# Planning Matters

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# Tax Tips for 2020

*In this edition of Planning Matters, we turned to accountants Jeffrey Brockman and Jim Chang for tax advice. They offer some excellent tips for income splitting, deducting home renovation costs, and claiming home office expenses during COVID-19.*

## Prescribed Rate Loan Planning

As governments borrow to fund COVID-19 programs, our clients are increasingly asking us about the potential for future tax increases – and options for managing their tax burden. One strategy that is appropriate for some clients is the use of prescribed rate loans in order to achieve a form of income splitting.

Approximately three years ago the Federal Government updated various rules to limit income splitting with family members, including the Tax on Split Income (TOSI). TOSI governs many income splitting strategies, mostly as they relate to private corporations with active and non-active family members as shareholders. With the amendments, however, typical income splitting techniques were put to rest in one fell swoop. What was once an easy plan has since turned into long analyses and discussions usually ending with the unsatisfying, "Well, it's possible."

TOSI did not shut down all income splitting strategies. One that still works well is Prescribed Rate Loan Planning. Before we discuss the strategy, it is important to know that the Income Tax Act (Canada) has rules that essentially attribute various types of income earned back to the transferor. This is the case for example when a parent gifts money to a minor child. Interest and dividend income earned on the gifted funds would attribute back to the parent. Similar rules exist when funds are moved from one spouse to another.

An exemption to the attribution rules exists where a *bona fide* loan is made from one spouse to another that bears interest at the "Prescribed Rate." The Canada Revenue Agency sets the Prescribed Rate quarterly and it was recently reduced to just 1% per annum, effective July 1, 2020. As long as interest is paid on the loan within 30 days of the year end, the income on the invested funds would not attribute back to the transferor. This strategy can be effective when one spouse is taxed at the top rate (approximately 50% in most provinces) and the other spouse has little to no income. By accessing marginal tax rate differences, the annual savings in tax on $200,000 of income can be in the range of $30,000, depending on the province or territory in which you reside.

The strategy can also work with minor children, however the creation of a formal Trust would be required. Creating a Trust involves some up-front legal costs as well as requiring a settlor to settle and identify trustees of the Trust. The objects of the Trust are noted in the Deed of Trust. The transferor would loan the funds to the Trust and the Trust trustees would ensure payment of the interest annually, within the allotted time frame. A Trust is a separate taxpayer and as such is required to file annual tax returns. Any net income in the Trust would be taxed at the top rate of tax if left in the Trust. However, the trustees can allocate the Trust's net income out to its beneficiaries annually. This would eliminate any top rate of taxes otherwise due in the Trust, and at the same time, access the individual beneficiaries' lower marginal tax rates.

As an example, assume that Mrs. X, the mother of Mrs. Y, settles a family Trust for the benefit of Mrs. Y's five children. Mrs. Y lends the trust $1,000,000. In the first year of the Trust, the income earned with Leith Wheeler is $60,000. The Trust pays Mrs. Y $10,000 for the 1% interest charged on the loan. This leaves $50,000 of net income in the Trust. Mrs. Y, being the trustee of the Trust, causes the Trust to allocate $10,000 to each of her five children. Therefore, the Trust pays no tax and absent any other income, each child would pay no tax. Had Mrs. Y earned that additional $50,000 personally she would have owed just over $25,000 of tax on that income.

While the plan works well when an individual has considerable "tax paid" funds held personally in non-registered accounts, it does not when the family wealth has been accumulated in a corporate setting. Many professionals and small businesses that are incorporated, accessing the long-term deferral of lower corporate tax rate planning, would have to withdraw the funds from their corporation to engage in this plan. This would trigger a tax burden of 40% or more.

In many instances, Prescribed Rate Loan Planning can be a compelling way to reduce a family's overall income tax burden. It should be considered as a potential element of a broader family tax plan, developed by a tax advisor.

## Home Accessibility Tax Credit (HATC)

The Canada Revenue Agency (CRA) first introduced the Home Accessibility Tax Credit (HATC) for the 2016 tax year to provide tax relief to individuals who are required to make alterations to their home due to mobility challenges. It is a non-refundable tax credit for work performed or goods acquired in respect of a **qualifying renovation** of an **eligible dwelling** of a **qualifying individual**. A maximum of $10,000 per year in **qualifying expenses** can be claimed by a qualifying individual or an **eligible individual**, resulting in a maximum non-refundable tax credit of $1,500 per year.

When there is more than one qualifying individual for an eligible dwelling, the total eligible expenses cannot be more than $10,000 for the dwelling. The claim can be split between the qualifying individual and the eligible individual(s) for the qualifying individual. If the claimants cannot agree on what amount each person can claim, the CRA will determine the amounts.

A **qualifying individual** is an individual who is eligible to claim the disability tax credit at any time in a tax year, or an individual who is 65 years of age or older at the end of a tax year.

An **eligible individual** includes a spouse, common-law partner, and certain supporting relatives of a qualifying individual.

A **qualifying renovation** is a renovation or alteration that is of an enduring nature and is integral to the eligible dwelling. The renovation must allow the qualifying individual to gain access to, or to be mobile or functional within, the eligible dwelling or reduce the risk of harm to the qualifying individual within the eligible dwelling or in gaining access to the dwelling.

**Qualifying expenses** qualify when they are made or incurred in relation to a qualifying renovation or alteration to an eligible dwelling and are of an enduring nature and integral to the dwelling. As a general rule, if the item you purchase will not become a permanent part of your dwelling, it is not eligible.

An **eligible dwelling** is a housing unit located in Canada. It must be the principal residence of the qualifying individual at any time in the tax year. In general, a housing unit will be considered to be a qualifying individual's principal residence where it is ordinarily inhabited (or is expected to be ordinarily inhabited within that tax year) by the qualifying individual and it is owned (either jointly or otherwise) by the qualifying individual or the qualifying individual's spouse or common-law partner. For the purposes of the home accessibility tax credit, a qualifying individual may have only one principal residence at any time, but may have more than one principal residence in a tax year.

As HATC is inter-related with other non-refundable tax credits such as the medical expense tax credit, it might not be as straightforward as it appears to be; thus, it is strongly advised to discuss with a tax accountant before completing this part of tax returns.

## Claiming Home Office Deductions During COVID-19

As the COVID-19 pandemic shifts employees from their offices to their homes, many employees are left wondering whether they will now be able to deduct home office expenses from their employment income in their 2020 tax return.

Prior to the COVID-19 pandemic, an employee could claim home office expenses if they were contractually required to maintain a home office for which they were not reimbursed, and met **one** of the **following two conditions:**

1) The home office is the place where the employee **principally** (more than 50% of the time) performed their employment duties; or

2) The space is **used exclusively** during the period for the purposes of earning **employment income** on a **regular** and **continuous basis**, and for **meeting** customers or other persons in the ordinary course of performing employment duties.

Given that the COVID-19 pandemic has required many **to work from home**, many more will likely be eligible under provision 1) than in previous years. However, at question is whether the workspace must be the main place of work in the **context of the entire year or just a specific period**, such as the several months dictated by preventative COVID-19 measures. While the CRA has not yet provided their comment, the tax preparation community has been pushing for guidance in time for next tax filing season.

If qualifying under **provision 2)**, a problematic issue is the requirement for **regular and ongoing meetings.** CRA has stated that those meetings must be **in person**; many tax practitioners have noted that position is outdated and should include video and teleconference meetings as well.

A **portion** of household costs can be deducted, such as **electricity, heating, water, rent, security and maintenance.** If, and only if, the individual is a commissioned **salesperson**, a portion **of property tax** and insurance can also be deducted. **No employees** (neither commissioned sales persons nor regular employees) can deduct **mortgage interest or capital cost allowance.** Employees must also limit expenses to the amount of related income earned during the year.

When calculating the **deductible percentage**, a **reasonable** basis should be used, such as the **area** of the workspace divided by the total finished area (including hallways, bathrooms, kitchen, etc.). Expenditures that **relate solely** to the workspace and employment duties **do not have to be prorated**. Employees must also prorate based on portion of the day used for work during the year.

Given the potential costs of setting up a home office, the CRA has indicated that reimbursements to employees up to $500 for computer equipment will not be considered a taxable benefit to employees, provided they retain supporting receipts. The CRA may further broaden this policy to include other types of home office equipment, although this remains outstanding. For example, if an employee purchases a laptop computer for $800 and the employer reimburses the full amount, the employee would only be required to include a $300 taxable benefit in their income. The employer, however, would generally be able to deduct the full $800 reimbursement.

In addition, employees must obtain a completed **T2200 Form – *Declaration of Conditions of Employment*** - from their employer.

It is expected these rules and interpretations will continue to change rapidly.

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