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TAX LETTER

August 2014

RRSP HOME BUYERS' AND LIFELONG LEARNING PLANS
WRITE-OFF OF BAD DEBTS AND WORTHLESS SHARES
TAX TREATMENT OF OPTIONS
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RRSP HOME BUYERS' AND LIFELONG LEARNING PLANS

Generally, when you withdraw an amount from your registered retirement savings plan (RRSP), the full amount is included in your income. However, there are two major exceptions where the withdrawn amounts are not included in your income: withdrawals under the Home Buyers' Plan and those under the Lifelong Learning Plan.

Home Buyers' Plan (HBP)

The HBP allows you to withdraw up to $25,000 from your RRSP in order to purchase a home. Your spouse or common-law partner can withdraw the same amount from their RRSP, so couples can withdraw a total of $50,000. As noted, the withdrawals are not included in your income. However, certain conditions must be met.

First, you cannot acquire the home more than 30 days before withdrawing the amount from your RRSP.

Second, neither you nor your spouse may have owned another home in the period beginning at the start of the fourth year before the year of withdrawal and ending on the 31st day before the withdrawal. This ownership period is waived for homes acquired for disabled persons eligible for the disability tax credit, if the new home will provide the person with more accessibility or a better-suited environment for the person's needs.

Third, you must provide your RRSP issuer with Form T1036, "*Home Buyers' Plan (HBP) – Request to Withdraw Funds from an RRSP*", which states the address of the home and that you are either residing in the home or intend to reside in the home within one year of acquiring it. Furthermore, you must have already entered into an agreement to purchase the home or to have it built.

Lastly, you must acquire the home before October of the year following the year of the withdrawal from your RRSP.

The amount withdrawn under the HBP must be repaid to your RRSP within 16 years. You do not have to pay interest

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on this "loan" from your RRSP to you. The repayments are made by way of a regular contribution to your RRSP, with an appropriate designation made in your tax return for the year of the repayment. Like a regular RRSP contribution, the repayment can be made in the year or within 60 days after the end of each year. The repayment period starts in the second year after the year of withdrawal, with a minimum of 1/15th of the withdrawn amount repayable each year. The repayments to the RRSP are **not** deductible (since the withdrawals were not included in your income).

If you do not repay the minimum amount in a year, the shortfall is included in your income for that year. If you repay more than required in a given year, the overpayment reduces your obligation to pay for the next year. (Thus, if you have extra cash available at any point, this allows you to put it back into your RRSP where it can continue to grow tax-free.)

Once you have withdrawn funds under the HBP, the CRA will send you a "*Home Buyers' Plan (HBP) Statement of Account*" each year with your income tax notice of assessment. This statement will show the total HBP withdrawals, the amounts you have repaid to date, and the minimum amount that has to be paid for the following year.

Lifelong Learning Plan (LLP)

Similar to the HBP, the LLP allows you to make a tax-free withdrawal from your RRSP. The LLP applies if you or your spouse (or common-law partner) are or will be studying at a post-secondary educational institution. The maximum amount you can withdraw is $20,000, although you cannot withdraw more than $10,000 in any particular year. Your spouse can similarly withdraw funds from his or her RRSP, for a possible maximum of $40,000.

At the time of the withdrawal, you (or your spouse) must be enrolled in the school on a full-time basis, or you must have received an offer to enroll on a full-time basis before March of the following year. If you are eligible for the disability tax credit, or have a mental or physical impairment such that you cannot reasonably be expected to be enrolled as a full-time student, you can be a part-time student and qualify under the LLP.

You must provide your RRSP issuer with Form RC96, "*Lifelong Learning Plan (LLP) Request to Withdraw Funds from an RRSP*", in order to make the tax-free withdrawal.

The amounts withdrawn under the LLP must be repaid to the RRSP over a period not exceeding 10 years. The repayment period begins at the earlier of the second consecutive year in which you are not enrolled in full-time studies and the fifth year after the first year in which an LLP withdrawal was made. As with the HBP repayments, you repay the LLP amounts by contributing to your RRSP and then making a designation in your

tax return for the year of the repayment. A minimum of $1/10^{th}$ of the withdrawn amount must be repaid in each year or within 60 days after the end of the year. The repayments are not deductible.

If you repay less than the minimum one-tenth amount in a taxation year, the shortfall is included in your income for that year. Again, if you repay more than the minimum, that reduces your later repayment obligation by the amount you have overpaid.

Similar to the HBP, once you withdraw under the LLP the CRA will send you an "*LLP Statement of Account*" each year with your notice of assessment. The statement will show the total LLP withdrawals, the amounts you have repaid to date, and the minimum amount that has to be paid for the following year.

Lastly, note that you can withdraw under the LLP even if you have withdrawn from your RRSP under the HBP. Thus, you can use the LLP and the HBP at the same time (assuming you qualify for both plans).

WRITE-OFF OF BAD DEBTS AND WORTHLESS SHARES

Bad Debts

If you lent money to someone or are otherwise owed a debt, there is tax relief if the debt becomes uncollectible or bad. The discussion here assumes that you hold the debt as capital property – namely, that the debt is not owed to you for selling goods or rendering services in your business.

If, at the end of the year, you determine that the debt is bad, you can make an election in your tax return for the year. The election provides a deemed disposition of the debt at the end of the year for nil proceeds. As such, you will incur a capital loss equal to your cost of the debt. If you are the original creditor, the cost of the debt will normally equal the principal amount of the debt. If you acquired the debt from a third party, your cost will normally be what you paid for it.

One-half of the capital loss will be an allowable capital loss, which can be deducted against your taxable capital gains.

Immediately after the deemed disposition, you will be deemed to have a cost of the debt equal to nil. As such, if you subsequently collect a part or all of the debt, the amount you collect will result in a capital gain, and half of that will be included in your income as a taxable capital gain.

It is question of fact as to when a debt has become bad. The Canada Revenue Agency (CRA) has stated that generally "a debt will not be uncollectible at the end of a particular taxation year unless the creditor has exhausted all legal means of collecting it or where the debtor has

become insolvent and has no means of paying it".

Worthless shares

If you own shares in a corporation, a similar election can be made for a taxation year to provide a deemed disposition of the shares for nil proceeds at the end of the year. This will result in a capital loss equal to your cost of the shares. The election can be made if

(i) during the year the corporation has become bankrupt; **or**
(ii) the corporation is insolvent and subject to a winding-up order in the year; **or**
(iii) at the end of the year, the corporation is insolvent, it does not carry on business, the fair market value of the shares is nil, and it is reasonable to expect that the corporation will be dissolved or wound up and will not begin to carry on a business.

Deemed loss may lead to an ABIL

The capital loss resulting from the deemed disposition of the share or debt may be a "business investment loss", and if so, one-half of that loss will be an allowable business investment loss (ABIL). An ABIL can be deducted against all sources of income, and not just taxable capital gains.

In general terms, the deemed disposition of a share can result in an ABIL if the corporation is a small business corporation. The deemed disposition of a debt can result in an ABIL if the debt is owed by a Canadian-controlled private corporation that is a small business corporation, or that was a small business corporation when it became bankrupt or subject to a winding-up order. ABILs were discussed in detail in our April 2014 Tax Letter.

TAX TREATMENT OF OPTIONS

In general terms, a "call option" is an option that gives you the right to acquire a property at a set price, sometimes called the "exercise price". On the other hand, a "put option" is an option that gives you the right to sell a property at a set price.

There are specific tax rules that apply to options and the exercise of options. Although many options apply to acquisitions and sales of stock and other securities, the rules discussed here apply to options to acquire or sell any type of capital property such as real estate. (Different rules apply to *employee* stock options, which were discussed in our January 2014 Tax Letter.)

Grant or purchase of option

In most cases, if you grant an option, you will have a deemed disposition of property. The adjusted cost base of the property is deemed to be nil. As a result,

you will have a capital gain equal to the amount received by you for the grant of the option. However, as discussed below, if the option is subsequently exercised, the capital gain from the grant of the option will be effectively nullified and an adjustment will be made in respect of your proceeds of disposition or cost of the optioned property, as the case may be.

If you purchase an option, the amount paid to acquire the option will be your adjusted cost base of the option.

Exercise of call option

If you exercise a call option and acquire the optioned property, your adjusted cost base of the option (i.e., what you paid for the option) is added to your cost of the property, which will also include the amount paid to acquire the property.

If you granted a call option and the option is exercised so that you must sell the optioned property, your proceeds of disposition of the property will include the sale price of the property and the amount received for the grant of the option. In such case, the grant of the option will not itself result in a capital gain (i.e. the capital gain described above is effectively nullified). If the exercise of the option takes place in a year subsequent to the original year of the grant of the option, you can file an amended return for the original year, so as to cancel the original capital gain (from the grant of the option as discussed above) in the original year. The amended return must be filed by the filing-due date for the subsequent year.

Example

In year 1, John grants a call option to Bill that gives Bill the right to acquire property from John at an exercise price of $50,000. Bill pays John $2,000 for the option. John's cost of the property is $30,000. In year 3, Bill exercises the option and pays John $50,000 for the property.

Tax results to Bill:

Bill's adjusted cost base of the property will be $52,000, equalling the $50,000 purchase price plus the $2,000 paid for the option.

Tax results to John:

In year 1, John will initially have a capital gain of $2,000. However, if he amends his year 1 return, there will be no capital gain in year 1. Instead, $52,000, being the total of the $50,000 exercise price and the $2,000 received for the option, will be included in his proceeds of disposition of the property in year 3. Since his cost of the property was $30,000, he will have a capital gain of $22,000, and half of that will be included in his income as a taxable capital gain in year 3.

Exercise of put option

If you grant a put option and it is subsequently exercised such that you must purchase the optioned property, your cost of the property will be reduced by the amount received by you for granting the option. In such case, the grant of the option will not itself result in a capital gain. If the exercise of the option takes place in a year subsequent to the original year of the grant of the option, you can file an amended return for the original year to nullify any capital gain (from the grant of the option as discussed earlier) in the original year.

If you purchase a put option and you exercise it and sell the optioned property, your proceeds of disposition of the property will be reduced by your adjusted cost base of the option.

Expiry of option

If you purchase an option and it expires (i.e. you do not exercise the option), there will be a deemed disposition at the time it expires. Since you will have nil proceeds of disposition, you will incur a capital loss at that time equal to your cost of the option.

If you granted an option and it is not exercised, you will have a capital gain in the year of the grant as discussed earlier. The capital gain will not be affected or adjusted by the non-exercise of the option.

CHILD CARE EXPENSES

Child care expenses can be deductible for income tax purposes if you are employed or carry on business or attend school. However, there are various limits and restrictions to the deduction.

First, there are three general monetary limits that apply. The amount you may deduct in a taxation year is limited to the lesser of:

- the qualifying child care expenses for the year;
- 2/3 of your earned income for the year; and
- the total of the annual child dollar amounts, which are $7,000 per child under 7 years of age at the end of the year, $4,000 per child 7 to 16 years of age, and $10,000 per child that is eligible for the disability tax credit. (Note that there is no requirement that the child care expenses have been paid for each qualifying child. You simply total up these dollar amounts to determine the maximum.)

Qualifying child care expenses include amounts paid for baby-sitting, day care, nursery, and nanny services rendered in the year. They do not include amounts paid to the child's mother or father for the services or paid to a person related to you that is under the age of 18. You will need a receipt from the child-care provider, showing their Social Insurance Number if they are an individual, to provide to the CRA if your claim is reviewed or audited (which is very common).

Although amounts paid for boarding schools and camps qualify as child care expenses, they are restricted. The amounts that qualify are limited to:

- Children under 7 at the end of the year: $175 per week of attendance
- Children 7 through 16: $100 per week
- Disabled children: $250 per week

Your "earned income" for a taxation year includes your salary, wages or other forms of remuneration from employment, net business income, certain research grants, and disability pension amounts received under the Canada Pension Plan or Quebec Pension Plan.

In the case of married couples or common-law spouses, only the individual with the lower "net income" for the year can claim the deduction, subject to the exceptions discussed below.

Example

Bill and Susan are married. They have a 4 year old son and a 10 year old daughter (neither is disabled). During the year, they incurred $10,000 in day care and baby-sitting fees. In addition, they sent their daughter to a summer camp for 8 weeks and paid $4,000 in camp fees.

Susan worked part-time and had the lower income for the year. Her earned income for the year was $36,000.

Susan may deduct the lesser of:

- Qualifying child care expenses of $10,000 day care and baby-sitting fees, plus (8 x $100) for the camp fees, for a total of $10,800;
- 2/3 of her $36,000 earned income, or $24,000; and
- Total annual amounts of $7,000 plus $4,000, or $11,000.

Therefore, she can deduct $10,800. On these facts, Bill cannot deduct any child care expenses.

Although the general rule is that only the lower-income spouse can claim the deduction, the higher-income spouse can claim a deduction in a year if:

- The lower-income spouse attended school in the year (secondary or post-secondary school); **or**
- The lower-income spouse was certified by a medical doctor as being incapable of caring for the children because of a mental or physical infirmity that confined the spouse to a bed or wheelchair or a hospital for at least 2 weeks, or as being incapable of caring for children for a long, continuous and indefinite period because of mental or physical infirmity; **or**
- The lower-income spouse was in a prison or similar institution for at least 2 weeks in the year.

In any of these cases, the higher-income spouse can claim a limited deduction.

The deduction is limited to the lesser of the 3 limits discussed earlier, but it is further limited to a maximum amount per week in which the other spouse attended school, was incapable or caring for the children due to the infirmity, or in prison, as the case may be. Under this further limit, the maximum amount that can be deducted by the higher-income spouse is $175 per child under the age of 7 at the end of the year, $100 per child age 7 through 16, and $250 per disabled child. If the lower-income spouse attended school on a part-time basis, the dollar amounts apply per month of attendance, rather than per week.

Generally, the lower-income spouse can also claim a deduction based on the 3 limits described earlier, net of the amount deducted by the higher-income spouse.

AROUND THE COURTS

Temporary "move" from Toronto to Ottawa not eligible for moving expense deduction

If you move to work in a new work location, you may deduct certain moving expenses if the move is an "eligible relocation". Among other requirements, you must "ordinarily reside" in a home after the move that is at least 40 kilometres closer to your new work location relative to your former home.

In the recent *Konecny* case, the taxpayer was a teacher employed by a Toronto school board during the regular school year. He had a home just outside of Toronto, where he lived with his spouse and three children. However, each July, he would work in Ottawa for an Ottawa school board. During the taxation year in question, he lived in Ottawa at his mother's home for the month of July and reported to work at the Ottawa school every day. Two of his children stayed with him in Ottawa. His spouse and other child remained at the Toronto-area home.

The taxpayer attempted to deduct moving expenses incurred in his move from Toronto to Ottawa. The CRA denied the deduction on the grounds that the taxpayer did not "ordinarily reside" in Ottawa during the period in question nor did he sever his ties with Toronto. On appeal, the Tax Court of Canada agreed with CRA and denied the deduction.

* * *

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.