BUCHANAN BARRY LLP
CHARTERED ACCOUNTANTS

TAX NEWSLETTER

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TRANSFERRING SHARES TO YOUR RRSP

Should you transfer shares that you already own to your RRSP?

The prospect can be attractive. The shares you transfer are considered a **contribution to your RRSP**. If you have unused RRSP contribution room, you can thus get a substantial **tax deduction** for shares that you already own. If you have not been making maximum RRSP contributions, you may have substantial accumulated contribution room since 1991. (This contribution room can be carried forward indefinitely.)

However, there are a number of problems and pitfalls that you should be aware of:

1. Contribute — don't swap!

You can *contribute* shares to your RRSP, subject to the further points made below. But **do not swap** shares for other shares, securities or money that is in your RRSP!

Some taxpayers were finding ways to manipulate their income for tax purposes by swapping securities in and out of their RRSPs (perhaps timed so that large dividends would be paid tax-free to the RRSP). The Department of Finance cracked down on this a few years ago, and introduced rules that severely penalize taxpayers for swapping assets into their RRSPs for cash or other assets. Any income or gain earned in the RRSP on such assets will effectively be 100% confiscated.

So make sure you are contributing to the RRSP, not exchanging the shares for something the RRSP already owns.

2. Do the shares qualify?

Shares in corporations listed on Canadian stock exchanges are no problem. For shares in private companies or foreign corporations, however, you must ensure that they qualify as RRSP investments. Some do, but the rules are complex and must be checked carefully by a professional.

The rules for private corporations generally require that you and your family members not own 10% or more of the shares of any class of the corporation, and that it use substantially all of its assets in active business carried on in Canada. The rules for foreign corporations generally require them to be listed on specific stock exchanges (including all the major U.S. exchanges as well as specific exchanges in about 25 other countries).

3. Capital gain on transfer

When you transfer shares to your RRSP, you are considered to have sold them at their fair market value for tax purposes. If the fair market value is higher than your cost base, you will have a **capital gain.**

One-half of the capital gain will be included in your income and subject to tax (except to the extent you have unused capital losses from the same year or carried over from other years). You will have to consider this cost when measuring the value of the RRSP contribution.

EXAMPLE

You have shares in a public company that you purchased in 2010 for $6,000. They are now worth $10,000. You have $10,000 of unused RRSP contribution room. Your income is high enough that you are in a 45% tax bracket (combined federal/provincial tax).

If you transfer the shares to your RRSP, you will have a $10,000 deduction, worth **$4,500** on your 2013 tax return.

However, you will also have a $4,000 capital gain, since you will be deemed to have sold the shares for $10,000. One-half of this gain, or $2,000, will be included in your income. In your 45% bracket, that will cost you **$900**.

The result is that you still benefit from the transfer, but your net tax saving will be $3,600 rather than $4,500. (If you donate the shares to charity instead, you will not pay tax on the capital gain so your tax savings will be about $4,500.)

4. No capital loss on transfer

As noted above, when you transfer shares to your RRSP, you are considered to have sold them at their fair market value for tax purposes. However, if this value is less than the cost of the shares to you, you **cannot claim a capital loss**. Clause 40(2)(g)(iv)(B) of the *Income Tax Act* specifically prohibits claiming a capital loss on shares that you transfer to your (or your spouse's) RRSP.

It is hard to quantify the cost to you of not being able to claim the capital loss, because it depends on various other factors. Capital losses normally can only be used against capital gains. If you have other capital gains to use up, the capital loss can be quite valuable. In such a case, you should definitely consider *selling* the shares on the market for a capital loss, and then transferring the cash to your RRSP. (Don't have the RRSP buy back the same shares within 30 days, or your capital loss will be denied as a "superficial loss".)

5. Cost of withdrawing the funds

Don't forget that any funds in your RRSP are taxed when you take them out. The transfer gives you a *deferral* of tax which can be very valuable, especially because of tax-free compounding within the RRSP. However, when you want access to the funds, you will have to pay the tax. The financial institution will withhold a percentage of the amount you withdraw, as prepayment against the tax you will owe on it.

If you are transferring shares to your RRSP, be sure you are aware of these costs if you may need the funds back soon. As well, if you do take them out, you will have effectively wasted the contribution room for future years.

6. No dividend tax credit or special capital gains treatment

Both dividends and capital gains are given special tax relief when you get them personally. For dividends from Canadian corporations, you get the dividend tax credit, which offsets much of the tax paid by the corporation on the income that it had to earn to pay you the dividend. The result is that the top tax rate on dividends may be in the range of 25% rather than about 45% (the details depend on your province of residence as well as your level of taxable income). Capital gains, as noted above, are only half taxed, so again the top rate is typically a little under 25%.

If you put shares into your RRSP, both of these advantages are lost. Any dividends or capital gains simply result in the RRSP having more cash. The RRSP pays no tax. However, when you withdraw the funds from the RRSP, you will be fully taxed on them, with no credit for the fact that part of the funds withdrawn were received as dividends or capital gains.

As long as you leave the funds in your RRSP for many years, these disadvantages can be outweighed by other advantages, such as the up-front tax deduction and the tax-free compounding within the RRSP, as well as the fact that you may be in a lower tax bracket when you eventually withdraw the funds on retirement. However, you may wish to calculate the trade-off, based on how long you expect to leave the shares in the RRSP and the expected rate of return.

Conclusion

Transferring shares to your RRSP can be an excellent way of obtaining a current tax deduction if you have unused contribution room. However, it is not always beneficial. You should not overlook the pitfalls and costs that may apply.

SELLING A CONDO PARKING SPACE — SURPRISE REFUND

Does GST or HST apply when you sell a parking space in a residential condominium?

The answer is surprising.

If you sell the unit together with a used residential condominium unit, then the answer is no. Both the condo and the parking space are exempt. (The exemption for the parking space is in *Excise Tax Act* Schedule V, Part I, section 8.)

Suppose you sell the unit separately? For example, you bought two parking spaces with your condo and no longer need one of them. In that case, the exemption does not apply. The sale is taxable. Even if you are not GST/HST-registered and do not normally file GST/HST returns, you must collect GST or HST on the sale, file a return and remit the tax to the Canada Revenue Agency (or to Revenu Québec in Quebec, where Quebec Sales Tax will apply as well).

However, if you paid GST or HST on purchasing the parking space (which will be the case if you bought the condo new), then a little-known rule in the *Excise Tax Act* allows you a **refund of part or all of the tax you originally paid**. This will reduce the amount you have to send to the CRA from what you collected on selling the parking space.

This refund is found in section 193 of the *Excise Tax Act* (as an input tax credit, if you’re already GST/HST-registered), or section 257 (as a rebate, otherwise). (We’re providing this reference because this rule is not well known — many accountants and lawyers may not be aware of it.)

The rule says that, if you sell real property in a taxable sale, and you paid GST or HST on the purchase and weren't able to recover it, you're allowed a special credit or rebate when you sell it, to prevent double tax from applying to the property.

This rule is somewhat complicated, but if you are in this situation it can be very worthwhile to learn the details.

The calculation is based on the "basic tax content" of the property, which is basically the GST or HST that you paid on buying it, but prorated down if the property has gone down in value.

So, consider the following example:

> *EXAMPLE*
>
> *Denise bought a condo in 2008 in Alberta, and as part of the price she paid for two parking spaces at $21,000 each including GST. She is now selling one of the parking spaces for $23,100 (the sale contract says that this price includes any applicable GST). Denise is not registered for GST/HST, as she doesn't carry on any business.*
>
> Since Denise is not selling her condo together with the parking space, the sale is taxable.
>
> The sale price is actually $22,000 plus $1,100 in GST. When Denise collects $23,100 on the sale, $1,100 of that is GST that she has to remit to the CRA.
>
> But before she remits the GST, Denise can claim the rebate under *Excise Tax Act* section 257.
>
> The "basic tax content" (BTC) of the parking space is $1,000, which is the GST Denise paid when buying it ($20,000 plus 5% GST of $1,000).
>
> Since the value hasn't gone down from $20,000 (it's gone up to $22,000), the BTC isn't reduced from $1,000.
>
> So Denise can file a rebate claim for the $1,000, and can deduct this $1,000 from what she has to remit to the CRA. Accordingly, she only has to send in a cheque for $100, not $1,100.

This particular example is quite simple. If the parking space has gone down in value, and the GST or HST rate in the province has changed since the purchase of the parking space, the calculation can get more complex.

This same credit or rebate applies in other situations where a taxpayer buys real property and pays GST or HST that they can't recover, and then sells the property later. For example, it can apply to the sale of an office building owned and used for their practice by a doctor or dentist who can't claim input tax credits because their services are GST/HST-exempt.

GARNISHMENT NOTICES

The Canada Revenue Agency (CRA) has various weapons at its disposal when trying to collect money from a person who has a tax debt, whether income tax or GST/HST.

One of these weapons is the Garnishment Notice, also known as a "**Requirement to Pay**" or a Third-Party Garnishment. This can be issued under section 224 of the *Income Tax Act* or, for GST/HST debts, under section 317 of the *Excise Tax Act*.

If you receive a garnishment notice referring to one of these sections, **and you are liable to pay any money to the tax debtor**, then you must pay that amount of money (up to the limit of the tax debt listed in the garnishment notice) to the CRA. If you do not, you can be assessed by the CRA for that amount of money.

Most people understand that they must pay the CRA rather than paying the tax debtor.

What is often not understood, however, is that the person who receives the notice will be liable *even if they do not pay anything to the tax debtor*, provided a liability to pay the tax debtor exists.

This has happened in several reported court cases. Even though the person who received the garnishment notice paid nothing to the tax debtor, they were liable to pay the CRA because they *owed* money to the tax debtor.

So if you receive a garnishment notice, you cannot avoid liability to the CRA by simply not paying anything further to the tax debtor! If the debt exists, you must pay the CRA or face an assessment. And if you're assessed, the CRA can then seize the money from your bank account or anyone who owes money to you.

THE GST OR HST COMPONENT IN SETTLING A BUSINESS DISPUTE

If you own or manage a business, you occasionally end up in disputes with customers or suppliers over the terms of a contract or payment. Sometimes these disputes have to be referred to lawyers, and sometimes they end up in court.

Regardless of how far the dispute goes until it's settled, are you aware of the GST or HST consequences of any settlement or damage award? Your lawyer might not be aware of this issue.

A settlement or award for breach of contract will normally **be considered tax-included** if the following conditions are met:

- The payment is made by the "recipient" to the "supplier" rather than the other way round. That is, it is the purchaser, lessee or customer who is making the payment, and the vendor, lessor or supplier who is receiving it. (In other words, money is flowing in the same direction as it would have flowed under the contract.)

- The payment is for breach, termination or modification of a **contract or agreement**. (It need not be a *written* contract; an oral agreement to buy or lease property, or to provide services, is still a contract.)

- GST or HST was payable, or would have been payable, under the contract, if it had been fulfilled as planned.

The supplier (vendor, lessor) must carve out a fraction of the total and remit it to the Canada Revenue Agency as GST or HST. The fraction depends on the province. In Ontario or New Brunswick, for example, where the HST rate is 13%, the fraction is 13/113ths, or just over 11.5%. In Alberta, where the GST rate is 5%, the fraction is 5/105ths.

The recipient (purchaser, lessee) can claim an input tax credit and *recover* the same amount from the CRA, provided the recipient would have been able to claim the credit if the moneys had been paid under the contract.

Note that in Quebec, the Quebec Sales Tax (QST) is treated the same way, in addition to the GST.

The same rule applies to an amount that is kept as a **forfeited deposit**.

> *EXAMPLE*
>
> *B (a builder) builds a new home for sale in Calgary. P (the purchaser) offers $300,000 for the home, putting down a $10,000 deposit. P then changes his mind and walks away from the deal, forfeiting the deposit. B decides not to sue and just keeps the $10,000.*
>
> B does not really get to keep $10,000. The $10,000 is considered to be GST-included. The GST is calculated as 5/105 of this amount, or $476.19. Thus, B really gets $9,523.81 plus 5% GST of $476.19, and must remit the GST to the government.
>
> (Note that in this case the deposit includes the full 5% GST even though, if the home sale had been completed, 1.8 percentage points of that GST would have been refunded to P via the new housing rebate.)

Note that these rules do not apply to payments *by* a supplier — *e.g.* payment by a landlord to cancel a tenant's lease early. They also do not apply to payments that are not related to a contract — for example, payments for damage caused by negligence, such as where someone with whom you have no contractual relationship damages your business's property.

AROUND THE COURTS

Home builders nailed for pretending new home was for their personal use

The recent Tax Court of Canada decision in *Sangha and Sekhon v. The Queen* is a good example of what happens to home builders who build a new home for sale, but pretend that they were building it for their personal use.

An individual who genuinely builds a home to live in doesn't have any negative tax consequences. They pay GST or HST on the construction costs (and may be eligible for a partial New Housing Rebate), but that's all the tax they pay. If they live in their home for a few years and then decide to sell it, any gain on the home is tax-free as the home is their "principal residence". Most people know this. Also, when they sell the home, no GST or HST (or Quebec Sales Tax, in Quebec) applies to the sale.

The story is very different for someone who builds a home intending to sell it at a profit. Such a person is considered to be in the "business" of building homes (even if they only build one home). When they sell the new home, GST/HST applies to the sale (though they can normally claim input tax credits to recover the GST or HST they paid on the costs of construction). On the income tax side, their gain on the home is fully taxable as business income, even if they lived in the home. The "principal residence" exemption applies only to *capital* property, and for someone who builds a home to sell, the home is not capital property but inventory.

Sangha and Sekhon were close friends. They decided to buy a vacant lot in Vancouver and flip it for a profit. Having bought a lot, they then decided to build a home on it. Shortly after the home was built, they listed it for sale, and it sold in a few months. This is a classic example of builders who will be taxed on their gains as business profit.

Within a few months they sold the property. Of course, for tax purposes they took the position that they did not need to report their gains as business profit since the home was their "principal residence" because they pretended to move in. Nor did they collect and remit GST on the sale.

The CRA, which now has good tools for tracking and finding taxpayers who hold properties for only a short time before selling them, assessed Sangha and Sekhon for tax on the gain as business profit, and assessed them for unremitted GST on the basis that they were "builders" of the home. Sangha and Sekhon appealed to the Tax Court of Canada.

The Court dismissed the appeals. The appellants' story was not even remotely credible, as there was far too much evidence that they built the home with the intention of selling it. They never actually lived there.

Note also that if Sangha and Sekhon had actually moved into the home and lived in it as a residence, they would have been no better off. Moving into the home (or renting it out) would trigger the "self-supply" rule, which would have required GST to be paid immediately on the full value of the home (including the land value). The subsequent sale of the home would then be exempt.

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