CHAPTER 4

INCOME FROM EMPLOYMENT

Review Questions

1. Explain this statement: "It is not the nature of the service that determines whether or not one is employed but, rather, the relationship which exists between the individual providing the service and the entity receiving the service."

2. Distinguish between:

    a. individual A (a student), who spent the summer painting three houses. The contract for one house provided for a fixed fee; the contracts for the other two provided for a fee per hour and materials costs; and

    b. individual B, who worked for a painting company and received a wage of $10 per hour for painting three houses.

3. "Income from employment for tax purposes includes the gross earnings from employment less expenses incurred to earn that income." Is this statement true? Briefly outline the fundamental rules for establishing income from employment.

4. An individual begins employment on December 16, 2022. Their employer pays salaries monthly, on the 15th day of each month. The individual receives their first salary payment of $3,000 on January 15, 2023. How much, if any, of the $3,000 is taxable in 2022? How much in 2023? Explain.

5. An employer follows the policy of awarding bonuses to employees for their exceptional efforts. Bonuses are awarded on the last day of each calendar year but are not paid until two years later. Does this policy benefit the employer and the employee? Explain.

6. In addition to salaries, wages, and commissions, an employer may provide a wide range of benefits to employees. Describe the general tax treatment to employees of benefits received from an employer, and explain how the value of these benefits is determined for tax purposes. If employees are permitted to operate an employer's automobile for personal use, does the treatment of this benefit conform to the general treatment of benefits? Explain.

7. From an employee's perspective, what benefits, if any, receive preferential tax treatment? Explain briefly and compare the tax treatment these different benefits receive.

8. Distinguish between an allowance and a reimbursement.

9. What effect does the receipt of an allowance have on employees' ability to deduct expenses incurred to earn employment income?

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10. With respect to deductions from employment income, compare the general tax treatment of employees who are salespeople and earn commissions with that of employees who earn a fixed salary.

11. Can employees who earn commission income and are required to pay their own expenses to generate that income incur losses from employment for tax purposes? Explain.

12. When employees are entitled to deduct particular expenses incurred to earn employment income, what restrictions, if any, are placed on the amount of expenses that can be deducted?

13. Why is it important for an employer to be familiar with the marginal tax rates that apply to its employees?

14. A number of indirect compensation benefits are considered to be taxable benefits to employees. What advantage can the employer and/or the employees gain by including such benefits as part of a compensation package?

15. When an employer provides a taxable benefit to employees at a cost that is lower than the normal retail price, what amount is included in the employees' income for tax purposes?

16. Certain indirect forms of compensation are deductible by the employer but are not taxable to employees. Does this special tax treatment provide a benefit to the employees or to the employer? Explain.

17. How should the employer describe the value of benefits provided in a compensation package to employees?

18. What is deferred compensation? How can it be of value to employees?

19. An employer contributes $2,000 annually to a deferred profit-sharing plan on behalf of an employee for 10 years. The plan invests the funds and earns an annual return of 12%. What is the pre-tax annual salary equivalent of such a benefit for an employee who is subject to a marginal tax rate of 40%?

20. Explain what benefits the employer and the employees can achieve by establishing the following:

    a. a stock option plan
    b. a stock purchase plan
    c. a stock bonus plan

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Solutions to Review Questions

R4-1 In order for an individual to derive employment income, an employer/employee relationship must exist. This relationship normally exists when a person agrees to provide their services at the full direction and control of the employer in return for a specific salary or wage. This relationship contemplates that the employer has the right to determine, not only what work is to be done, but, when, where, and how that work is to be done. In comparison, an individual may provide services as an independent contractor in return for a fee for service. In such circumstances, the individual is not subject to the same direction and control. Income earned in this fashion is business income. A worker carrying on their own business usually provides their own tools and helpers, and takes on a certain amount of financial risk and has an opportunity for profit.

For example, an individual may provide accounting services as an employee or as a business activity. The distinction rests with the manner in which the service is provided as determined by the relationship between the parties and not the type of service.

It is not always easy to determine whether the person who has been engaged to perform the services is performing them as a person in business on his own account. Many professionals, even independent contractor professionals, provide few if any tools other than their know-how.[1] It is always best to have the intention of the parties involved, as to the relationship, clearly laid out in a written contract.

R4-2 Individual A contracts on a fee for service basis (either a fixed fee or an hourly rate) and bears full risk for the quality of work, how it is performed, and the collection of the fee. As an independent contractor, the income earned is business income.

Individual B is under the direction and control of the painting firm, which in turn contracts with the customer. Individual B receives a wage and is not responsible to the customer for quality of work or collection of the fees. Therefore, B is employed and earns employment income.

R4-3 This statement is not entirely true. While employment income consists of the gross earnings minus the deduction of expenditures, not all remuneration is taxable and not all expenses incurred to earn that income are deductible. Income from employment is determined from the following basic rules:

a) Gross employment income includes the salary, wages, commissions and gratuities earned, all benefits which are received or enjoyed by virtue of the employment, and all allowances received from the employer [ITA 5(1), 6(1)(a) & (b)].

b) By exception, a limited number of benefits and allowances are excluded from income [ITA 6(1)(a) & (b)].

c) As a general rule, no deductions are permitted in arriving at employment income except a limited number of specifically listed items [ITA 8(1)].

Consequently, certain income earned from employment is not taxable and certain expenses

1 1 [2011] TCC 422 *Luke E. Follwell v The Queen*

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incurred to earn that income are not deductible.

R4-4 The taxation year of an individual is the calendar year ending on December 31 [ITA 249(1)]. Income from employment is included for tax purposes only when received [ITA 5(1)]. Therefore, even though a part of the salary is earned in 2022 and a part is earned in 2023, it is all included in the 2023 taxation year when it was received.

R4-5 Normally an employer deducts expenses for tax purposes on an accrual basis - when incurred, not when paid. However, if the remuneration is not paid before 180 days following the end of the taxation year, the deduction for tax purposes is delayed until the year in which the payment is made [ITA 78(4)] (in this case two years). While this is a disadvantage, the employer has the advantage of increased cash flow for two years, which may increase profits for the business. Even if the employer pays interest on the obligation, they should still be able to generate a higher return from the use of the funds.

The bonus is employment income to the employee and is therefore taxable on a cash basis when received [ITA 5(1)] (after two years). This may be advantageous if the employee receives interest on the deferred bonus, as he/she will be, earning a return on amounts that otherwise would have been paid out for tax. If interest is not paid then no advantage will occur unless the future tax rate (after two years) is lower than the tax rate in the year the bonus was awarded.

There is also a possibility that the tax rate after two years will be higher than the current rate, which will be a disadvantage to the employee. The employee must therefore consider the potential returns that can be achieved from the use of the bonus and the applicable tax rates before it can be determined if the delayed payment is an advantage or disadvantage.

R4-6 As a rule, an employee must include in income the value of any benefit received or enjoyed by virtue of their employment. While the term value means fair market value, CRA will, in some circumstances, accept the cost incurred by the employer to provide the benefit as the value to be included in the employee's employment income [ITA 6(1)(a)].

The benefit derived from the personal use of an employer's automobile may not always conform to the general rule. Two types of benefits can occur. The employer may provide the use of the car and may also pay for its operating expenses. The benefit derived from the payment of operating expenses is based upon an arbitrary amount of 29¢ (2022 prescribed amount) for each kilometer driven for personal use [ITA 6(1)(k)(v)]. If the employment use is greater than 50%, the employee has the option of determining the operating expense benefit as one-half of the standby charge [ITA 6(1)(k)(iv)].

The benefit from use of the car itself, referred to as a standby charge, is calculated from a strict formula which allocates a portion of the car's cost or lease amounts to the employee based on its *availability* for personal use rather than on its actual use. For example, a leased car used by the employee 60% for personal use and 40% for employer business requires that 2/3 of the lease cost be included as a taxable benefit if the car was available for personal use throughout the period [ITA 6(1)(e), 6(2)]. Therefore, in this case, the taxable benefit is greater than the actual benefit. Similarly, if the car is used 100% for personal use, only 2/3 of the lease cost is considered a taxable benefit providing an advantage to the employee.

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R4-7 Although the general rule requires that all benefits are taxable as employment income, a number of specific exceptions are permitted [ITA 6(1)(a)]. These are:

- Employer contributions to a registered pension plan
- Employer contributions to a deferred profit-sharing plan
- Employer contributions to a pooled registered pension plan
- Premiums for group sickness or accident insurance plans
- Premiums for private health insurance
- Payments for supplementary unemployment insurance plans
- Counseling services relating to mental or physical health, or to the re-employment or retirement of the employee.
- Scholarships, bursaries, and free tuition provided to family members of the employee.

The benefits derived from the above insurance plans are normally not taxable to the employee. However, benefits for lost wages under the group sickness or accident insurance plans are taxable as employment income to the extent that they exceed the accumulated amount of any premiums paid by the *employee* [ITA 6(1)(f)]. The benefits from contributions to a pension plan and DPSP are not taxable until they are paid out of the plans to the employee.

R4-8 An allowance is a fixed amount paid to an employee on a regular basis to cover certain undetermined expenses, which may be incurred by the employee. For example, the monthly receipt of $400 for travel expenses is an allowance and the employee may or may not incur that amount of expenses. Normally, an allowance is taxable [ITA 6(1)(b)].

A reimbursement is the repayment to an employee by an employer of specific costs incurred by the employee on behalf of the employer. For example, if an employee incurs travel costs for an employer and is repaid for the exact cost of those expenses, the repayment is a reimbursement and not an allowance. A reimbursement is not taxable to the employee.

R4-9 Payment of an allowance to employees presumes that they will use the allowance to pay for certain expenses they incur to perform their duties. Whether or not the expenses can be deducted for tax purposes by the employee may depend on the tax treatment of the related allowance received to assist in the payment of those expenses.

Although the general rule is that allowances are taxable, specific exceptions permit certain allowances to be received tax free [ITA 6(1)(b)]. For example, travel allowances may be tax free if certain conditions are met. When an employee receives a tax-free travel allowance, she/he is not entitled to deduct the following expenses:

- If the employee is a salesperson, no deductions are permitted for any costs incurred to earn the commissions. Therefore, the tax-free travel allowance removes the ability to deduct travel expenses as well as a number of other expenses such as promotion, advertising and so on. On the other hand, if the travel allowance received is unreasonable (too high or too low) the allowance is taxable and all expenses can then be deducted [ITA 8(1)(f)].

- If the employee is not a salesperson, the tax-free travel allowance will eliminate the right to claim only travel expenses incurred by the recipient [ITA 8(1)(h)].

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R4-10 The general rule relating to deductions from employment income is that, no deductions are permitted, except those provided in a limited list of exceptions [ITA 8(2)]. The exceptions for a salesperson are different from those of other employees.

By exception, a salesperson is permitted to deduct all expenses incurred to earn commission income to a maximum of the commissions earned [ITA 8(1)(f)]. Therefore, a sales person, meeting certain conditions, can deduct costs such as accounting and legal fees, advertising and promotion, automobile expenses, food and beverages, entertainment, parking, supplies, licences, lease payments for computers, cell phones, copy machines and other equipment, salaries for an assistant, office rent, training costs, travel, work-space-in-the-home expenses (including a portion of house insurance and property tax), monthly home internet access fees, a basic cell phone plan, and union and professional dues.

On the other hand, employees who are not salespeople are permitted only a limited number of specific types of expenses. For example, of the above-mentioned expenses, only the legal, automobile, office rent, parking, supplies, salaries for an assistant or substitute, travel, parking, work-space in the home expenses (limited to utilities and maintenance), monthly home internet access fees, a basic cell phone plan, and union and professional dues are permitted as a deduction for employees who are not salespeople and who meet specific conditions [ITA 8(1)(h), (h.1), (i)].

R4-11 A salesperson is entitled to deduct expenses incurred for earning employment income to a maximum of the commissions earned in any particular year. In addition, the salesperson can, as separate deductions, deduct supplies consumed, union & professional dues and capital cost allowance and interest on an automobile (also an airplane) to the extent they are incurred in the performance of their duties of employment [ITA 8(1)(i), (j)]. Therefore, to the extent that these expenses exceed the commission income, a loss from employment can occur.

R4-12 There are several general restrictions imposed:

- A permitted expense is deductible only to the extent that it is reasonable under the circumstances [ITA 67].
- The amount of capital cost allowance on a vehicle is limited to 30% on a declining balance basis [Reg. 1100(10]. The maximum cost of an automobile available for capital cost allowance is $34,000 plus tax [ITA 13(7)(g)].
- The maximum deductible lease cost of a leased automobile is $900 plus tax per month [ITA 67.3].
- Interest on a loan to acquire an automobile is restricted to a maximum of $300 per month [ITA 67.2].
- Only 50% of the actual cost of meals and enjoyment of entertainment is permitted [ITA 67.1].

R4-13 Employees are subject to progressive tax rates. Therefore, the after-tax value of additional compensation varies for employees subject to different tax rates. For example, a 10% wage increase for an employee in the 40% tax bracket results in only a 6% increase in his or her disposable income, whereas, the same increase for a person in a 24% bracket increases disposable income by 7.6%. Certain forms of compensation offer reduced tax costs, tax deferrals, or are tax-free. Analyzing the applicable tax rates of all employees helps to identify which and how many employees within the organization would prefer alternate forms of compensation that minimize their tax and increase disposable income.

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R4-14 Taxable indirect employee benefits include such items as the use of an employer's car for personal use, low interest loans, life insurance coverage and so on. Advantages can be gained if the employee would normally acquire these items on their own from after-tax income and if the employer can obtain the benefits (because of volume buying) at a cost that is lower than what the employee would have to pay on their own. The value of this cost saving can be kept by the employer exclusively for their advantage, or it can be passed on to the employee in whole or in part to provide greater after-tax income value at no extra cost to the employer.

R4-15 The value of the benefit that must be included in the employee's income is the cost amount of that benefit to the employer. For example, if an employer can purchase group term life insurance for a premium cost of $600 compared to the normal retail cost of $800 that the employee would pay on his or her own, the taxable amount to the employee is only $600. (Note that the employer' cost is the market price for the product when purchased in a group environment.)

R4-16 The special tax treatment can provide a benefit to either the employee, the employer, or be shared by them. For example, a $2,000 salary increase for an employee would cost the employer (who is subject to a 25% tax rate) only $1,500 after-tax ($2,000 - 25% tax saving) and would provide an employee (in a 32% tax bracket) with an after-tax value of $1,360 ($2,000 - tax cost of 32%). If the employer instead provided $2,000 of tax-free benefits, the employer's cost would remain at $1,500 after-tax, but the after-tax value to the employee would increase to $2,000 from $1,360. In this case, the full value of the tax treatment is passed on to the employee.

Alternatively, the employer could provide the employee with $1,360 of tax-free benefits which is equivalent to a $2,000 fully taxable salary (above). The employer's after-tax cost is then only $1,020 ($1,360 - 25% tax saving) compared to $1,500 for a $2,000 salary. In this case, the preferential tax treatment is fully retained by the employer as a cost reduction.

As a third alternative, the employer could provide tax-free benefits that are less than $2,000 but greater than $1,360 in which case both parties benefit from the special tax treatment.

R4-17 Benefits provided to employees as an alternative to direct salary should be described to employees in terms of their pre-tax salary equivalents in order that they can appreciate the real value of the compensation package. For example, the receipt of a $1,000 tax-free benefit (such as private medical insurance coverage) is the same as receiving a salary amount of $1,667 for an employee in a 40% tax bracket ($1,667 - tax @ 40% = $1,000). This is especially important when wage settlements are being negotiated in order to obtain cost efficiencies. In addition, providing an annual statement of the value of an employee's total compensation package in terms of pre-tax salary equivalents can have a positive impact on employee relations and future wage demands.

R4-18 Deferred compensation is a form of compensation that establishes a certain amount of remuneration for an employee in a particular year, but the payment of that amount is delayed until some future time. As such, income is taxed only when received, the payment of tax is also delayed. The benefits from this form of compensation can be significant if the delayed payment is invested on behalf of the employee in a manner that the investment returns also accumulate on a tax-deferred basis, such as when the funds are invested in a registered pension plan or a deferred profit-sharing plan.

The compounding of investment returns on a pre-tax basis combined with the possibility that future tax rates may be lower if the invested funds are not paid out until retirement, will provide a

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substantially higher wealth accumulation than receiving annual taxable salaries and investing the after-tax proceeds.

R4-19 The $2,000 paid annually into a DPSP will earn interest at 12% without tax until the accumulated amount is distributed after 10 years. Its value is as follows:

Future value of regular deposits of $2,000 earning 12%	$39,309
Less tax on distribution (40%)	(15,724)
	$23,585

In comparison, an annual salary is taxable annually as received and only the after-tax amount is available for investment. The investment returns are also taxable annually leaving only 7.2% available for reinvestment (12% - 40% tax = 7.2%). The pre-tax salary equivalent required to accumulate $23,585 after 10 years is as follows:

Regular deposits for 10 years required, and invested at 7.2%, to yield $23,585 =	$1,577

Pre-tax salary equivalent

x - .40x = $1,577

x = $2,628

Therefore, a $2,000 contribution to a DPSP is equal to direct salary increase of $2,628.

R4-20 A **stock option plan** permits an employee to purchase shares directly from the employer corporation at a specified price for a certain time. It is attractive to the employer because it does not result in a cash cost. In fact, the issue of shares increases the company's cash resources. It also stimulates employees to be concerned about the long-term profitability of the business. For the employee, an advantage occurs from the fact that the share option price is fixed for a time even though the stock value may continue to grow. Therefore, any growth in value accrues to the employee even though the stock has not yet been purchased.

When the stock is purchased, a taxable benefit occurs equal to the difference between the value of the shares at the time of purchase and the preferential purchase price.

If the stock value at the date the option was granted is the same as (or less than) the option price, the employee is entitled to claim the stock option deduction (one-half of the taxable benefit) in arriving at taxable income.

If the employer is a CCPC, the same taxable benefit occurs but is taxable to the employee when the shares are sold. Where the employer is a CCPC, the employee is entitled to the stock option deduction even if the options price is below the value of the shares at the date the option is granted provided the employee holds onto the shares for at least two years.

A **stock purchase plan** is simply a funding program of the employer permitting the employee to purchase shares in the employer's corporation by providing a loan. There is no cash cost for the employer because the funds loaned are returned immediately for the issued shares. The benefits

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for the employer are similar to the stock option plan above. For the employee, the stock purchase plan provides an investment opportunity without a financial burden.

A **stock bonus plan** means that an employer issues shares to an employee at no cost in lieu of a cash bonus. While this may be beneficial to an employer because it requires no cash payment, it does not provide a significant benefit to the employee as the full value of the shares received is taxable as if it were received as a salary.

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Key Concept Questions

QUESTION ONE

Carole Patel receives a salary of $60,000 during the current year. In addition, she earns commission income of $25,000, of which she receives $15,000 in the current year. She receives the remaining $10,000 in the first quarter of the following year.

Determine Carol's employment income for the current year, 2022.

CPA Competency 6.3.2 General principles of employment income. Income tax reference: ITA 5(1).

QUESTION TWO

Mike Bernard's employer has a generous benefit program. During 2022, his employer provides him with the following benefits:

- a contribution to the company RPP of $6,000.
- group term life insurance coverage of $100,000; the premium for the coverage is $400.
- group sickness or accident insurance coverage; the premium paid is $550.
- a private health services plan that provides Mike with dental, vision, prescription drugs, and private-hospital room coverage; the premium is $800.
- mental health counselling for Mike's daughter; the psychologist's fee is $1,500.
- fitness club membership for Mike's personal enjoyment; the membership dues are $900.
- public transit pass for city bus; the annual cost is $800.

Determine the amount to be included in Mike's employment income for tax purposes for 2022.

CPA Competency 6.3.2 Common employment benefits. Income tax reference: ITA 6(1)(a), 6(4).

QUESTION THREE

Jennifer Garcia's employer provides her with the following gifts and awards in 2022:

Golf shirt with the employer logo (cost amount)	$ 15
Birthday gift (monetary restaurant gift certificate)	75
Reward for meeting sales performance (holiday weekend)	400
10-year anniversary award (golf club); previous award was on her fifth anniversary with the employer	275
Wedding gift (cutlery)	300
Innovation and excellence award (tickets to a concert)	250
Holiday season gift (artwork)	150

Briefly describe the tax consequences to Jennifer for the above gifts and awards.

CPA Competency 6.3.2 Employee gifts and awards. Income tax reference: ITA 6(1)(a).

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QUESTION FOUR

On September 1 of the current year, Teresa Chang will have worked for A Ltd. for three years and will be entitled to a company car as of that date. A Ltd. will have to pay $48,000, including tax, to purchase the car that Teresa wants. If the car is leased, the monthly lease cost will be $950, including tax. In either case, A Ltd. will pay all of the operating costs for the car, which are expected to be $2,500 annually. Teresa anticipates that she will drive the car 2,000 km per month, of which 200 km will be for employment purposes.

a) Determine the amount to be included in Teresa's employment income for the current year, 2022, if (i) A Ltd. purchases the car, and (ii) A Ltd. leases the car.

b) Teresa drives the car 12,000 km for employment purposes and 8,000 km for personal use in 2023. Determine the amount to be included in her income for tax purposes in 2023, assuming A Ltd. purchases the car.

CPA Competency 6.3.2 Employer-provided automobiles. Income tax reference: ITA 6(1)(e), (k), 6(2).

QUESTION FIVE

On March 1, 2022, Len Horvat receives a $100,000 loan from his employer. The loan bears interest at 1% per year. The interest is payable monthly. The principal is repayable at the end of five years. Len uses $90,000 of the loan toward the purchase of his home. He uses the remaining $10,000 to purchase investments. Assume the prescribed interest rates for the current year are 4% for the first quarter and 5% for the remainder of the year.

Determine the amount to be included in Len's employment income for tax purposes for the current year, 2022.

CPA Competency 6.3.2 Employee loans. Income tax reference: ITA 6(9), 80.4(1), (4), (6), 80.5, 20(1)(c).

QUESTION SIX

In Year 1, Kayla Mejia, an employee of a public company, was granted an option to acquire 100 shares from the company's treasury at a price of $12 per share. At the date that the option was granted, the shares were trading on the stock market at $22 per share. In Year 2, Kayla exercised the option and acquired 100 shares. At that time the shares were trading at $40 per share. In Year 6, Kayla sold the shares for $66 per share.

Discuss the income tax consequences of Kayla's transactions (show calculations).

CPA Competency 6.3.2 Stock options. Income tax reference: ITA 7(1).

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QUESTION SEVEN

How would Kayla's tax consequences change in Question Six (above) if her employer was a Canadian-controlled private corporation?

CPA Competency 6.3.2 CCPC Stock options. Income tax reference: ITA 7(1.1), 110(1)(d.1).

QUESTION EIGHT

In Year 1, a public company granted an employee resident in Canada an option to purchase 1,000 common shares of the employer company for $10 per share. The fair market value of the shares at the date the option was granted was $8 per share. No other stock options were granted to this employee during Year 1. In Year 2, when the shares were worth $16 per share, the employee exercised the option and purchased all 1,000 shares. In Year 5, the employee sold the 1,000 shares for $38 per share. The shares do not have any special dividend rights or restrictions.

Discuss the income tax consequences to the employee from these transactions (show calculations).

CPA Competency 6.3.2 Stock options. Income tax reference: ITA 7(1), 110(1)(d).

QUESTION NINE

Richard Ahmed earns a salary of $70,000 in 2022 as an employee of B Ltd. He pays the following expenses to earn his income:

Car expenses	$ 2,500
Transportation (other than car) & accommodation	5,000
Client entertainment meals	600
Advertising and promotion	2,000
	$10,100

(a) Determine the maximum deduction for employment expenses that Richard is entitled to claim in computing his income for 2022.

(b) How would your answer to (a) change, if at all, if Richard was a salesperson and received commission income of $6,000 in addition to his salary, in 2022?

(c) How would your answer to (b) change, if at all, if Richard's commission income were $20,000?

CPA Competency 6.3.2 Common employment deductions. Income tax reference: ITA 8(1)(f), (h), (h.1), 67.1.

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QUESTION TEN

Julie Sami is required to use her own automobile and pay for all her travelling expenses in carrying out her duties of employment. She purchased a new car on January 2, 2022, for $45,000 (plus HST @ 13%) and incurred the following expenses during the year:

• Gasoline	$2,100
• Repairs and maintenance	400
• Parking (employment related)	100
• License and insurance	2,300
• Interest on loan to acquire car (12 months)	4,100

Julie drove her car 20,000 km in 2022, of which 8,000 km were for carrying out her duties of employment.

Calculate the maximum tax deduction available to Julie for her car for 2022.
(The CCA rate for automobiles is 30%, except in the first year when the accelerated rate is 45%).

CPA Competency 6.3.2 Employment deductions for automobiles. Income tax reference: ITA 8(1)(h.1), (j), 13(7)(g), 67.2.

QUESTION ELEVEN

Howard Rahman is employed as a computer programmer and is required by his employment contract to maintain an office in his home. He estimates that 40% of his cell phone usage is employment related. He purchases a new computer for his office on September 1, 2022. He estimates that he uses the computer 90% for employment purposes. Howard works in his home office four days each week and attends meetings at his employer's place of business on the fifth day. The office occupies 10% of the square footage of his home. He paid the following amounts in 2022:

Mortgage interest (10%)	$1,200
Property taxes (10%)	450
House insurance (10%)	120
Utilities (10%)	420
Maintenance (10%)	200
Cell phone basic plan (40%)	300
New computer (100% of cost)	2,000
Internet (60%)	570

What is the maximum amount that Howard can deduct in 2022 for his home office?

CPA Competency 6.3.2 Employment deduction for home office. Income tax reference: ITA 8(1)(i), 8(13).

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Solutions to Key Concept Questions

KC 4-1

[ITA: 5(1) – Cash basis for employment income]

Carole's employment income for the current year is $75,000. Only the amount she received in the current year is included (salary of $60,000 + commission of $15,000) [ITA 5(1)(a)].

KC 4-2

[ITA: 6(1)(a), 6(4) – Taxable benefits]

Mike must include $2,100 in his income for tax purposes.

Employer-paid premium for life insurance coverage [ITA 6(1)(a), 6(4)]	$ 400
Club membership dues, not principally for the employer's benefit [ITA 6(1)(a)].	900
Public transit pass	800
	$2,100

The following benefits are excluded from income for tax purposes:

- Employer's contribution to the RPP [ITA 6(1)(a)(i)]
- Employer-paid premium for group sickness or accident insurance coverage [ITA 6(1)(a)(i)]
- Employer-paid premium for a private health insurance plan [ITA 6(1)(a)(i)] and
- Counselling services for mental health for Mike or his relatives, paid for by his employer [ITA 6(1)(a)(iv)].

KC 4-3

[ITA: 6(1)(a)]]

Tax consequences in accordance with CRA published administrative policy – See CRA website "Rules for gifts and awards":

- The golf shirt is not a taxable benefit since it is of an immaterial/nominal value.
- The gift certificate is a taxable benefit since it is a near-cash gift.
- The weekend holiday given to the employee for meeting the sales performance target is a taxable benefit. Performance-related rewards are considered to be a form of remuneration and are taxable.
- The 10-year anniversary award in not a taxable benefit. Jennifer has not received an anniversary award for the past five years of service and the total value of the gift was not in excess of $500.
- The total value of the remaining gifts and awards (wedding, innovation and excellence and holiday season) amount to $700. Jennifer will be considered to have received a taxable benefit in the amount of $200 ($700 – $500).

Note that although the 10-year service/anniversary award was $225 less than the allowable $500 threshold, this shortfall *cannot* be applied to offset the taxable benefit arising as a result of the excess value of the annual gifts and awards over $500.

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KC 4-4

[ITA: 6(1)(e), (k), 6(2) – Automobile benefits]

a) (i) A Ltd purchases the car for $48,000:

Standby charge [ITA 6(1)(e), 6(2)]	
$48,000 x 2% x 4 months	$3,840
Operating expense benefit [ITA 6(1)(k)]	
29¢ x 7,200 personal km	2,088
(2,000 km – 200 km = 1,800 x 4 months = 7,200)	
	$5,928

(ii) A Ltd leases the car for $950 per month:

Standby charge [ITA 6(1)(e), 6(2)]	
2/3 x $950 x 4 months	$2,533
Operating expense benefit [ITA 6(1)(k)]	
29¢ x 7,200 personal km	2,088
	$4,621

b) A Ltd purchases the car for $48,000 and Teresa drives more than 50% of the km in the year for employment purposes:

Standby charge [ITA 6(1)(e), 6(2)]	
$48,000 x 2% x 12 months x 8,000/(1,667 x 12 mo)	$4,607
Operating expense benefit [ITA 6(1)(k)] - lesser of	
• 50% x $4,607 = $2,304	
• 29¢ x 8,000 personal km = $2,320	2,304
	$6,911

Note that since the car was driven more than 50% of the total km for employment purposes, the standby charge is reduced and Teresa has the option of calculating the operating expense benefit as 50% of the standby charge.

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KC 4-5

[ITA: 6(9). 80.4(1), (4), (6), 80.5, 20(1)(c) – Employee loans]

Employee loan interest benefit [ITA 6(9), 80.4(1), (4)]

	House Loan $90,000	Investment Loan $10,000
Prescribed interest -		
March 1 to March 31 – 31 days @ 4%	$ 306	$ 34
April 1 to December 31 - 275 days @ **4%**	2,712	
April 1 to December 31 - 275 days @ 5%	.	377
	3,018	411
Less interest @ 1% for the year **paid** by 30 days after the end of the year – 306 days	(755)	(84)
	$2,263	$327

The prescribed interest rate for the investment loan changed throughout the year whereas the prescribed interest rate for the home loan remained at 4%, the rate at the time the loan was received. Home loans benefit from this prescribed rate protection. If the prescribed rate declines, the lower rate can be used. However, if it increases, the rate at the time the loan was made will be used, for a maximum of five years [ITA 80.4(4), (6)].

Len will be entitled to deduct interest paid of $411 (actual interest paid $84 + low-interest benefit $327 deemed to be interest paid [ITA 80.5] in computing his investment income for tax purposes [ITA 20(1)(c)].

KC 4-6

[ITA: 7(1) – Stock options]

No benefit is recognized for tax purposes in Year 1 when the option is granted.

Year 2 (shares purchased):

Value of shares at date acquired (100 @ $40)	$4,000
Option purchase price (100 @ $12)	1,200
Employment income [ITA 7(1)]	$2,800

Year 6 (shares sold):

Selling price (100 @ $66)	$6,600
Value at share purchase date (100 @ $40)	4,000
Capital gain	$2,600
Taxable capital gain	$1,300

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KC 4-7

[ITA: 7(1.1), 110(1)(d.1)]

The difference is in the timing of the recognition of the employment income. In KC 4-6, the stock option benefit was recognized when the shares were purchased. In KC 4-7, the stock option benefit is recognized when the shares are sold. The value of the benefit remains the same.

Year 6 (shares sold):

Employment income –

Value of shares at date acquired (100 @ $40)	$4,000
Option purchase price (100 @ $12)	1,200
Employment income [ITA 7(1.1)]	$2,800

Taxable capital gain –

Selling price (100 @ $66)	$6,600
Value at share purchase date (100 @ $40)	4,000
Capital gain	$2,600
Taxable capital gain	$1,300

Stock option deduction (taxable income calc.)

(½ x $2,800 employment inclusion)	$(1,400)

In computing *taxable income*, Kayla qualifies for the stock option deduction because she meets the following conditions [ITA 110(1)(d.1)]:

- She did not dispose of the shares within 2 years after acquiring them, and
- her employer is a CCPC, dealing at arm's length with Kayla when the stock option agreement was entered into.

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KC 4-8

[ITA: 7(1), 110(1)(d) – Stock options]

In this case, the employee qualifies for the stock option deduction in computing *taxable income*. The employee qualifies for the following reasons: (1) the shares are ordinary common shares, (2) the employee was at arm's length with the employer when the option was granted, and (3) the value of the shares when the stock option agreement was entered into did not exceed the exercise price of the option [ITA 110(1)(d)].

Year 2 (shares purchased):

Employment income -	
Value of shares at date acquired (1,000 x $16)	$16,000
Option purchase price (1,000 x $10)	(10,000)
Employment income [ITA 7(1)]	$6,000
Stock option deduction (taxable income calc.)	
(1/2 x $6,000 employment benefit)	$(3,000)

Year 5 (shares sold):

Selling price (1,000 x $38)	$38,000
Value at share purchase date (1,000 x $16)	(16,000)
Capital gain	$22,000
Taxable capital gain	$11,000

KC 4-9

[ITA: 8(1)(f), (h), (h.1), 67.1 – Employment deductions]

There is only one provision of the Act that permits an employee to deduct advertising and promotion and entertainment expenses. That provision is the salesperson's provision [ITA 8(1)(f)]. This provision allows employees to deduct all expenses incurred to earn employment income subject to a limit, that limit being commission received in the year or a bonus based on sales volume.

(a) The maximum deduction that Richard is entitled to claim is $7,500. His travel expenses of $5,000 are deductible under the travel provision [ITA 8(1)(h)] and his car expenses of $2,500 are deductible under the car provision [ITA 8(1)((h.1)]. These provisions have no limits.

(b) The answer is still $7,500 (travel expenses of $5,000 and car expenses of $2,500). Since Richard has commission income, he is eligible to deduct up to $6,000 of expenses under the salesperson's provision [ITA 8(1)(f)], the $6,000 being the amount of commission income received in the year. However, if a deduction under the salesperson's provision is made, deductions under the travel and car expense provisions [ITA 8(1)(h)&(h.1)] are not allowed. Since the commission income is less than the travel and car expenses, Richard's maximum deduction is achieved by claiming the deductions under the travel and car expenses provisions, which have no limits.

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(c) The maximum deduction that Richard is entitled to claim is $9,800. Under the salesperson's provision [ITA 8(1)(f)] Richard can deduct $9,800 (car expenses $2,500 + travel expenses $5,000 + entertainment $600 x 50% + advertising and promotion $2,000). The total does not exceed Richard's commission income of $20,000. [Entertainment expenses are only 50% deductible for tax purposes [ITA 67.1]].

KC 4-10

[ITA: 8(1)(h.1), (j), 13(7)(g), 67.2 – Automobile deductions]

The maximum tax deduction available to Julie for her car is $10,392, calculated as follows:

Automobile operating costs [ITA 8(1)(h.1)]:		
Gasoline	$2,100	
Repairs & maintenance	400	
License and insurance	2,300	
	4,800	
prorate for employment use	x 8/20	
	1,920	
Parking (all employment)	100	$2,020
Automobile CCA and Interest expense [ITA 8(1)(j)]:		
CCA $38,420 * x 45%	$17,289	
Interest on car loan – limited [ITA 67.2]		
○ $300/30 x 364 days = $3,640		
○ actual $4,100	3,640	
	20,929	
prorate for employment use	x 8/20	8,372
		$10,392

* The maximum cost of an automobile available for CCA is $34,000 plus applicable taxes. Therefore, CCA is calculated on $38,420 ($34,000 x 1.13) even though the car cost $45,000 plus tax.

KC 4-11

[ITA: 8(1)(i), 8(13) – Home office]

The maximum tax deduction for Howard with respect to his home office expenses is $1,490.

Howard is entitled to a deduction for home office expenses under ITA 8(1)(i). The deduction is not denied by ITA 8(13) since Howard's home office is the place where he principally performs his duties of employment. He works four days out of five in his home office. Howard's deductible expenses consist of utilities $420 + maintenance $200 + cell phone plan $300 + internet $570.

Comments:

Mortgage interest is never deductible in computing employment income. It can be deducted in computing

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business and property income [ITA 20(1)(c)].

Property taxes and house insurance are not deductible by a regular employee as they are not consumed. They can be deducted by a salesperson, subject to commission limitation [ITA 8(1)(f)].

The cost of the computer is not deductible because it is capital in nature as opposed to a supply consumed. Employees are permitted a deduction for interest and CCA on two capital items only – cars and airplanes [ITA 8(1)(j)].

Employees who work from home can include reasonable home internet access fees and basic cell phone fees prorated for employment use [T4044 – Employment Expenses].

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