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JULY 2020

TAX NEWSLETTER

MORE ON THE CANADA EMERGENCY WAGE SUBSIDY ("CEWS")

We discussed the Canada Emergency Wage Subsidy ("CEWS") in the May Tax Letter. The CEWS is one of the federal government's responses to the COVID-19 situation in Canada.

As discussed in the May letter, the CEWS provides a 75% wage subsidy to certain eligible entities (employers) for up to 12 weeks, from March 15, 2020 and up to June 6, 2020.

On May 15, 2020, the Department of Finance announced that it was extending the eligibility period a further 12 weeks, to August 29, 2020. Each 4-week period from March 15 through August 29 is a “qualifying period”.

Under the CEWS criteria, an employer can receive a maximum subsidy of 75% of the amount of remuneration paid to each employee per week in a qualifying period, up to a maximum benefit of $847 per employee per week. If an employee’s average weekly remuneration from January 1, 2020 through March 15, 2020 (“baseline remuneration”) was greater than that paid during a qualifying period, 75% of the baseline remuneration average will apply, but still subject to the $847 maximum per week.

As originally announced, a special rule applied to non-arm’s length (e.g. related) employees. Under this rule, an employer could claim the CEWS for non-arm’s length employees only if they were employed prior to March 15, 2020, and the maximum subsidy for the remuneration paid for a week in a qualifying period was 75% of the baseline remuneration. In the May 15, 2020 announcement, the Department of Finance stated that it is changing this rule because it could lead to unintended outcomes in some situations, such as when non-arm’s employees were on parental, disability, or unpaid leave from January 1 to March 15, 2020.

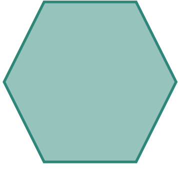
Under this change, employers can choose one of two periods when calculating the baseline remuneration of their employees. They can continue to calculate the baseline remuneration as the average weekly remuneration paid to an employee from January 1 to March 15, 2020, or they can use the average weekly remuneration paid to the employee from March 1 to May 31, 2019. In either case, the calculation does not include any period of seven or more consecutive days without remuneration. Employers are allowed to choose which period to use on an employee-by-employee basis. This change is proposed to be retroactive to April 11, 2020. Although the change was not passed as law at the time of writing, we trust that it will be passed and will apply retroactively as the Department states it will.

The federal government also passed regulations that expand the category of eligible employers under the CEWS. Those eligible now include:

- Partnerships that are up to 50% owned by non-eligible entities;
- Indigenous government-owned corporations that are carrying on a business, and partnerships where the partners are Indigenous governments and eligible entities;
- Registered Canadian amateur athletic associations;
- Registered journalism organizations; and
- Non-public colleges and schools, including institutions that offer specialized services, such as arts schools, driving schools, language schools or flight schools.

The expansion of the eligible entities is retroactive to April 11, 2020 (the date the CEWS was enacted by Parliament), which means that it applies retroactive to the first qualifying period starting March 15, 2020.

In the May 15 announcement, the Department also stated that it “will consult with key business and labour representatives over the next month on potential adjustments to the program to stimulate jobs and growth”. Unfortunately, at the time of writing, these other “potential adjustments” had not yet been released.



TAXATION OF OPTIONS

There are generally two types of options – a call option and a put option.

A call option gives the holder of the option the right to purchase a property at a set price ("exercise price") at or up to a certain date. Conversely, a put option gives the holder of the option the right to sell a property at an exercise price at or up to a certain date.

GRANT OF OPTION

For income tax purposes, if you grant or sell an option, you have a deemed disposition of the option and your adjusted cost base is deemed to be nil. As such, you will have a capital gain equal to the sales price of the option, and one-half of that will be included in your income as a taxable capital gain. The purchaser of the option will have an adjusted cost base in the option equal to what they paid you for it, i.e. the purchase price of the option.

EXERCISE OF OPTION

The holder of the option may exercise the option and either purchase (call) or sell (put) the property that is subject to the option. Upon the exercise, the tax consequences of the initial grant of the option, described above, are essentially negated (once the option is exercised, the former grant of the option is deemed not to have been a disposition of property). Furthermore, the exercise of the option is not itself a disposition of property.

Instead, on the exercise of a call option, the vendor of the property, who granted the option, includes in their proceeds of disposition of the property the proceeds received on the grant of the option. If the exercise of the option is in a taxation year after the year in which the option was granted ("grant year"), the vendor can amend the tax return for the grant year to exclude the proceeds that were initially received for the option. The purchaser of the property, who paid for the option, includes in their adjusted cost base of the property their cost of the option.

On the exercise of a put option, the purchaser of the property, who granted the option, subtracts from their adjusted cost base of the property the amount they received for the option. As with a call option, if the exercise takes place in a year after the grant year, the purchaser can amend the tax return for the grant year to exclude the proceeds received on the grant of the option. The vendor, who paid for the option, subtracts from their proceeds of disposition of the property their cost of the option.

EXPIRATION OF OPTION

If a call or put option expires without being exercised, the holder of the option has a deemed disposition for nil proceeds. As such, the holder will have a capital loss, one-half of which will be an allowable capital loss.

In this case, the initial grant of the option stands, so that the grantor of the option will still include the proceeds received for the option in the grant year.

EXAMPLE (CALL OPTION)

Bill grants a call option in respect of a property to Clara, with an exercise price of $100,000. Clara pays $5,000 for the option.

Initial tax consequences:

Bill has a deemed disposition for $5,000, resulting in a $2,500 taxable capital gain. Clara has an adjusted cost base in the option of $5,000.

Assume next that Clara exercises the option and buys the property for $100,000.

New tax consequences:

Bill's previous deemed disposition of the option is deemed not to have occurred. Instead, Bill includes the $5,000 received for the option in

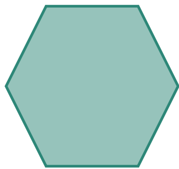
his proceeds of disposition for the property, which becomes $105,000. He will have a capital gain or loss, depending on his cost of the property.

Clara's adjusted cost base of the property includes the $5,000 she paid for the option, so her adjusted cost base becomes $105,000.

Assume instead that Clara does not exercise the option and it expires.

Expiration tax consequences:

At the time the option expires, Clara will have a deemed disposition for nil proceeds, resulting in a $5,000 capital loss. Bill's previous deemed disposition of the option remains unchanged.



ASSOCIATED CORPORATIONS AND THE SMALL BUSINESS DEDUCTION

The small business deduction generally applies to the first $500,000 of the active business income of a Canadian-controlled private corporation (CCPC). The "deduction" is actually a deduction from tax, not from income, so it is really a credit. It results in a combined federal and provincial rate of around 9% to 13%, depending on the province. The $500,000 threshold also applies to each province, except for Saskatchewan, which has a $600,000 limit for provincial tax purposes.

However, the $500,000 annual threshold ($600,000 for Saskatchewan) must be shared by two or more CCPCs if they are "associated". This rule prevents the multiplication of the $500,000 threshold by individuals setting up CCPCs. For example, if I own and control two CCPCs, they are associated, and I am not allowed to double up the $500,000 limit. Instead, the two CCPCs must share the limit. I can allocate any amount to the two corporations as long as the total amount allocated does not exceed $500,000.

So when are corporations associated? As noted above, two corporations are associated if they are controlled by the same person. But two corporations are also associated with each other if:

a) one of the corporations is controlled by the other corporation,

b) both corporations are controlled by the same group of persons,

c) each of the corporations is controlled by a person, the person who controls one of the corporations is related to the person who controls the other, and either of those persons owns at least 25% of the shares of any class of each corporation,

d) one of the corporations is controlled by a person, that person is related to each member of a group of persons that controls the other corporation, and that person owns at least 25% of the shares of any class of each corporation, or

e) each of the corporations is controlled by a related group of persons, each of the members of one of the groups is related to all of the members of the other group, and one or more persons who are members of both groups own at least 25% of the shares of any class of each corporation.

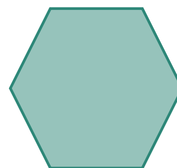
A "group" simply means two or more persons. A "related group" means a group of persons each member of which is related to every other member of the group.

Control for these purposes includes the normal rule for income tax purposes, being de jure control or control "in law". This generally means the ownership of more than 50% of the voting shares in the corporation.

However, control for the purposes of the associated corporation rules also include de facto control, or control "in fact" (which has its own definition in the Income Tax Act).

On top of that, there are various "deemed" control provisions under the association rules. For example, a person or group of persons is deemed to control a corporation if they own shares representing more than 50% of the fair market value of all of the shares in the corporation, or common shares representing more than 50% of the fair market value of all of the common shares of the corporation. Under another deeming rule, if parent controls a corporation, and the parent's child under age 18 owns shares in another corporation, the parent is deemed to own the child's shares in the other corporation. There are also other deeming rules.

Furthermore, as noted above, it is often necessary to determine whether persons or corporations are "related" in determining whether corporations are associated. The "related" concept is different than the "associated" concept. For example, if I control one corporation and my spouse (or adult child) controls another corporation, the two corporations are related. However, they are not associated, unless one of us also owns at least 25% of the shares of the other person's corporation (see item (c) in the above list). So I can run my own business through my corporation and my spouse or adult child can run their own business through their own corporation without worrying about sharing the small business limit, as long as the 25% rule does not come into play. (However, there is an anti-avoidance rule: the corporations can be considered associated if one of the reason for setting up two corporations rather than one was to multiply access to the small business deduction.)



HOW THE DIVIDEND TAX CREDIT WORKS

A corporation is a taxpayer that pays income tax on its business income and other income. And of course, an individual shareholder in the corporation is a taxpayer who pays income tax on dividend income received from the corporation. Since a corporation pays a dividend out of after-tax income (that is, dividends are not a deductible expense to the corporation), there is the potential for double taxation.

In order to prevent double taxation, the Canadian income tax system provides a "gross-up" and "dividend tax credit" mechanism for individual shareholders receiving dividends from taxable Canadian corporations.

There are two types of dividends with different gross-up and dividend tax credit amounts. An "eligible dividend" is generally a dividend paid out of the corporation's business income that was subject to the general corporate rate of tax, which is between 25% and 30%, depending on the province. A "non-eligible dividend" is generally a dividend paid out of the corporation's income that was subject to the small business deduction, so that the corporation's tax rate on the income was about 9% to 13%, depending on the province.

For eligible dividends, the gross-up is 38% of the dividend and the federal dividend tax credit is 6/11ths of the gross-up. The provincial credit depends on the province. For non-eligible dividends, the gross-up is 15% of the dividend and the federal credit is 9/13ths of the gross-up. Again, the provincial credit depends on the province.

The gross-up of the dividend is meant to put the shareholder in roughly the same position as if the shareholder earned the corporation's pre-tax income. The shareholder then computes their tax payable on that amount, and the dividend tax

credit is meant to roughly offset the corporate tax payable. The net result, if there is perfect “integration”, is no double taxation, and the shareholder pays personal tax on the corporation's underlying income at the shareholder's marginal tax rate, while getting a refund of the tax the corporation paid.

EXAMPLE

A corporation earns $138 of business income and is subject to a combined federal and provincial regular corporate tax rate of 27.5%. The corporation distributes the after-tax amount of the income to its individual shareholder. The shareholder is in a 40% tax bracket.

Since the dividend is an eligible dividend, the gross-up is 38% of the dividend. The federal dividend tax credit is 6/11 of the gross-up. We will assume that the provincial dividend tax credit is 5/11 of the gross-up, meaning that the total credit is equal to the gross-up.

The corporation's initial 27.5% corporate tax on the $138 is $38 (to keep things simple, all numbers are rounded to the nearest dollar). The corporation thus has $100 left to pay as a dividend to the shareholder.

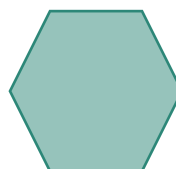
The shareholder includes in income $100 plus the 38% gross-up, for a total of $138. Note that this the same as the corporation's pre-tax income.

The shareholder then computes their initial 40% tax on $138, which is $55. The shareholder gets a combined federal and provincial dividend tax credit of $38. This leaves the shareholder with net tax payable of $17.

In this example, there is perfect integration because the shareholder’s dividend tax credit of $38 exactly offsets the corporate income tax paid of $38, and the total corporate tax ($38) and personal tax ($17) paid is $55, the same as if the shareholder had paid 40% tax on the original $138 of business income. Across the provinces, there is not always perfect integration due to minor differences between the federal and provincial tax systems and calculations. But in each province the dividend tax credit provides a result that is close to integration.

The other way to determine whether there is perfect integration is to compare the corporate result with that seen where the individual instead carries on the business personally (i.e. without a corporation). In such case, using the individual in the above example, the individual would pay 40% tax on $138 of business income, being $55, the same result as in the example.

The dividend tax credit applies only to Canadian resident individuals receiving taxable dividends from Canadian resident corporations. It does not apply to dividends you receive from foreign corporations, as it is not considered appropriate for the Canadian government to provide you with a credit for foreign corporate tax paid by the foreign corporation. However, you will get a foreign tax credit for the foreign tax that you pay personally on the dividend (often a 15% withholding tax, but the rate depends on the country and the provisions of Canada's tax treaty with that country, if there is one).



AROUND THE COURTS

TAXPAYER LIABLE FOR SPOUSE’S TAX LIABILITY FOR UNREMITTED SOURCE DEDUCTIONS

Under the Income Tax Act, a director of a corporation can be liable for the corporation’s failure to remit source deductions to the Canada Revenue Agency (CRA), such as income tax that is withheld from salary of the corporation’s employees.

Under a different rule (the “transfer of property rule”), if a person transfers property to a non-arm’s length person such as a spouse, then the transferee can be liable for the transferor’s tax debts owing for the year of transfer or previous years.

There have been many recent cases where a transferee spouse has been held liable for a transferor's liability as a director which arose from the corporation's liability for source deductions (or GST/HST).

In the recent Colitto case, the transferee (wife) argued that her husband's liability as director for the corporation's unpaid source deductions did not arise until the CRA had attempted to collect the corporation's debt and "execution had been returned unsatisfied" – a legal Federal Court step that the Income Tax Act says is required before the director is liable.

The corporation's unremitted source deductions arose in 2008, and that was when the husband became liable as director. He transferred property to his wife, also in 2008.

In 2011, after the CRA could not collect from the corporation (i.e. "execution was returned unsatisfied"), the CRA assessed the husband as director for the corporation's source deduction liability. Some years later, the CRA then assessed the wife for the value of the property the husband transferred to her, and she appealed to the Tax Court of Canada.

The Tax Court held that, because the husband could not yet be assessed as director in 2008 (since the CRA had not yet tried to execute judgment against the corporation), the wife was not liable for the transfer of property.

The CRA appealed further to the Federal Court of Appeal, which allowed the appeal and found the wife liable. The Court of Appeal held that the director's liability arises at the time of the corporation failing to remit the source deductions, even though the CRA could not assess the director until the CRA had tried to collect from the corporation.

Thus, the wife ended up on the hook for the value of the property the husband transferred to her.

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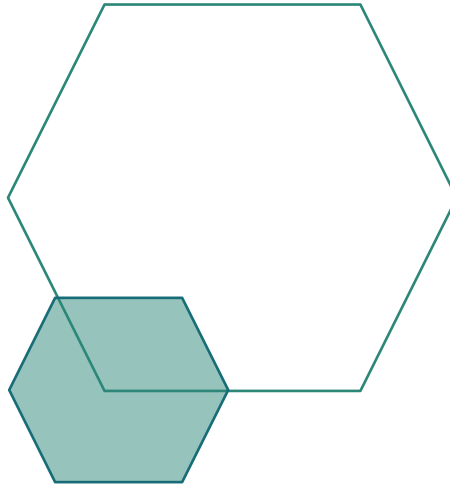

This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.

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