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Tax Newsletter

Topics for discussion:

- Charitable donations on death
- Taxation of put and call options
- Employee stock options
- T1134 filing update
- Around the courts

Charitable donations on death

General rules

The charitable donations tax credit is one of the more generous tax credits under our tax system. The federal credit equals:

- 15% of the first $200 of donations in a year;
- 29% on additional donations in the year, except that to the extent you are in the highest tax bracket (over $205,842 of taxable income for 2018), the credit is 33% for all donations that come from income subject to that highest rate of tax.

Example

In 2018, you make $10,000 in charitable donations. Your taxable income is $210,842, which means that $5,000 of that amount is coming from income that is subject to the highest tax bracket.

Your federal credit will be:

15% x $200 = $30;

33% x $5,000 = $1,650; plus

29% x $4,800 = $1,392

On top of that, you will receive a provincial tax credit. This credit depends on your province of residence, bringing the total credit up to 50% or more.

The donation can be claimed in 2018, or alternatively can be carried forward and claimed in any of the next five years.

Special rules on death

If you make charitable donations under your will, or if your executor makes donations out of your estate, special timing rules apply.

Generally, if the donation is made within the first 60 months after your death, the credit can be claimed on your return for the year of death or the immediately preceding year, or by your estate in the year of donation or one of its first three taxation years (in particular, while the estate is a "graduated rate estate"). Alternatively, the credit can be claimed by your estate in the year of donation or for any of the next five taxation years. The donation amount can be shared between you and your estate but cannot be doubled up.

Example

Under your will, you make a $10,000 donation to charity to be paid after your death. You die in 2018. Your estate makes the gift in its third taxation year.

The credit can be claimed on your 2018 or 2017 tax return. Alternatively, the estate can claim the credit in any of its first three taxation years or carry the donation forward and claim it in any of the subsequent five years.

As a further alternative, you and your estate could split the donation amount and share it amongst any of those years – for example, you might claim $5,000 in the year of death and your estate might claim $5,000 in its first taxation year.

If the donation is made after the 60-month period, the credit cannot be claimed on your personal return. Only your estate can claim the credit, either in the year of donation or in any of the next five taxation years.

If you make the donation while you are alive but in the year of your death, the credit can be claimed on your return for the year of death or the preceding year. Alternatively, your spouse (or common-law partner) can claim the credit in the year of your death. The donation amount can be shared by your and your spouse, but again the credit cannot be doubled up. In this scenario, your estate cannot claim the credit.

Taxation of put and call options

Special income tax rules apply to options, whether you purchase them or sell or grant them.

First, some terminology. A "call option" on a property provides the holder of the option with the right to *buy* the property at a set price, sometimes called the exercise price. In contrast, a "put option" on a property provides the holder with the right to *sell* the property at the exercise price.

Purchase and sale of call option

Generally, there are no immediately income tax consequences for the purchaser of a call option, except that the purchase price of the option becomes the purchaser's adjusted cost base of the option. If the option expires and is not exercised, the purchaser will have a capital loss in the year of expiration equal to the purchase price, and half of that will be an allowable capital loss.

Exercise of call option

If the option is exercised and the property is acquired, the purchase price of the option is added to the adjusted cost base of the property for the purchaser.

For the grantor, the amount received for the option will be added to its proceeds of disposition of the property, which will generate a capital gain or loss. In this case, the grantor's capital gain on the sale of the option (see above) will be reversed. If the sale of the option was in an earlier year, the grantor can amend the earlier year's tax return to delete the previously reported gain and claim a tax refund, if applicable.

> ***Example***
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> In 2018, John purchases a call option from Mary for $10,000. The option provides John with the right to purchase Mary's shares in a private corporation for $200,000 until the end of 2019. Mary's adjusted base cost of the shares was $120,000.

In 2019, John exercises the option and purchases the shares for the exercise price of $200,000.

Results: In 2018, Mary will have a capital gain on the grant of the option equal to $10,000 and therefore a taxable capital gain of $5,000.

In 2019, Mary will have proceeds of disposition of $210,000, which is the $200,000 exercise price plus the $10,000 she received for selling the option, for a total of $210,000. The 2018 capital gain will be reversed / deleted if she amends her 2018 return.

Therefore, in 2019 Mary will have a capital gain of $90,000 ($210,000 proceeds minus her adjusted cost base of $120,000), and half of that, or $45,000, will be included in her income as a taxable capital gain.

John will acquire the property at an adjusted cost base of $210,000, which is the $200,000 exercise price plus the $10,000 amount paid for the option.

Purchase and sale of put option

The grantor of a put option will have proceeds of disposition equal to the amount received for granting the option, and therefore will have a capital gain, half of which will be a taxable capital gain included in the grantor's income.

There are no immediately income tax consequences for the holder of the put option, except that the purchase price of the option becomes the holder's adjusted cost base of the option. If the option expires and is not exercised, the holder will have a capital loss in the year of expiration equal to the purchase price, and half of that will be an allowable capital loss.

Exercise of put option

If the holder of the option exercises the option and sells the underlying property, its proceeds of disposition for the property will equal the exercise price minus the adjusted cost base of the option.

The grantor of the put option, who will purchase the underlying property upon exercise of the option, will have an adjusted cost base in the property equal to the exercise price minus the amount it received for the option. If the option was granted in an earlier year, the grantor can have the earlier year's tax return amended to take out the previously reported gain (see above) and claim a tax refund, if applicable.

Example

In 2018, John grants a put option to Mary for $10,000. The option provides Mary with the right to sell her shares in a private corporation to John for $200,000 until the end of 2019. Mary's adjusted base cost of the shares was $120,000.

In 2019, Mary exercises the option and sells the shares to John for the exercise price of $200,000.
Results: In 2018, John will have a capital gain on the grant of the option equal to $10,000 and therefore a taxable capital gain of $5,000.

In 2019, Mary will have proceeds of disposition of $190,000, which is $200,000 exercise price minus the $10,000 she paid for the option. Therefore, in 2019 Mary will have a capital gain of $70,000 ($190,000 proceeds minus her adjusted cost base of $120,000), and half of that, of $35,000, will be included in her income as a taxable capital gain.

John will acquire the property at an adjusted cost base of $190,000, which is $200,000 exercise price minus the $10,000 he received for the option. The 2018 capital gain will be reversed / deleted if he amends his 2018 return.

Employee stock options

Employee stock options have specific rules that are different from the tax rules that apply to other options as discussed in the article above.

Generally, an employee stock option refers to an option granted to an employee of a corporation that entitles the employee to buy shares in the employer (or a related corporation) at a set price over a set term. In other words, the option is basically a call option for the employee on shares in the employer (or related corporation).

The grant of the option is not a taxable event for either the employee or employer.

Instead, the Income Tax Act provides a "wait and see" approach, under which the employee has tax consequences only if the employee *exercises* the option and acquires the shares. If the employee does not exercise the option, it simply expires with no tax consequences. (In the rare case where the employee paid something for the option, the amount paid will constitute a capital loss for the employee if the option expires. But generally employees do not pay for these options — they receive them as an employee benefit.)

Exercise of option

If the employee exercises the option and acquires the underlying shares, the employee will include in employment income a benefit equal to the difference between the option exercise price and the fair market value of the shares when they are acquired.

The timing of the inclusion will depend on whether the employer corporation is a Canadian-controlled private corporation (CCPC) or not. If it is not a CCPC, the benefit is included in income in the year in which the *shares are acquired*. If it is a CCPC, the benefit is included in the year in which the *employee sells the shares*. In other words, the CCPC stock option provides a potential deferral for the employee. (This recognizes that the market value of shares in a CCPC is usually unknown until shares can actually be sold. For shares of a public company, in contrast, the value can easily be determined.)

The amount of the benefit is added to adjusted cost base of the shares for capital gain / capital loss purposes, so as to prevent double taxation.

One-half deduction

In most cases, if you exercise an employee stock option, you will be allowed a deduction of one-half of the benefit in computing your taxable income. In other words, similar to capital gains, in most cases only one-half of employee stock option benefits are subject to tax.

You are allowed the one-half deduction in either of the following two scenarios.

First, you get the deduction if:

- The option exercise price was not less than the fair market value of the shares when the option was granted (in colloquial terms, the option was not “in the money” when it was granted to you);
- The shares were common shares (or prescribed shares with similar characteristics to common shares); and
- You deal at arm’s length with the employer.

Alternatively, you can get the deduction if the employer is a CCPC and you hold on to the shares for at least two years before selling them.

> ***Example***
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> In 2015, you were granted an option to acquire common shares in your employer at an exercise price of $20 per share. At the time of the grant in 2015, the shares were trading at $18 per share. Your employer is a public company and thus is not a CCPC. You deal at arm’s length with your employer.

In 2018, you exercise the option and acquire the shares when they are worth $30 per share. In 2019, you sell the shares for $35 per share.

Results: In 2015, there is no tax effect on you, since you have not yet exercised the option.

In 2018, you include a benefit of $10 per share ($30 − $20) in your employment income. However, in computing your taxable income, you will be allowed to deduct half of that amount, or $5 per share. The initial $10 benefit amount is added to the cost of each share, which becomes $30.

In 2019, you will have a capital gain of $5 per share ($35 − $30), and half of that will be included in your income as a taxable capital gain.

Note that if you sold the shares in 2019 for, say, $25, you would have a capital loss of $5 per share. However, this capital loss cannot be used to offset the employee stock option benefit, since capital losses can only offset capital gains, and the stock option benefit is considered employment income.

T1134 filing update

In the 2018 budget, Finance Canada proposed to change the filing requirements from 15 months after the year-end, to 6 months, effective for years ending after 2019. On October 25, 2018 Finance Canada issued a Notice of Ways and Means to amend the filing requirement from 6 months to 12 months for years after 2019, and to 10 months for years after 2020. This is welcome news but will still likely cause increased pressure for multinational corporations and clients who are subject to reporting obligations in the United States.

Around the courts

Royalties qualified for small business deduction

A Canadian-controlled private corporation (CCPC) is entitled to the small business deduction on the first $500,000 of its active business income in a taxation year. The small business deduction reduces the corporate tax rate to around 11-14%, depending on the province, as compared to the regular corporate tax rate of around 25-30%, again depending on the province.

As a general rule, active business income does not include income from a "specified investment business", which includes a business the principal purpose of which is to derive income (including interest, dividends, rents and royalties) from property.

In the recent Rocco Gagliese Productions case, the taxpayer was a CCPC whose sole shareholder was Mr. Rocco Gagliese. Mr. Gagliese was a music composer who wrote music for various television programs. He did so as an employee of the CCPC. The CCPC received royalties for the use of the music from SOCAN, which collects and distributes royalties to music creators. The CCPC claimed the small business deduction on its earnings.

The Canada Revenue Agency (CRA) assessed the company, disallowing the small business deduction on the grounds that its business was a specified investment business the principal purpose of which was to earn royalty income.

The company 's appeal of the assessment to the Tax Court of Canada was allowed. The judge held that the principal purpose of the taxpayer's business was to earn business income from Mr. Gagliese's daily activities of originating and recording music tracks for television episodes. This was an active business of the taxpayer, and so the small business deduction was allowed.

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