Davidson & Company
CHARTERED PROFESSIONAL ACCOUNTANTS

TAX UPDATE

Did You Know

Davidson and Company's skilled and experienced Valuation, Advisory and Consulting team is able to deliver the credible results that you need in a timely and cost efficient manner? Our advisory professionals are Chartered Business Valuators (CBV) and Chartered Professional Accountants (CPA, CA) with deep and relevant experience with both public and private companies across a wide range of industries.

Give us a call today at 604-687-0947 and ask for Mark Weston!

Laneway House and GST/HST

If you construct a laneway house (or engage another person to construct a laneway house) on your land, and you subsequently supply the laneway house by way of lease, licence or similar arrangement for use by another individual as a place of residence, you will generally be considered as a "builder" of the laneway house for GST/HST purposes.

As a builder of a laneway house, you are generally considered to have sold and repurchased (i.e., self-supplied) the laneway house at its fair market value. You are also considered to have sold the laneway house and collected the GST/HST equal to the GST/HST on the fair market value of the laneway house at the time of the sale.

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You must account for the GST/HST that is considered to have been collected on that sale by reporting it on a GST/HST return (self-assessing) regardless whether or not you are a GST/HST registrant.

Information credit: Canada Revenue Agency

CRA ACCESS TO YOUR RECORDS

The Income Tax Act gives the CRA wide powers to access your accounting records, bank records, and any other documents it can find or demand.

An auditor can ask for records about you from you, your bank, your accountant, your employer or almost anyone else you deal with, such as investment dealers, casinos, insurers, customers or credit-card issuers.

Under section 231.1 of the Income Tax Act, an audit request must be complied with. If the person from whom information is requested does not comply, the auditor will normally issue a Requirement for Information under section 231.2. This is a formal document, delivered in person or by registered mail, which requires the person to comply. Not complying is an offence that can be prosecuted.

In practice, if a person does not comply with a Requirement for Information, the CRA then escalates to obtaining a compliance order under section 231.7 from the Federal Court, which is served on the person. Continued non-compliance then constitutes contempt of Court, and will usually land the person in jail. This is a very effective tool to ensure compliance!

There are very few exceptions to these rules. As long as the documents or records being sought are reasonably relevant to the audit of a taxpayer, the CRA is normally entitled to request them.

One important exception is lawyers' offices (including offices of notaries in Quebec). Due to the Supreme Court of Canada's ruling in the 2016 Chambre des notaires case, the CRA cannot at present demand documents from a lawyer or law firm, even if those documents are not subject to solicitor-client privilege.

Another exception is documents protected by solicitor-client privilege, even if they are not in a law office. This privilege covers communications to or from a lawyer for the purpose of obtaining legal advice. However, if the document is in someone else's hands — e.g., your accountant's office — then privilege may have been waived and the document might not be protected. Guard carefully any privileged documents, and ensure that if copies go elsewhere, it is on the basis that privilege is not being waived!

Also, if the taxpayer is unidentified and the CRA wants to use a business's records to find taxpayers of a certain class — such as all customers of a particular tax advisor or all real estate agents paid by a particular broker — then a Court Order is required before the Requirement for Information can be issued.

Finally, note that if the CRA has internally moved from an audit to a criminal investigation, then the above audit powers cannot be used to gather information for a prosecution, and evidence collected by audit request, Requirement for Information or compliance order will not be admissible as evidence in the prosecution. (It can still be used to support a tax assessment and as evidence in Tax Court in an appeal of that assessment.) This rule, under the 2002 Supreme Court of Canada Jarvis case, does not apply to evidence collected while the CRA is only auditing the taxpayer and has not begun a criminal investigation.

In general, you should assume that any documents about you and your financial affairs that exist anywhere other than in your lawyer's office may become available to the CRA.

PUBLIC TRANSIT PASS CREDIT ELIMINATED — TIMING

The March 22, 2017 federal Budget has eliminated the 15% credit for buying public transit passes.

This move was expected, as the Liberal government is doing away with a number of the tax credits introduced by the Conservatives during their 10 years in power.

However, what was not expected was the timing of the elimination of the credit. Some taxpayers who were expecting the credit to be cancelled may have stocked up on passes ahead of the federal Budget, thinking that as long as they bought the passes before the Budget announcement, the credit would be available.

Unfortunately for those taxpayers, the credit is eliminated where the use of the pass is after June 2017. Thus, any passes bought ahead of time but not used before July 1 will not generate the credit on a taxpayer's 2017 Income Tax Return.

IN VITRO FERTILIZATION AS A MEDICAL EXPENSE

The March 22, 2017 Federal Budget has added a special rule allowing in vitro fertilization costs as a medical expense, eligible for a 15% federal credit (subject to a threshold of a base amount of medical expenses in the year), plus a provincial credit.

Such costs were already allowed as a medical expense where needed for medical reasons, due to infertility.

Now, however, fertility expenses will be allowed even if there is no medical need. Thus, a woman who is in a same-sex relationship, or who is single and chooses to have a child through in vitro fertilization, will be able to claim the medical costs as a medical expense.

GST/HST ON 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.

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 is still a contract.)

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

In these circumstances, any settlement amount is normally deemed by the Excise Tax Act to be a total that already includes GST or HST.

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. If your customer is in Ontario, 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 money had been paid under the contract.

Example 1

Landlord leases office space in Ontario to Tenant for $5,000 per month plus 13% HST, under a one-year lease. Six months into the lease, Tenant wishes to cancel. After some discussions, Landlord agrees to accept a one-time payment of $10,000 to release Tenant from the lease.

Landlord must treat the amount received as HST-included. If Landlord accepts $10,000, it must calculate 13/113ths of this amount or $1,150 and remit this amount to the government as HST collected. In other words, Landlord has really settled for $8,850 plus 13% HST of $1,150. (The $8,850 will also be income for income tax purposes, but this article is not about income tax.)

Similarly, Tenant is paying $8,850 plus HST of $1,150. If Tenant is a normal business that can claim input tax credits for HST that it pays, Tenant can recover the $1,150 as a refund when filing its next HST return — which may be something of a windfall if Tenant made the deal without expecting this. This is so even if the settlement agreement does not mention the HST.

If Landlord really wants to settle for $10,000, Landlord should add 13% for HST and settle for $11,300. Then Landlord keeps $10,000 and sends $1,300 (13/113ths of the $11,300) to the government as HST, and Tenant (if a business) can claim the same $1,300 as an input tax credit.

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 2

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. Thus, B really gets $9,524 plus 5% GST of $476, and must remit the GST to the government. (Again, the $9,524 is also income for income tax purposes.)

This may come as a shock to B. B should not have accepted the $10,000 deposit unless B was aware that it was really only a deposit of $9,524 plus GST.

(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.

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 (most of these concerns also apply to a RRIF, TFSA, RESP or RDSP):

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 in 2011, 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 "qualified 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 uses 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 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 2013 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 50% tax bracket (combined federal/provincial tax).

If you transfer the shares to your RRSP, you will have a $10,000 deduction, worth $5,000 on your 2017 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 50% bracket, that will cost you $1,000.

The result is that you still benefit from the transfer, but your net tax saving will be $4,000 rather than $5,000. (If you donate the shares to charity instead, you will not pay tax on the capital gain so your tax savings will be about $5,000, though they will vary by province.)

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, 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 30-50% rather than about 50% (the details depend on your province of residence as well as your level of taxable income and the kind of dividend). Capital gains, as noted above, are only half taxed, so again the top rate is typically about 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 tradeoff, 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. Do not overlook the pitfalls and costs that may apply.

AROUND THE COURTS

Collecting GST/HST on a sale of commercial real property

On a sale of commercial real property, GST/HST usually applies, but the vendor normally does not (and should not) collect the tax from the purchaser, if the purchaser is GST-registered. Instead, the purchaser "self-assesses" the tax (and in most cases claims an offsetting input tax credit so that the tax actually costs nothing).

However, vendors of real estate need to be very careful when relying on this rule.

In the recent case of 2252493 Ontario Ltd. v. The Queen, the vendor (a numbered company) sold a commercial property in Ontario for $3.2 million plus

HST. The Excise Tax Act (which contains the GST/HST legislation) provides that a vendor does not collect tax on closing from a GST-registered purchaser. However, the reference is actually to the "recipient", not the "purchaser". The term "recipient" is defined as the person who is contractually liable to pay the purchase price. In this case, the Agreement of Purchase and Sale was signed by Mayling Holding Inc., as purchaser. On closing, Mayling requested that title be directed to 840 Yonge Street Holdings Inc. ("840"). Since 840 was GST-registered, the vendor thought it did not need to collect tax on the purchase, and accepted $3.2 million on closing as satisfying the purchase price.

Mayling was not registered, however. The CRA audited the vendor and assessed it for not collecting and remitting HST of $416,000 on the sale.

The vendor appealed to the Tax Court of Canada. It argued that 840 (whose registration had been retroactively cancelled) was a bare trustee for two other entities that were GST-registered, and which had self-assessed the tax on the purchase.

The Tax Court dismissed the vendor's appeal. The legislation relieves a vendor from collecting GST/HST on a sale only if the "recipient" is registered, and the "recipient" could not possibly be either 840 or the other entities. Only Mayling was liable under the Agreement of Purchase and Sale, and there was no evidence that, at the time it signed the Agreement, it was doing so in trust for 840 or anyone else. The fact the other entities had self-assessed the tax did not matter.

One must be very careful about these rules!

This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this Update, which are appropriate to your own specific requirements.

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