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TAX LETTER

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CHILD CARE EXPENSES

You can often deduct child care expenses that enable you to carry on your employment or business, or to attend school. The types of expenses that qualify include those for baby-sitting, day care, nanny services, and certain boarding schools and camps. Your children must be under the age of 16 at some time during the year, otherwise both dependent upon you and having a mental or physical infirmity.

There are various limitations on the deduction. The more significant ones are described below:

Three general limits

First, there are three monetary limitations. For each taxation year, you can deduct the least of the following three amounts:

1) Your actual child care expenses incurred for the year.
2) The total of the "annual child care expense amounts" for the year. These amounts are $11,000 for a disabled child eligible for the disability tax credit, $8,000 for each child under the age of 7 at the end of the year, and $5,000 for each other eligible child. Note, however, that this is a total limit for all of your children; you are not limited to the dollar amount for each child. Thus, if you spend nothing on child-care for your 14-year-old and $13,000 for your 5-year-old, your dollar limit is still $13,000.
3) 2/3 of your "earned income" for the year.

In terms of your actual child care expenses, there is a further limit if the expenses are incurred for a boarding school or camp (say, an overnight summer camp). The maximum

amounts that qualify are 1/40th of the annual child care expense amount per child, per week, in the year that the child attends the camp. For example, if your 9-year old child attends an overnight summer camp for 4 months and you paid $2,000 for the camp, only 4 x (1/40 x $5,000), or $500, would qualify as a child care expense under item 1) above.

Your "earned income" includes gross employment income, net business income, research grants, and a disability pension received under the Canada Pension Plan or Quebec Pension Plan.

Lower-income spouse must normally claim

This is often the most significant limitation. If you are married or in a common-law relationship, the lower-income spouse (common-law partner) must normally claim the deduction. The higher-income spouse can deduct no expenses (except in the limited circumstances listed under the next heading).

As an extreme example, if the lower-income spouse stays at home and has no income for the year, his or her earned income will be nil, meaning that no deduction can be claimed at all!

Exception where higher-income spouse gets a claim

There are three scenarios under which the higher-income spouse for the year can claim a limited deduction in a taxation year. The scenarios are:

1) The lower-income spouse attended school in the year;
2) The lower-income spouse was incapable of caring for the children because of an infirmity, and confinement to a wheel-chair, or a hospital or similar institution; or
3) The lower income-spouse was in prison during the year.

Where one of the scenarios existed during the year, the higher-income spouse can claim a deduction using the three monetary limits described earlier, along with a fourth limitation. The fourth limitation is 1/40th of the total annual child care expense amounts for the year multiplied by the number of weeks that the lower-income spouse is in full-time school, infirm and confined, or in prison, as the case may be. (If the lower-income spouse is attending school part-time, the number of months in school is used rather than the number of weeks).

The lower-income spouse can still claim a deduction using the three monetary limits, but net of the amount claimed by the higher-income spouse.

Example

John and Mary are married. Mary's earned income for the year is $90,000. John's earned income is $30,000. John attended university on a full-time basis for 26 weeks during the year.

They have two healthy children, aged 5 and 8. Mary and John incurred $16,000 in child care expenses for the 5-year-old for the year.

Mary's deduction: least of:

1) $16,000 actual expenses;
2) Total annual child care amounts of $8,000 + $5,000 = $13,000;
3) 2/3 of her earned income, or $60,000; and

4) 26 x 1/40 x $13,000 = $8,450.

Therefore, Mary can deduct $8,450.

John's deduction: least of:
1) $16,000 (same);
2) $13,000 (same); and
3) 2/3 of $30,000, or $10,000
But net of Mary's claim.

So John's deduction is $10,000 minus the $8,450 claimed by Mary, or $1,550.

INTERPLAY BETWEEN CREDITS IN RESPECT OF INFIRM DEPENDENTS

If a relative with a mental or physical infirmity is dependent upon you for support, you may qualify for one of the tax credits discussed below in respect of the dependant. The monetary amounts listed are for 2017; the amounts are indexed each year for inflation.

Caregiver tax credit: This credit is allowed if the infirm dependent is 18 years or older, is dependent upon you, and lives with you in the year. The credit with respect to each infirm dependent for 2017 is 15% x ($6,883 minus the amount, if any, by which the dependant's net income exceeds $16,163). Thus, the credit is reduced or eliminated if the dependant's net income exceeds the $16,163 threshold. A smaller credit is allowed in respect of non-infirm parents or grandparents who live with you and are 65 or over.

Infirm dependant tax credit: This credit is allowed if the related infirm dependent is 18 years or older and is dependent upon you in the year. Unlike the caregiver credit, the dependant is not required to live with you. The credit for 2017 equals 15% x ($6,883 minus the amount, if any, by which the dependant's net income exceeds $6,902).

Equivalent-to-spouse credit: If you are not married or in a common-law partnership, you can claim the credit for a related infirm dependant that lives with you. The credit is 15% x ($13,785 minus the dependent's net income). A smaller credit is allowed in respect of healthy parents or grandparents or minor children who live with you.

If you would otherwise qualify for two or three of these credits, you can only claim one of them for a particular dependant for a particular year. The order of priority is:

1) Equivalent to spouse
2) Caregiver
3) Infirm dependant

In other words, the equivalent-to-spouse credit takes precedence over the two others, and the caregiver takes precedence over the infirm dependant. Of course, if you qualify for only one credit, you just claim that one.

Example

You are unmarried and your 19-year old infirm son is dependent upon you and lives with you. At first blush, it appears that all three credits potentially apply. However, because of the order of priority, you would claim the equivalent-to-spouse credit.

Note that if the caregiver credit would exceed the equivalent-to-spouse credit, you would still claim the latter, but you would get a "top-up" of the credit to equal to the excess, if any.

Number of credits that can be claimed

You can claim only one of the above credits per dependent per year.

You can claim only one equivalent-to-spouse credit per year.

You can claim more than one caregiver or infirm dependant credit if you support more than one dependant.

TAX TREATMENT OF OPTIONS

There are two basic types of options. A "call option" is an option that gives the option holder the right to *purchase* a property at a set price (sometimes called the exercise price or strike price). A "put option" is an option that gives the option holder the right to *sell* a property at a set price. In either case, because the right is an "option", it obviously is not mandatory for the option holder to exercise it.

The following is a summary of the income tax rules that apply to options. (We are assuming you are not in the business of selling options.)

Grantor of call option

If you grant (sell) a call option to someone, the amount you receive for the option is considered a capital gain, half of which is included in your income as a taxable capital gain.

If the option is subsequently exercised by the option holder, so that you must sell the underlying property, your proceeds of disposition of the property will include the amount previously received for the grant of the option. The original gain on the grant of the option will be revised to nil. If the grant of the option took place in a previous year, you are allowed to amend the previous tax return to take this revision into account.

Purchaser of call option

If you purchase an option to acquire property, there is no immediate tax consequence. If the option expires without being exercised, you will have a capital loss at that time equal to the amount you paid for the option, and half of that will be an allowable capital loss.

However, if you exercise the option and purchase the property, the amount you paid for the option will be added to your cost of the property.

Example of call option

This year, you grant a call option to Mr. Option Holder for $2,000. The option gives Option Holder the right to purchase certain property from you for $50,000 over the next 18 months. Next year, within the 18-month period, Option Holder exercises the option and buys the property for $50,000 from you. Your cost of the property was $30,000.

Your tax results: On the grant of the option, you will initially have a $2,000 capital gain and $1,000 of that will be included in your income as a taxable capital gain. However, since the option was later exercised, this taxable capital gain will be revised to nil (and you can amend this year's return if you have already filed it). Next year, your proceeds of disposition of the property will be $52,000, resulting in a $22,000 capital gain, of which $11,000 will be included in your income as a taxable capital gain.
Option Holder's tax results: Option Holder's cost of the property will include

the $50,000 paid for the property plus the $2,000 paid for the option, for a total cost of $52,000.

Grantor of put option

If you grant (sell) a put option to someone, the amount you receive for the option is considered a capital gain, half of which is included in your income as a taxable capital gain.

If the option is later exercised by the option holder, so that you must buy the underlying property, your cost of the property will be reduced by the amount previously received for the grant of the option. The original gain on the grant of the option will be revised to nil. If the grant took place in a previous year, you are allowed to amend the previous tax return to take this into account.

Purchaser of put option

If you purchase an option to sell property, there is no immediate tax consequence. If the option expires without being exercised, you will have a capital loss at that time equal to the amount you paid for the option, and half of that will be an allowable capital loss.

However, if you exercise the option and sell the property, the amount you paid for the option will reduce your proceeds of disposition of the property.

ASSOCIATED CORPORATIONS

The concept of "associated corporations" is relevant for various purposes under the *Income Tax Act*, most of which relate to beneficial tax preferences that would otherwise apply to the corporations.

One of the significant tax preferences is the small business deduction, which lowers the rate of tax on active business income of up to $500,000 per year. If your Canadian-controlled private corporation (CCPC) is associated with one or more other CCPCs in a taxation year, the $500,000 limit for the small business deduction must be shared and allocated amongst the corporations for that taxation year (in other words, the small business deduction cannot be doubled up, tripled up, and so on).

For example, if two associated CCPCs had active business income of $400,000 each, they could claim a total small business deduction between them based on $500,000 of income rather than $800,000. The corporations must file an agreement setting out their allocation of the small business deduction between them. If they do not, the Canada Revenue Agency (CRA) will make the allocation for them.

Meaning of "Associated"

So when are corporations associated with each other? The rules in this regard can be quite complex. However, some of the main circumstances in which they are associated can be illustrated as follows.

For example, Corporation A is associated with Corporation B if:

1) A controls B, or B controls A;
2) A and B are controlled by the same person or group of persons; or
3) A and B are each controlled by a person and the two persons are related, and one of the persons owns at least 25% of the shares of any class of both corporations. (There are similar rules where Corporation A

and / or Corporation B are controlled by a related group of persons.)

A group of persons means two or more persons who own shares in the corporation.

Significantly, the associated corporation rules do not normally apply when you and a related person each control a corporation, as long as neither of you meets the 25% threshold. For example, you control corporation A and your spouse controls Corporation B, and neither of you owns 25% or more of a class of the shares of both A and B, the corporations are not associated. As such, both A and B can qualify for the full small business deduction in respect of each corporation's active business income. (However, there is an anti-avoidance rule: if the CRA concludes that one of the main reason you set up two corporations was to save tax, the corporations can be deemed to be associated.)

Extended Meaning of "control"

For most income tax purposes, including the associated-corporation rules, the concept of control of a corporation by a shareholder or group of shareholders is *de jure* (legal) control. This generally means the ownership of shares in the corporation entitling the shareholder or group to more than 50% of the votes of all shares.

In addition, for the purposes of the associated corporation rules, other rules can apply, including the following:

1) Control includes *de facto* control or control "in fact", such as where a shareholder that does not have *de jure* control nonetheless has influence that could result in the shareholder controlling the corporation as a matter of fact.
2) A corporation is deemed to be controlled by a person or group of persons if the person or group owns shares in the corporation whose value exceeds 50% of the value of all of the shares in the corporation, or common shares in the corporation whose value exceeds 50% of the value of all of the common shares in the corporation.
3) Where a child under the age of 18 owns shares in a corporation, and another corporation is controlled by a parent of the child or a group of persons that includes the parent, the parent is deemed to own the shares owned by the child. (This rule does not apply if it can reasonably be considered that the child manages the business and affairs of the first corporation and does so without a significant degree of influence by the parent.)

Example

You and your 16-year-old son each own 30% of the common shares of Corporation A, based on the value of the shares. You own more than 50% of the common shares of Corporation B. Your child does not manage the business and affairs of A. You will be deemed to own 60% of the common shares of A, meaning that A and B will be associated.

Meaning of "Related"

As noted above, the concept of "related persons" is relevant in determining whether corporations are associated. Again, the determination of related persons can be quite

complex. Having said that, the following are some typical examples where persons are related.

1) Individuals are related for income tax purposes if they are related by blood, marriage, or adoption. For example, you are related to your lineal descendants and ascendants (children, grandchildren, parents, grandparents, etc.), your siblings, your spouse, and most of your in-laws.
2) A corporation is related to a person who controls the corporation, or to each member of a related group of persons that controls the corporation; and
3) Two corporations are related if they are each controlled by the same person or group of persons, or each is controlled by a person and the two persons are related. (There are similar combinations of related persons controlling corporations that can lead to the corporations being related.)

AROUND THE COURTS

Employee stock options taxed in full

Normally, one-half of an employee stock option benefit is deducted in computing taxable income, which means that only half the benefit is taxable. However, certain conditions must be met in order to claim the one-half deduction. If the conditions are not met, then the entire stock option benefit is taxable.

For example, in general terms, the shares must be common shares, or shares with attributes that are similar to common shares. The fair market value of the shares at the time the option is granted cannot exceed the exercise price under the option. Also, at the time that the shares are issued, it must be shown that the employer or a person not dealing at arm's length with the employer cannot reasonably be expected to redeem, acquire or cancel the shares within two years (the "two-year reasonable expectation" test).

(In some cases, CCPC shares qualify for the one-half deduction with less stringent requirements.)

This two-year reasonable expectation test proved fatal in the recent *Montminy* case. In this case, a corporation granted options to the taxpayer and other employees to acquire shares in the corporation. The taxpayer subsequently exercised the option and acquired the shares. On the same day, he sold the shares to the parent corporation of the employer.

The CRA assessed the taxpayer to deny the one-half deduction. On appeal, the Tax Court of Canada upheld the CRA assessment. The Court found that, at the time the taxpayer and other employees exercised their option and acquired the shares, the parent corporation had entered into an agreement under which it agreed to purchase those shares immediately. As a result, the two-year reasonable expectation test was not met. The entire stock option benefit was taxable to the taxpayer because the one-half deduction did not apply.

This decision is currently under appeal to the Federal Court of Appeal.

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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.