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TAX LETTER

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TAX TREATMENT OF PUT AND CALL OPTIONS

A call option is an option under which the holder has the right, but not the obligation, to buy a particular property at a set price (exercise price). On the other hand, a put option gives the holder the right to *sell* a property at a set price (also, the exercise price).

Depending on the terms of the option, it may be exercised by the holder (so that the property is sold or purchased, as the case may be) over a period of time or at a specific set time. If the option is not exercised, it normally just expires and the property will not be sold or purchased under the option.

Call Options – Tax Position of Holder

There is no tax consequence to the holder until the holder exercises the option and acquires the property. At that time, the holder's cost of the property, for tax purposes, will include the exercise price to acquire the property plus the holder's cost of the option.

If the holder does not exercise the option and it expires, at that time of expiration the holder will have a capital loss equal to the amount paid for the option.

Call Options – Position of Grantor of Option

On granting the option, the grantor will have deemed proceeds of disposition equal to the amount received from the holder for the option. In most cases, an individual grantor's cost of the option is deemed to be nil. As such, the grantor will realize a capital gain equal to the amount received for the option. Half of the capital gain is included in income for tax purposes, as a taxable capital gain.

However, if the option is exercised by the holder, the grantor's initial grant of the option will be deemed not to result in a disposition or capital gain. Instead, the exercise price under the option plus the amount received for the grant of the option will form the grantor's proceeds of disposition of the property. If the exercise takes place in a year subsequent to the initial year of the grant of the option, the CRA will re-assess the initial year and eliminate the initial gain (described in the preceding paragraph).

Put Options – Tax position of Holder

There is no tax consequence until the holder exercises the option and sells the subject property. Upon exercise, the holder's cost of the option is subtracted from the proceeds of disposition of the property, effectively reducing any gain (or increasing any loss) on that disposition.

If the option is not exercised and expires, at that time the holder will have a capital loss equal to the amount paid for the option.

Put Options – Tax position of Grantor of Option

As above, upon granting the option, the grantor will have proceeds of disposition equal to the amount received from the holder for the option, and will generally realize a capital gain equal to that amount.

If the put option is exercised by the holder, such that the grantor must purchase the property subject to the option, the grant of the option is deemed not to have occurred, so the gain in the preceding paragraph will be nil. Instead, on the exercise, the grantor's cost of the purchased property is reduced by the amount received for the option. As above, if the exercise takes place in a year subsequent to the initial year of the grant of the option, the CRA will re-assess the initial year and eliminate the initial gain.

Example of Call Option

Last year, Mr. B granted you an option to purchase some commercial real estate from him at an exercise price of $200,000. Mr. B's cost of the real estate was $100,000. You paid $5,000 for the call option. This year, you exercised the option and purchased the real estate for $200,000.

Your tax treatment: Your cost of the real estate will include the $5,000 paid for the option plus the $200,000 exercise price paid for the real estate pursuant to the option, for a total of $205,000.

Mr. B's tax treatment: Last year, he had an initial capital gain of $5,000. However, in this year, his proceeds of disposition of the real estate will include the $200,000 exercise price received plus the $5,000 received for the option, or $205,000. As a result, he may have a gain this year equal to his $205,000 proceeds minus his

$100,000 cost, or $105,000. The CRA should then re-assess last year to remove the initial $5,000 gain reported in that year.

Example of Put Option

Last year, Mr. B granted you a put option that allows you to sell some commercial real estate to him (i.e., force him to buy it) at an exercise price of $200,000. Your cost of the real estate was $100,000. You paid $5,000 for the put option. This year, you exercised the option and sold the real estate to Mr. B for $200,000.

Your tax treatment: Your $200,000 proceeds of disposition of the property will be reduced by the $5,000 you paid for the option, for a total of $195,000. As such, you have a capital gain of $95,000, half of which is included in your income as a taxable capital gain.

Mr. B's tax treatment: Last year, he had an initial capital gain of $5,000. However, this year, his $200,000 cost of the real estate will be reduced by the $5,000 he received for the option, for a total cost of $195,000. The CRA will then re-assess last year to remove the initial $5,000 gain reported in that year.

Employee stock options

The above tax rules do not govern employee stock options, e.g. those granted to employees by their employer corporations. The employee stock option rules were discussed in our May 2015 Tax Letter.

NON-RESIDENTS WITH CANADIAN RENTAL INCOME

Basic withholding tax

A non-resident individual who earns rental income from real estate in Canada is subject to non-resident withholding tax at the rate of 25% of the gross rental income. The resident payer of the rent must withhold the 25% tax from the rental payments and submit the amount withheld to the CRA on behalf of the non-resident tax liability. Unlike the withholding tax on other forms of passive investment income (e.g. dividends), the 25% rate is not reduced under Canada's income tax treaties.

Unless the non-resident chooses the alternative method of reporting the rental income (discussed below), that is basically the end of the matter. The non-resident does not file a Canadian tax return, and the 25% tax withheld is generally the final tax liability for the relevant year.

Alternative method

As an alternative, the non-resident can elect to file a regular T1 tax return under Part I of the Act within 2 years after the end of the year (rental year) in which the rental income was received. In such case, the net rental income for the rental year will be subject to the same graduated rates of tax as apply to resident individuals. That may save the non-resident tax compared to the 25% flat rate on the gross income.

Note that if the non-resident has more than one Canadian rental property, the election will cover all net rental income from all of those properties. In other words, one can't make the election for one property and not for another.

Any previously withheld non-resident tax in excess of the actual Part I tax payable for the rental year will be refunded to the non-resident.

Reduction in withholding tax under alternative method

A non-resident who uses the alternative method and wishes to reduce the 25% withholding tax otherwise applicable to the rent can file Form NR6 with the CRA. Once the form is approved by the CRA, the agent who collects your rent will be required to withhold only 25% of the *net* rental income paid to the non-resident rather than 25% of the gross rental income from the property. (The agent must be resident in Canada.) The CRA requires the form to be filed by January 1 of the relevant year.

In such case, the non-resident must file the T1 return for the year by June 30 of the following year.

If the non-resident files the return late, a rather harsh provision in the Income Tax Act provides that the non-resident will be subject to the withholding tax on his or her gross rental income. The CRA provides the following example:

> **Example**
>
> Emily, a resident of Australia, rents out a property she owns in Canada. Before January 1, 2015, Emily and her agent completed Form NR6 and sent it to the CRA, and the CRA approved it.
>
> For 2015, she received rental income and had rental expenses as follows:
>
> Gross rental income of $20,000
> Minus allowable expenses of $15,000
> Equals net rental income of $5,000
>
> Because the CRA approved Form NR6, the agent was able to withhold and remit non-resident tax for 2015 on the net rental income (25% of $5,000 = $1,250) rather than on the gross rental income (25% of $20,000).
>
> Emily must file for 2015 a Canadian return on or before June 30, 2016.
>
> If she does not send the return by the due date, her agent will have to pay an additional $3,750, plus interest, on Emily's account. This $3,750 is the difference between the amount withheld on her net rental income (25% of $5,000 = $1,250) and the amount Emily would have to pay on her gross rental income (25% of $20,000 = $5,000) if she had not filed Form NR6.

CHILD CARE EXPENSES

Subject to monetary limits (discussed below) child care expenses are deductible in computing your income if they enable you to

- be employed;
- carry on business;
- carry on research for which you received a grant; or
- attend post-secondary or secondary school.

Qualifying expenses

The types of child care expenses that qualify for the deduction include those paid for baby-sitting, day care services, a nursery, or a nanny or other child-care provider. However, they do **not** include amounts paid to the child’s mother or father for the services, to a related minor child, or to a person for whom you claimed a personal credit amount.

They do **not** include amounts paid for medical or hospital care, clothing, transportation or education.
Otherwise, the qualifying expenses **can** include amounts paid to adult relatives such as aunts, uncles, grandparents, and so on. They also include amounts paid to non-related minors, such as your 17-year old neighbour who is the baby-sitter.

They also include amounts paid for a boarding school or camp, but these amounts are subject to a separate monetary restriction noted below.

If the child care is provided by an individual, you will need to obtain a receipt showing the individual's Social Insurance Number, and provide it to the CRA on request. (This generally ensures that the individual will be required to include the amounts in income.)

Monetary limits

There are two general monetary limits to the deduction of your child care expenses paid in a year. Normally, you can deduct only the lesser of the following amounts for the year:

- 2/3 of your "earned income" for the year; and
- the total annual dollar limits per child; as of 2015 these amounts are $8,000 per child under 7 years of age at the end of the year, $5,000 per child 7 to 16 years of age, and $11,000 per disabled child (these amounts were each increased by $1,000 over the 2014 amounts).

For this purpose, your "earned income" for the year includes your employment income (including taxable benefits, allowances, and employee stock option benefits), net business income, the taxable amount of fellowships and research grants, and any disability pension payments received under the Canada Pension Plan or Quebec Pension Plan.
Note that the child care expenses do not have to be paid for the children that generate the dollar limits. For example, you might pay nothing for child care for a 15 year old, yet your dollar limit includes $5,000 because you have that child, even if all your child care is paid for a six year old.

As noted, amounts paid for boarding schools and camps can qualify as child care expenses. However, they are limited to the following amounts (as of 2015):

- Children under 7 at the end of the year: $200 per week of attendance
- Children 7 through 16: $125 per week
- Disabled children: $275 per week

Furthermore, for married or common-law couples, the individual with the **lowest income** for the year must normally claim the deduction and the higher income spouse cannot claim a deduction (subject to the section below). Thus, for example, if one spouse stays at home and has no income while the other spouse works, there will be no deduction allowed because the higher-income spouse will not qualify, and 2/3rds of the stay-at-home spouse's earned income will be nil.

Note that expenses that cannot be deducted in one year because of the monetary limitation cannot be carried forward to other years.

When the higher income spouse can claim the deduction

The higher income spouse or common-law partner can claim a deduction for child care expenses in a year in the following circumstances only:

- The lower income spouse attended school in the year;
- The lower income spouse was certified by a medical doctor as incapable of caring for 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 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 either of these cases, the higher income spouse's deduction is limited to the lesser of the two general monetary limits discussed above (i.e. 2/3 of income and the annual child care amounts). However, the deduction is further limited to a maximum amount per week in which the other spouse attended school, was incapable owing to the infirmity, or in prison, as the case may be. Under this last limit, the maximum amount per week that can be deducted is $200 per child under the age of 7 at the end of the year, $125 per child age 7 through 16, and $275 per disabled child. (If the lower income spouse attended school on a part-time basis, these dollar amounts apply on a per month basis, rather than on a per week basis.)

Any remaining child care expenses can be claimed by the lower income spouse, subject to the monetary limits for that spouse, discussed earlier.

Example

Harry and Sarah are married and have two healthy children aged 4 and 9 years. In 2015, Sarah had $120,000 of earned income and Harry had $30,000 of earned income. During the year, Harry attended university on a full-time basis for 13 weeks. They incurred $18,000 of qualifying child care expenses for the year.

Since Harry attended school full-time for 13 weeks, Sarah can claim a maximum deduction of the least of:

- 2/3 of her $120,000 earned income = $80,000;
- $8,000 + $5,000 annual child care amounts = $13,000; and
- 13 weeks that Harry was in school x ($200 + $125) = $4,225

Therefore, Sarah can deduct $4,225.

Harry can then claim a deduction equal to the least of:

- 2/3 of his $30,000 earned income = $10,000; and
- annual child care amounts of $13,000;

which is $10,000, minus the $4,225 claimed by Sarah, so Harry can deduct $5,775.

PRESCRIBED INTEREST RATES

On September 16, 2015, the CRA announced the prescribed interest rates that apply to amounts owed to the CRA and to amounts the CRA owes to individuals and corporations for the current calendar quarter. The amounts are subject to change every calendar quarter. The following rates are in effect from

October 1, 2015 to December 31, 2015, and remain unchanged from the last several quarters.

- The interest rate charged on overdue taxes, Canada Pension Plan contributions, and Employment Insurance premiums is 5%, compounded daily.

- The interest rate paid on late CRA refunds paid to corporations is 1%, compounded daily.

- The interest rate paid on late CRA refunds paid to other taxpayers is 3%, compounded daily.

- The interest rate used to calculate taxable benefits for employees and shareholders from interest-free and low-interest loans is 1%.

AROUND THE COURTS

Travel expenses did not qualify as medical expenses

In general terms, medical expenses that qualify for the medical expenses credit include travel expenses incurred to go to a location for medical services at least 40 kilometres from the patient's home. They must be paid for services that are not provided in the home locality of the patient.

In the recent *Tallon* case, the taxpayer incurred travel expenses to Thailand and Indonesia for the purpose of "obtaining medical services". The taxpayer suffered from temporomadibular joint dysfunction which was a debilitating condition that led to the replacement of joints with prosthetic devices. The prosthetic devices were adversely affected by the cold winter climate of Thunder Bay where the taxpayer lived. According to the taxpayer, the warmer climates in Thailand and Indonesia should have been considered "services" that were not provided by the taxpayer's home locality.

The CRA denied the deduction, but the Tax Court of Canada allowed the taxpayer's appeal. However, the CRA appealed further to the Federal Court of Appeal, which allowed the appeal, ruling that the Tax Court was wrong. The beneficial effects of a warmer climate were not "medical services". As a result, the taxpayer's deduction was denied.

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