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TAX LETTER

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RECORDING YOUR BUSINESS AUTOMOBILE EXPENSES

If you carry on a business, you can deduct a reasonable amount of car expenses incurred in the course of your business. The expenses can include your fuel costs, license and insurance costs, leasing costs, maintenance, repairs, capital cost allowance (CCA) on the cost of a purchased car, and interest expense on a loan taken out to purchase the car. (See the next section of this Letter regarding dollars limits for leasing costs, interest, and CCA.)

Assuming that you also use the car for personal purposes, you need to keep records or a “logbook” to track your business use versus your personal use. The Canada Revenue Agency (CRA) suggests that the best evidence to support the use of a vehicle is an accurate logbook of business travel maintained for the entire year, showing for each business trip, the destination, the reason for the trip, and the distance covered.

You can then pro-rate the expenses, based on the business kilometres driven divided by the total kilometres driven, and deduct that portion in computing your business income. Of course, you should also keep receipts that prove your expenses.

Simplified logbook

Alternatively, the CRA allows a simplified logbook method to keep track of your business use of your car. Under this method, you must first maintain a full logbook for one complete year to establish the business use of a vehicle in a "base year".

Once you have established the base year by completing one complete year of keeping a logbook recording your business and total kilometres, for subsequent years you can use a three-month sample logbook to extrapolate business use for the entire year. The three-month sample logbook can be used only if the usage for the subsequent year is within the same range (within 10 percentage points) of the results of the base year. According to the CRA, businesses will need to demonstrate that the use of the vehicle in the base year remains representative of its normal use.

In determining your deductible portion of car expenses in the subsequent year, the business use of the car in the subsequent year is calculated by multiplying the business use as determined in the base year by the ratio of the sample period and base year period. The CRA provides the following formula for this calculation:

> (Sample year period % ÷ Base year period %) × Base year annual % = Calculated annual business use for subsequent year

The CRA provides the following example of the simplified method.

> **Example:**
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> An individual has completed a logbook for a full 12-month period, which showed a business use percentage in each successive quarter of 52/46/39/67, respectively, and an annual business use of the vehicle as 49%. In a subsequent year, a logbook was maintained for a three-month sample period of the second quarter of April, May and June, which showed the business use as 51%. In the base year, the percentage of business use of the vehicle for the second quarter of April, May and June was 46%. The business use of the vehicle would be calculated as follows:
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> **(51% ÷ 46%) × 49% = 54%**

In this case, the CRA would accept, in the absence of contradictory evidence, the calculated annual business use of the vehicle for the subsequent year as 54%. Note that the calculated annual business use is within 10% of the annual business use in the base year in this example.

The CRA states that if the calculated annual business use in a subsequent year goes up or down by more than 10 percentage points, the base year is not an appropriate indicator of annual usage in that later year. In such a case, the sample period logbook would only be reliable for the three-month period it records. For the remainder of the year, the business use of the vehicle would need to be determined based on an actual record or logbook of travel or alternative records. If you later wanted to revert to the simplified method, you would use your most recent base year, assuming you maintained a logbook for a new 12-month period.

PRESCRIBED AUTOMOBILE AMOUNTS FOR 2012

The Department of Finance has announced the automobile expense deduction limits and the prescribed rates for the automobile operating expense benefit that will apply in 2012. The limits and rates are as follows.

CCA, interest, and leasing expense limits

For cars purchased or car leases entered into after 2000 and through 2012, the limits are:

- The maximum cost of your car on which CCA that can be claimed is $30,000 plus federal and provincial sales tax;
- The maximum allowable interest deduction for car loans is $300 per 30-day period in the year; and
- The general limit on deductible leasing costs is $800 per 30-day period in the year plus federal and provincial sales tax. However, the deductible lease payments will also be reduced if the manufacturer's list price of your car exceeds $39,882.

Tax-free car allowances

If you use your own car for employment purposes, your employer can pay you a tax-free allowance in respect of the employment use of the car if the allowance is reasonable. Furthermore, if certain monetary limits are not exceeded, the entire allowance is normally deductible to the employer.

For 2012, the monetary limits are increased by one cent over last year's amount to 53 cents for the first 5,000 kilometres driven in the course of employment and 47 cents for each additional kilometre driven. For the Northwest Territories, Yukon and Nunavut, the allowance limits are also increased by one cent to 57 cents for the first 5,000 kilometres driven and 51 cents for each additional kilometre driven.

Employee car benefits

If your employer provides you with a car and pays *any* of your personal operating costs, you are required to include in income an operating expense benefit. For 2012, the prescribed rate used to determine the operating expense benefit is increased by two cents over last year's amount to 26 cents per kilometre. For employees who are employed principally in selling or leasing automobiles, the prescribed rate is also increased by two cents to 23 cents per kilometre.

You can avoid having the operating expense benefit included in your income if you repay the expenses in full to your employer in the year or within 45 days after the end of the year (i.e., by February 14). If you repay only a portion of the expenses, the benefit is included but reduced by the amount of your repayment.

If you are required to include the operating expense benefit and your employment-related kilometres exceed your personal kilometres for the year, you can elect that the benefit be calculated as half of your "stand-by charge" for the year (instead of the per-kilometre benefit described above). The stand-by charge is a benefit also included in your income, determined by a set formula, which is meant to reflect your personal use of the car. This election must be made by notifying your employer before the end of the year.

The stand-by charge formula is not changed for 2012. In general terms, the stand-by charge is, for an employer-leased car, 2/3 of the lease costs including GST or HST for the period in which you have the car. For an employer-owned car, it is 2% of the original cost of the car including GST or HST times the number of months that you have the car (i.e., 24% per year). In either case, the stand-by charge is reduced if your employment-use kilometres exceed your personal-use kilometres and the latter do not exceed 1,667 per month. There is also an optional reduced standby charge for employees employed principally in selling or leasing automobiles.

EMPLOYEE LOANS

An employee who receives from his or her employer a no-interest loan or one that bears interest less than the prescribed rate (described below) will normally be subject to the "deemed interest benefit" provisions of the Income Tax Act.

The rules work as follows: If you receive such a loan from your employer, you must include in your income a benefit equal to the prescribed rate of interest computed on the loan while the loan remains outstanding. For these purposes, the prescribed rate is set quarterly, and, as noted under "Prescribed Interest Rates" below, is 1% per year during the first quarter of 2012 ending on March 31.

However, the benefit inclusion is reduced or offset by the amount of any interest you pay on the loan in the relevant year or within 30 days after the year. Therefore, if you pay (at least) the prescribed rate of interest that applied throughout the year, you will have no net benefit included in your income for the year.

Furthermore, there will be no benefit if you can establish that the interest rate actually charged on the loan (if any) is equal to or greater than the rate that would have applied at the time of the loan between parties dealing with each other at arm's length, on the assumption that (i) the loan was not received by virtue of employment, and (ii) the ordinary business of the lender included the lending of money.

If you are required to include the benefit in income, you can get an offsetting interest deduction to the extent that you use the loan for income earning purposes. For example, if you used the loan to purchase stocks or mutual funds, the deemed interest benefit will be included in your income but you will get an offsetting deduction, resulting in a wash. If you used half of the loan for income earning purposes and the other half for personal purposes, then you can deduct half of the deemed benefit.

> **Example**
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> On January 1 2011, you received a $20,000 interest-free loan from your employer. The prescribed rate of interest throughout 2011 was 1% and the loan remains outstanding. You used half of the loan to purchase mutual funds that you still own, and the other half to purchase personal-use furniture for your home.
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> You will include 1% x $20,000, or $200, in income as a deemed benefit. You will get a partially offsetting deduction of 1% x $10,000, or $100.

Home purchase loans

Home purchase loans are given preferential tax treatment. A home purchase loan is generally a loan used to acquire a home that will be inhabited by you or by a related person, or that is used to repay another home purchase loan.

If you receive a home purchase loan from your employer, during the first five years of the loan the maximum interest rate that will apply in determining your benefit is the prescribed rate that was in effect *at the time of the loan*, even if the prescribed rate increases during that time. However, if the prescribed rate decreases below the rate that was in effect at the time of the loan, the lower rate will apply. Effectively, the rate at the time of the loan is a maximum cap on the amount of the interest benefit for up to five years.

For example, if your employer provided you with an interest-free home purchase loan during the current quarter ending on March 31, 2012, the deemed interest benefit will not exceed 1% per year (the current prescribed rate) for the first five years of the loan. If the loan remains outstanding five years after the time the loan was made, the rule then applies to the prescribed rate of interest in effect at that later time. In other words, the maximum rate or cap is re-set every five years of the loan.

Home relocation loans

Home relocation loans are also given preferential treatment. In general terms, a home relocation loan is a loan used to acquire a home that is at least 40 kilometres closer to your new employment location than your former home was (to the new employment location).

A home relocation loan is subject to the treatment accorded to home purchase loans described above. Furthermore, in computing your taxable income, you are normally allowed to deduct the deemed interest benefit in respect of up to $25,000 of the loan for up to five years. In other words, you will have no net taxable benefit in those years in respect of the deemed interest on the first $25,000 of your home relocation loan.

CRA SIMPLIFIED RATES FOR MOVING EXPENSES INCURRED IN 2011

If you move in order to carry on employment or a business, you can normally deduct your moving expenses if your new residence is at least 40 kilometres closer to the new work or business location relative to your former residence.

The qualifying moving expenses include your meal and vehicle expenses incurred in the course of moving you and your family members to the new residence. They also include meal and accommodation expenses incurred near your old residence or new residence for up to 15 days – for example, if you have moved out of your old home but your new home is not ready to be inhabited. The main vehicle expenses will include your gas costs incurred in the move.

For the meal and vehicle expenses, you can claim your actual expenses, in which case you should retain your receipts. However, the CRA allows an alternative “simplified method” of claiming your meal and travel costs at certain flat rates that the CRA publishes annually. If you use this simplified method, you do not have to keep detailed receipts.

The CRA recently announced the flat rates that will apply for moves that occurred in

2011. The deductible flat rate for meal costs remains at $17 per meal per person, to a maximum of $51 per day (3 meals a day).

The deductible rate for vehicle costs under the simplified method is based on the number of kilometres driven in the course of the move, and depends on the province from which the travel originated. For moves that occurred in 2011, these rates were increased from the 2010 levels. For example, for moves in 2011 originating in Ontario, the rate is 57 ¢ per kilometre (up from 55 ¢), for moves originating in Quebec, the rate is 59 ¢/km (up from 56.5 ¢), and for moves originating in Alberta, the rate is 53 ¢/km (up from 51.5 ¢). The rates can be found at cra-gc.ca/travelcost).

CRA PUTS END TO JOINT VENTURE TAX DEFERRAL

In the past, corporations could defer the payment of income tax if they were partners in partnerships that had fiscal year ends that differed from that of the corporation. For example, if a corporation with a calendar year taxation year (and fiscal period) was a partner in a partnership with a fiscal period ending on January 31, the corporation's share of the business income of the partnership fiscal period from February 1, 2009 to January 31, 2010 would have been included in the corporation's taxation year of 2010 ending on December 31, 2010.

The 2011 Federal Budget eliminated this deferral, effective for taxation years of a corporation that end after March 22, 2011. (The government eliminated a similar deferral for individual partners in 1995.) To prevent the "stacking" of income in a corporation's first affected taxation year, transitional relief allows the additional income of that year (resulting from the elimination of the partnership deferral) to be spread out over 5 taxation years.

The CRA has historically allowed participants in a joint venture to defer taxes in the same manner described above, where the participants had different taxation year ends than the fiscal period of the joint venture. A joint venture is generally a business undertaking or arrangement by two or more participants that lacks the full characteristics of a partnership.

On November 29, 2011, the CRA announced that joint ventures can no longer have a fiscal period for income tax purposes. Therefore, participants in joint ventures will no longer be eligible for the tax deferral. The new CRA policy applies to participants' taxation years ending after March 22, 2011. The new policy may result in the inclusion of significant additional income of a participant taxpayer of a joint venture for the affected first taxation year. Accordingly, for that first taxation year ending after March 22, 2011, the CRA will allow, on an administrative basis, transitional relief similar to the relief provided for partnerships described above. The additional income can be spread out over 5 years.

PRESCRIBED INTEREST RATES

The CRA recently announced the prescribed annual interest rates that will apply to amounts owed to the CRA and to amounts the CRA owes to individuals and corporations for the first quarter of 2012. These rates are set each calendar quarter. The following rates are in effect from January 1, 2012 through March 31, 2012.

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

- The interest rate to be paid on late refunds paid to corporations (after 30 days) will remain at 1%, compounded daily.
- The interest rate to be paid on late refunds paid to other taxpayers (after 30 days) will remain at 3%, compounded daily.
- The interest rate used to calculate taxable benefits for employees and shareholders from interest-free and low-interest loans (as discussed above) will remain at 1%.

AROUND THE COURTS

Taxpayer entitled to principal residence exemption for property more than one-half hectare

By virtue of the "principal residence exemption", you can normally sell your home and any resulting capital gain will be exempt from tax. This will be the case if the home was your principal residence for all years that you owned it (or all years but one). For these purposes, your principal residence can include up to ½ hectare of land on which your home is situated. However, if the land exceeds ½ hectare, the excess is not included as your principal residence (and therefore not eligible for the exemption) unless you establish that it was "necessary for your use and enjoyment".

In the recent *Cassidy* case, the taxpayer sold his home, which stood on 2.43 hectares of land, and claimed the principal residence on the resulting capital gain on the whole property. He had owned and lived on the property from 1994 to the sale in November 2003. Up until at least May 2, 2003, the land could not be legally subdivided. The taxpayer thus argued that until that time, the entire 2.43 hectares was necessary for his use and enjoyment because his house could not be situated on a smaller piece of land. Therefore, the excess land formed part of his principal residence in each year of ownership.

The CRA disallowed the principal residence exemption in respect of the portion of the gain relating to the land in excess of ½ hectare. The CRA was of the view that the ½ hectare rule applied only on the date of disposition. Since, at that time, the subdivision of the property was allowed, the taxpayer could not show that the excess land was necessary for his use and enjoyment and therefore it did not form part of his principal residence.

The Tax Court of Canada agreed with the CRA, but on appeal, the Federal Court of Appeal agreed with the taxpayer and allowed his appeal. The Federal Court held that the principal residence determination is made each year, not just at the time of disposition, such that ½ hectare rule applied throughout the period of ownership. As a result, the taxpayer's entire gain on his property was exempt under the principal residence exemption.

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