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TAX LETTER

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NON-ARM'S LENGTH TRANSFERS

Overview

There are special rules under the Income Tax Act (the "Act") that apply to transfers of property to a non-arm's length person. The rules, discussed below, can override the actual proceeds or sales price received on the transfer.

For most purposes, "related" persons, as defined in the Act, are non-arm's length persons.

With individuals, related persons and therefore non-arm's length persons include the types of individuals you would normally consider related to you. For example, they include:

- Your spouse or common-law partner
- Your children, grandchildren, great-grandchildren, and so on
- Your parents, grandparents, great-grand parents, and so on
- Your siblings
- Your in-laws

Interestingly, they do not include aunts, uncles, cousins, and nieces and nephews. So the non-arm length rules do not normally apply to transfers of property to these individuals.

In terms of corporations, the rules are somewhat more complex. Some basic examples of related and non-arm's length relationships include:

- You and a corporation that you control
- You and a corporation that you control with a related group of persons (say, you and your two siblings control a corporation)
- Two or more corporations, if they are controlled by the same person or group of persons

For these purposes, control typically means owning more than 50% of the voting shares of the corporation.

The rules that apply on transfers

One rule states that where you transfer a property to a non-arm's length person for something more than zero, but **less** than the fair market value of the property, you are deemed to dispose of the property for proceeds equal to the fair market value of the property. But the rule is one-sided, in that the person acquiring the property gets a cost of what they actually paid you. As illustrated in the example below, this rule is punitive, and can lead to double taxation.

> **Example**
>
> I sell a property to my sister for $5,000, when the fair market value of the property is $15,000. My cost of the property was $5,000.
>
> Under this rule, I will have deemed proceeds of $15,000, leading to a capital gain of $10,000, and half of that will be included in my income as a taxable capital gain.
>
> But my sister's cost is not bumped up to fair market value and is simply the $5,000 that she paid me for the property. So let's say she sells the property to a third party for $15,000. She will have a capital gain of $10,000, and half of that will be included in her income as a taxable capital gain.
>
> There is double taxation. Both I and my sister were taxed on the same capital gain.

Note: There is a major exception to this rule and the other non-arm's length transfer rules, where you transfer the property to your spouse or common-law partner. This exception is discussed in the text below under the heading "Exception for transfers to spouse".

Another rule applies where you transfer a property to a non-arm's length person for **more** than fair market value. In this case, your proceeds on the sale remain whatever they paid you. But the purchaser's cost of the property is ground down to its fair market value, even though they paid you more than that for the property. Again, this can lead to double taxation.

> **Example**
>
> My sister buys a property from me for $15,000, when the fair market value of the property is $5,000. My cost of the property was $5,000. So I will have a capital gain of $10,000 (my actual capital gain), and half of that will be included in my income as a taxable capital gain.
>
> Under this rule, my sister's cost of the property is ground down to $5,000. Assume she sells the property a few years later to a third party for $15,000. She will have a capital gain of $10,000, and half of that will be included in her income as a taxable capital gain.

So again, there is a potential for double taxation.

Gifts of property

For gifts, the rules are somewhat different. If you give a property, you have deemed proceeds equal to the fair market value of the property. But in this case, the recipient of the gift has a deemed cost equal to the fair market value, so that there is no double tax.

Example

I give a property to my sister when the fair market value of the property is $15,000. My cost of the property was $5,000.

Under this rule, I will have deemed proceeds of $15,000, leading to a capital gain of $10,000, and half of that will be included in my income as a taxable capital gain.

But my sister's cost is bumped up to fair market value of $15,000. So let's say she sells the property to a third party for $15,000. She will have no capital gain. There is no double taxation.

On a final note, for gifts, the recipient of the gift does not include the amount of the gift in income, whether it is cash or other property. For example, if I give my child a cash gift, or buy them a car or a house, they do not include anything in income.

Exception for transfers to spouse

If you transfer property to your spouse (or common-law partner), a different rule applies. It is a tax-free "rollover", meaning that you have deemed proceeds equal to your cost of the property and your spouse picks up the same cost. So you have no capital gain or loss on the transfer.

If you wish, you can elect out of the rollover in your tax return for the year of the transfer. If you do so, the rules discussed above apply. In most cases, you will not want to elect out of the rollover. But in some cases it will make sense.

For example, let's say you give a property to your spouse with an accrued capital gain. You have some capital losses that you could use to offset the gain. (Capital losses can only be used against capital gains.) So you elect out of the rollover, trigger the accrued capital gain, and use your capital losses to offset the gain, meaning you pay no tax on the transfer. The result *for you* is basically the same as under the rollover. But the difference, *for your spouse*, is that they get a bumped-up adjusted cost base equal to the property's fair market value.

Example

I give a property to my spouse when the fair market value of the property is $15,000. My cost of the property was $5,000. I have $25,000 of capital losses that I have not yet claimed.

If I use the rollover, I will have proceeds of $5,000 and therefore no capital gain. My spouse will have a cost of $5,000 for tax purposes.

If I elect out of the rollover, I will have deemed proceeds of $15,000, leading to a capital gain of $10,000. But I can offset that gain with $10,000 of my unused capital losses. My spouse will then have a cost in the property of $15,000.

Unfortunately, you can not normally trigger a capital loss by electing out of the rollover.

This is because of the "superficial loss" rule, discussed under the next heading.

SUPERFICIAL LOSSES

When you sell a capital property for less than your adjusted cost base, you will have a capital loss. One-half of the capital loss is an allowable capital loss, and offsets any taxable capital gains that you have.

However, the capital loss will be denied if you or an "affiliated person" acquire the same property or an identical property within the period that begins 30 days before you sold the property and ends 30 days after that, and you or the affiliated person owns that property at the end of the period. This is the "superficial loss" rule.

The one upside of the rule is that the cost of the property for the person acquiring the property (whether that is you or someone else) is bumped up by the amount of your loss that was denied under the rule.

An affiliated person includes your spouse or common-law partner, a corporation that you control, among others. Interestingly, it does **not** include your children or other relatives.

> **Example**
>
> On day 1, I sold 100 shares in XCorp for $90,000. My adjusted cost base in the shares was $100,000, so I incurred a capital loss of $10,000.
>
> On day 12, my spouse bought 100 shares in XCorp for $91,000 (they went up slightly in value). She continued to own them through to day 31.
>
> Result: My $10,000 loss is a superficial loss, so my capital loss is zero. My spouse's adjusted cost base equals the $91,000 she paid for the shares plus the $10,000 denied loss, for a total of $101,000.

As can be seen, although my initial loss is denied, the loss is not "lost" forever, but rather is deferred. For example, if my spouse later sells the shares for $91,000, they will have a $10,000 capital loss because their cost in the shares was bumped up by my denied loss (assuming my spouse or an affiliated person does not acquire the shares within 30 days after their sale, etc.).

STOCK DIVIDENDS

Normally, if you receive a dividend from a corporation, it is paid in cash. But sometimes, the corporation will issue you more shares as the dividend instead of cash. In this case, it is called a stock dividend ("stock" and "share" have the same meaning and are used interchangeably).

When you receive a stock dividend, the amount of the dividend included in your income for income tax purposes is the "paid-up capital" in respect of the shares that were issued to you as the dividend. The paid-up capital is a legal and tax concept, and sometimes the paid-up capital of the issued shares will simply equal their fair market value. However, that is not always the case. If the paid-up capital is different than the fair market value, the paid-up capital remains the amount to be included in income.

The amount included in income also becomes your cost of those shares. Since you will own other shares in the corporation (you must have owned shares to receive the stock dividend), the cost of the issued shares on the stock dividend is averaged out with your cost of the other shares. Technically, the cost is called the "adjusted cost base" for capital gains purposes.

Example

I own 1,000 shares in XCorp, which I have owned for several years. My adjusted cost base of those shares was $100 per share, or $100,000 in total.

XCorp pays a 1% stock dividend, which means that every shareholder gets one share for every 100 that they own. So I get ten more shares as the stock dividend. The paid-up capital of the ten shares is $200 per share.

I include in income $200 x 10, or $2,000. (I will also be subject to the "gross-up" of the dividend, described below.)

The adjusted cost base of my new shares is initially $200 per share, or $2,000 in total. But I now own 1,010 shares, and the cost of the new shares must be averaged out with the cost of the old shares, which had a total cost of $100,000. So the adjusted cost base of each of my 1,010 shares becomes $102,000 / 1,010 = $101 per share (rounded off).

If the stock dividend is received from a taxable Canadian corporation, the regular gross-up and dividend tax credit rules apply. These rules are meant to prevent double taxation. That is, since the corporation was presumably subject to tax on its income, and then paid out a dividend, the recipient shareholder gets a credit which ostensibly offsets the tax paid at the corporate level. So, in the above example, the $2,000 dividend will be subject to these rules.

Applying the gross-up / dividend tax credit to the example

Let's assume XCorp is a public corporation and the stock dividend I received was an "eligible dividend" (basically, this type of dividend is eligible for a larger credit than a "non-eligible dividend").

I include the $2,000 dividend in income, but must "gross-up" the dividend by 38%, so I actually include $2,760 in income. I am in a 50% tax bracket, so my initial tax on that $2,760 amount is $1,380.

However, I can claim the federal dividend tax credit, which is approximately 15.02% of the grossed-up dividend. The provincial credit varies by province, but let's assume it's 10%. So I get a total credit of 25.02% x $2,760 = $690. So my final tax on the stock dividend is actually the initial tax of $1,380 minus the $690 credit, which equals $690. (All of these numbers are rounded off.)

Therefore, on my $2,000 stock dividend, I paid $690 in tax, which is a 34.5% tax rate, even though I am otherwise in the 50% tax bracket. The reason – as noted above – is that the dividend tax credit gives me some relief due to the fact that the corporation likely paid corporate income tax on its earnings.

MEDICAL EXPENSE CREDIT

As the name implies, the medical expense credit can provide a tax break for medical expenses that you and your family incur.

The mechanics of the credit are explained below. But first, a couple of things to note.

First, and not surprisingly, the credit is allowed only for medical expenses that you pay out of your own pocket. If they are reimbursed by your employer, or are paid or reimbursed to you under a health insurance plan, you cannot claim the credit.

Second, although many medical expenses qualify, any given expense must be specified under the Act to be eligible for credit. If they are not, they do not qualify. The list of qualifying medical expenses is long and not all are listed here. See CRA Income Tax Folio S1-F1-C1 for a complete list.

The following describes some of the more common qualifying expenses, summarized in general terms (there are often more specific conditions that need to be fulfilled):

- Fees paid to a medical practitioner, nurse, or dentist, but again only to the extent you paid for them. For services provided by medical practitioners and nurses, the fees are typically paid by the provincial government. Any fees that are not covered, such as extra fees for a private hospital room, can qualify for the credit. Most dental fees are not paid by the provincial government and therefore qualify (except to the extent they are paid by, or reimbursed to you, under a health insurance plan).
- Fees paid to an attendant to care for a disabled person.
- Fees paid to a group home for the care of a disabled person.
- Fees paid for an ambulance to or from a hospital.
- The cost of certain tangible items such as an artificial limb, iron lung, wheelchair, crutches, spinal brace, a brace for a limb, an ileostomy or colostomy pad, truss for hernia, artificial eye and laryngeal speaking aid.
- The cost of prescription eyeglasses and contact lenses.
- For an individual who is blind, deaf, or has other specified medical conditions, fees paid for a service animal.
- For an individual who has a speech or hearing impairment, fees paid for sign language interpretation services.
- Amounts paid for most prescription drugs. (Over-the-counter drugs do not qualify.)
- Premiums paid for a private medical health plan.
- If you have celiac disease, the additional cost of buying gluten-free food (compared to food with gluten).

There are two components to the medical expense credit.

The first one covers qualifying medical expenses paid for you, your spouse or common-law partner, and your children who are under 18 in the year. For 2021, the federal credit equals:

15% x the qualifying medical expenses **in excess of** the lesser of:

- 3% of your income for the year (income means “net income” as shown on your tax return, which is after most deductions are claimed), and
- $2,421 (this amount is indexed each year for inflation)

(There is a parallel provincial credit against provincial tax as well; the value and dollar thresholds depend on the province.)

Although the rule technically applies to the individual who pays the expenses, in the case of couples, the Canada Revenue Agency allows either spouse or partner to claim the credit. It normally makes sense for the lower income spouse or partner to claim the credit because of the 3% income limitation (unless the lower income person has little or no tax and therefore cannot benefit from the credit).

The second component covers the qualifying medical expenses that you pay for adult dependants, such as your children aged 18 or over who are dependent upon you for support (in certain cases, it can cover medical expenses for other relatives dependent upon you for support – for example if your 18-year sibling is living with you and is dependent upon you for support). The federal credit here is similar to the first one above but with one major difference. The federal credit for 2021 is:

15% x the qualifying medical expenses in excess of the lesser of:

- 3% of the **dependant's** income for the year, and
- $2,421

Since your dependant's income will be typically less than your income (since they are dependent upon you for support), the second component can potentially lead to a larger credit than the first component.

On a final note, the credit can be claimed for qualifying medical expenses paid in any 12-month period ending in the year. Normally, most people just claim the credit for expenses paid in the calendar year. But in some cases it makes sense to use the 12-month rule to claim the credit in one year for expenses paid in two different calendar years. The following example illustrates why this might be the case.

Example

Bill is single. In the last six months of 2020, Bill paid $2,500 of medical expenses. In the first six months of 2021, he also paid $2,500 of medical expenses. He had no other medical expenses in those years. His net income for each year was $50,000.

Because of the 3% limitation described above, he can only claim the credit with respect to the medical expenses in excess of $1,500 in either year (that is, 3% of his income of $50,000).

If he claims the credit in **both** 2020 and 2021, he can claim the credit for only $1,000 of expenses each year (since he paid $2,500 in each year).

However, if he uses the 12-month rule, he can claim the credit for $3,500 of expenses in his 2021 tax return – the $5,000 he paid during the last six months of 2020 and first six months of 2021, minus the $1,500 limitation. So he will be much better off pooling his medical expenses under the 12-month rule and claiming the larger credit in 2021.

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