverage" for the persons to whom *coverage is extended*. This applies where the PHSP has been "*extended* to a particular employee" regardless of whether or not the employee chooses to accept the coverage. The various exceptions are complicated.

Also, a deduction is only *allowed* if the individual's *business income* in the current or preceding year *exceeds 50%* of the total income for that year or, if the income from *non-business sources* in the current or preceding year does *not exceed \$10,000*.

LEASES

On June 14, 2001, CCRA *cancelled Interpretation Bulletin IT-233R*, Lease-Option Agreements; Sale-Leaseback Agreements. CCRA note that the IT was intended to curb abuses in *leases* where the *substance* of the transaction was in



effect a *sale*. However, the Supreme Court recently ruled that the *economic realities cannot be* used to *recharacterize* the bona fide *legal* relationships. Unless there is a sham, the taxpayer's legal relationships must be respected. Thus, generally, and subject to the "*General Anti-Avoidance Rule*" (*GAAR*), *recharacterization* is permissible *only if* the label attached by the taxpayer to the transaction does *not* properly reflect its *legal effect*.

In a recent *Technical Interpretation*, CCRA reviewed a situation where a lessee has the right at the expiration of the lease (a forty-eight month term) to *acquire* the leased property *for \$1*. The taxpayer's view was that this would be a *capital lease*.

CCRA note that the determination of whether a contract is a lease or a sale is based on the *legal relationship* created by the terms of the agreement, rather than on any attempt to ascertain the underlying economic reality. Therefore, in the absence of sham, it is CCRA's view that a *lease is a lease* and a sale is a sale.

Election

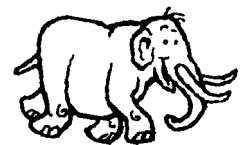
The Income Tax Act also permits a lessor and a lessee, under certain circumstances, *to elect* to treat a lease as a *purchase and sale* for income tax purposes.

CAPITAL GAINS

55(4)

CAPITAL GAIN DEFERRAL - ELIGIBLE SMALL BUSINESS INVESTMENTS

The Income Tax Act permits an *individual* to defer up to \$2 million of a capital gain on a



Tax Tips & Traps

disposition of an *eligible small business corporation* (“*ESBC*”) share after February 27, 2000.

To qualify the “*ESBC*” share must be of a *corporation* where all, or substantially all, of the fair market value of the assets are used principally in an *active business* carried on by the corporation, or by an active business corporation *related to it*, shares or debts of other related “*ESBCs*” or a combination of those types of assets.

Excluded from this “*ESBC*” definition are *professional corporations*, corporations the principal business of which is the leasing, rental, development or sale of real property, or a corporation in which more than 50% of the value of the property is attributable to *real property*.

The *deferral* is based on the timely acquisition of qualifying *replacement shares*. The *qualifying cost* has a \$2 million limit.

Example

In a disposition of shares with an ACB of \$3 million, proceeds of \$4.5 million and a purchase of *replacement shares* in Corporation B of \$2.2 million and Corporation C of \$2.3 million, the capital gain otherwise determined is \$1.5 million (\$4.5 million minus \$3.0 million).

The “*qualifying cost*” of the replacement shares in Corporation B is *\$2 million* and in Corporation C is *\$2 million* for a total of \$4 million.

The permitted *deferral* in respect of the disposition is *\$1 million* and, therefore, the *capital gain* after deducting the deferral is *\$.5 million*.

Editor’s Comment

Because of the *complexity* of this deferral, a *detailed review* of its applicability and calculation is needed.

MARRIAGE BREAKDOWN

55(5)

ARREARS

In a *Technical Interpretation*, CCRA note that where *spousal arrears* are “*settled*” for an amount which is *less than* the total periodic amounts due, the amount paid and received, whether as a lump sum or by way of installments, would *not* be deductible to the payor or taxable to the recipient.

PAYMENTS MADE TO THIRD PARTIES

In a *Tax Court* case, the Court noted that the Income Tax Act permits *deductible/taxable* treatment on *third party* payments if the Order or Written Agreement *provides* that *Subsections 60.1(2) and 56.1(2)* apply to the amount.

Mr. F made \$41,856 of third party payments under the Support Agreement for medical expenses, tuition fees, recreation expenses for the children, and the maintenance of the house including heating, electricity, gas, telephone, snow removal, lawn care, landscape maintenance and tenant’s repairs. The *Agreement* noted that the payments would be *taxable* to Ms. B (the former spouse) and *deductible* by Mr. F. However, when Mr. F asked for the inclusion of references to Subsections 56.1(2) and 60.1(2), Ms. B noted that this might add further *confusion*. Therefore, the Section references were not put into the Agreement.

It appears that Ms. B then took the position that because the Section references were not in the Agreement,



she should not have to pay tax on the \$41,856. The Judge was *not pleased*. He noted that, “It is deplorable that Ms. B availed herself in such an *abusive manner* of a provision of the Act that was enacted

to provide better protection for women’s interests. I conclude that Ms. B abused the provision...” Therefore, the appeal is *allowed* with *costs* for a fixed sum of \$1,500.

Editor’s Comment

For greater certainty of the *deduction* for *third party payments* it is *best to refer* to Subsections 56.1(2) and 60.1(2) in the Agreement.

REGISTERED RETIREMENT SAVINGS PLAN (RRSP)

55(6)

SMALL BUSINESS CORPORATION SHARES

In a CCRA *Advance Income Tax Ruling*, a Canadian-controlled private corporation wished to *attract and retain* qualified arm’s length *employees* through a *share-purchase* plan. However, the current fair market value of the company was making the cost prohibitive. Therefore, the company undertook a *partial “freeze”* of the share value under the Income Tax Act and then permitted the employees to acquire the new shares at a lower amount.

The Ruling provided that the employees could buy these shares *through their RRSPs* on the basis that the shares were *qualified investments* and that the employees were at arm’s length with the company.

In another *Ruling*, CCRA noted that *shares* of a corporation that is developing a parcel of land into a retirement community would be a qualified investment for an *RRSP, RRIF or RESP*.

The company will enter into contracts for the construction and sale of the units. A share will *not* be issued to an RRSP, a RRIF or an RESP if the annuitant or subscriber is a *connected* shareholder. (A 10% test)

Tax Tips & Traps

SECOND MORTGAGE

In another *Ruling*, CCRA found that a *second mortgage* would also be a *qualified investment* for an arm's length RRSP. Company A will *borrow from investors'* RRSPs using a second mortgage on the land as security for the debts. The purpose is to provide Company A with a *source of funding* which is only secured by a second mortgage on the land and only requires the payment of interest until its maturity or redemption.

RRSP WARNING

On May 31, 2001, a *warning* about *newspaper ads* promising *tax-free access* to *locked-in RRSPs* and locked-in retirement account savings was issued by British Columbia's Superintendent of Pensions.



To take advantage of the alleged loophole, the investor must use the RRSP to purchase shares in a company. In return, the company advances the investor a loan of 60% to 70% of their share purchase. The remaining 30% to 40% is held as security.

The release notes that there are a *number of problems* such as the shares *not being qualified investments* thereby triggering full taxable income. Also, the taxpayer could be called upon to pay back the loan at any time. If you don't pay back the loan, you forfeit the 30% to 40% of your investment being held as security.

Also, *locked-in RRSPs* have to be used for *retirement income*. *Financial institutions* that hold locked-in funds may be required to *pay a pension* to the owner if the money is used for other purposes and the pension income is lost.

CHARITABLE DONATIONS

55(7)

GIFT BACKS

In a *Technical Interpretation*, CCRA notes that where a volunteer has *incurred reimbursable expenses* on behalf of a charity and, of his own *volition*, chooses to give some, or all, of the reimbursement monies back to the charity (i.e., there can be no agreement or understanding, written or oral, that the volunteer will return the reimbursement to the charity), CCRA will accept that a *gift eligible* for a *donation tax credit* has been made.



However, where a charity has a policy that *expenses incurred* by a volunteer will only be reimbursed through the issuance of a *donation receipt*, it is CCRA's view that the volunteer has *not made an eligible gift*.

NEW RATES

The Income Tax Act permits a *25%* taxable capital gain (not 50%) on gifts of *publicly-traded* shares, mutual funds or government bonds to a charity up to *December 31, 2001*. The donor receives a *tax credit* based on the *full value* of the gift.

FARMING

55(8)

QUALIFIED FARM PROPERTY - RENTAL PROPERTY

In a *Technical Interpretation*, CCRA notes that where a taxpayer acquired farmland after June 17, 1987 and *actively farmed* the land for *at least two years*, but is now *renting* it out on a crop-share basis, the taxpayer will still be entitled to the *capital gain exemption* on *qualified farm*

property. The farmland would be "*qualified farm property*" if, for any period of at least *twenty-four months*, the property was used principally in the business of farming in Canada, you were actively engaged on a regular and continuous basis in the farming business, and the gross revenue that you earned from the farming business exceeded your gross revenue from all other sources.

GST

55(9)

PERSONAL LIABILITY

In a *Tax Court* case, the Court found that the taxpayer/director was *not personally liable* for the *unremitted GST* of \$66,442 in 1993 and 1994 and noted that:

1. Even though the taxpayer was an "*inside director*" because he was involved in the day-to-day management of the corporation, he is eligible for the "*due diligence*" exemption.
2. The Court believed that the *reliance* of the taxpayer upon his *chartered accountant*, a highly experienced person, helps meet the due diligence test.
3. The taxpayer had *given up control* of the *finances* as all draws from his construction project went into a bank account over which only the *monitors* had signing authority.

Editor's Comment

Caution: If "*due diligence*" is not exercised, a director may be held *personally liable* for unremitted GST and income tax source deductions.

GST PAYABLE

In a *Federal Court of Appeal* case, the



Tax Tips & Traps

Court found that when a *trucking corporation deducted* amounts from payments to its *owner/operators* for insurance, licenses, oil and fuel, *GST applied* to the withheld amounts as a *resupply*.

DID YOU KNOW...

55(10)

LIFE INSURANCE POLICIES

One way of *donating life insurance on death* is to make the *beneficiary* your *Estate* and then leave the proceeds to charity. The advantage is the charitable donation at death is eligible up to **100%** of income in the *year of death* and the *preceding year*. One drawback is that once the funds are in the Estate, they are available to creditors who could have a prior claim to that of the named beneficiary.

Under *new amendments* to the Income Tax Act, the *donation* on the terminal return may also be available if the *beneficiary* is the *charity*, thereby precluding the disadvantage of having the funds in the Estate.



This also applies to donations of *RRSPs* and *RRIFs* where the donee is named as the beneficiary under the trust.

The preceding information is for educational purposes only. As it is impossible to include all situations, circumstances and exceptions in a commentary such as this, a further review should be done. Every effort has been made to ensure the accuracy of the information contained in this commentary. However, because of the nature of the subject, no person or firm involved in the distribution or preparation of this commentary accepts any liability for its contents or use.

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