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TAX LETTER

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“ASSIGNING” A RESIDENTIAL PURCHASE AGREEMENT FINDING A MISTAKE IN A PAST YEAR’S TAX RETURN NOT PAYING INSTALMENTS CAN BE COSTLY! AROUND THE COURTS

“ASSIGNING” A RESIDENTIAL PURCHASE AGREEMENT

Purchasers of new homes and condominiums sometimes sell their rights to the property before the closing.

This happens frequently with new homes or condos that take years to be built. It may happen because of a change in circumstances, or simply because the buyer wants to profit from an increase in market value of the property. Many builders’ purchase agreements permit such “assignment” of purchase rights, as an incentive encouraging people to buy.

EXAMPLE

Alice signed an agreement in 2018 to pay **\$300,000** for a new condominium, to be built. She planned to live there and had no intention of selling it anytime soon.

The closing was supposed to take place in 2021. However due to construction delays caused by COVID-19, her unit won’t be ready until fall 2023.

Alice has paid **\$40,000** in deposits toward the new condo so far.

Meanwhile, Alice’s circumstances have changed. She had planned to live in the

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condo on her own. But since 2020 she's in a new relationship. In summer 2023 she'll be getting married, and will move to another town to be with her new husband.

So Alice doesn't need the condo. But its market value has gone up to \$450,000, which is what the builder is now charging for identical units that are not yet sold. So she can do better than simply asking the builder to cancel the deal.

Through a real estate agent, Alice finds a buyer, Joe, who is willing to pay **\$400,000** for the condo once it's ready.

Alice **assigns** her rights under the Agreement of Purchase and Sale (that she has with the builder) to Joe. Joe will become the new buyer under the purchase agreement, taking Alice's place.

Since Joe is willing to pay \$400,000 for the condo and the "assignment" will give him the right to buy it for \$300,000, Joe pays Alice **\$100,000** for the assignment of her purchase right.

As well, Joe pays Alice a further **\$40,000**, to reimburse her for the \$40,000 in deposits that she has already paid the builder, since Joe will get credit for that \$40,000 when he closes the purchase with the builder.

Now, what happens for tax purposes?

GST/HST

First, let's look at **GST/HST** (which applies at 13% in Ontario, 15% in the Atlantic provinces and 5% in other provinces; in Quebec, the 9.975% QST works the same as the GST).

Until May 6, 2022, the application of GST or HST to the assignment depended on Alice's original intentions. If she intended all along to sell or "flip" the condo to make a profit, then GST or HST would apply to the assignment. But in this situation, where she planned only to live in the property, GST/HST wouldn't have applied.

However, the GST/HST legislation was changed, for assignment contracts signed after May 6, 2022. (The new rule is in *Excise Tax Act* section 192.1, in case you want to look it up.)

Now, when Alice assigns the purchase agreement, **GST or HST applies** to the assignment. She must charge 5%, 13% or 15% tax, depending on the province the condo is in, and remit that amount to the CRA as "net tax" collected (minus the GST/HST she pays on legal fees and real estate commission, if she registers for GST/HST before incurring those expenses). However, the reimbursement for her \$40,000 deposit is deducted in calculating the "consideration" to which GST/HST applies, so she charges the tax on only **\$100,000**.

If Alice assigns the agreement for a flat \$140,000 as per above without adding tax, and the assignment contract says that any GST/HST is "included" rather than "extra", then the GST or HST she must remit will be 5/105ths, 13/113ths or 15/115ths of \$100,000, again depending on the province. In Ontario, for example, an HST-included price of \$100,000 means the price is actually \$88,495.58 plus HST of \$11,504.42, which is 13% of that amount, for a total of \$100,000.

Income tax

For income tax purposes, the tax treatment depends on Alice's original intentions. If she

intended all along to sell or “flip” the condo to make a profit — or even had a so-called “secondary intention” to sell if it proved worthwhile — then Alice’s \$100,000 profit from the assignment (minus expenses such as real estate commission and legal fees) would be business profit. It would have to be reported as business income on her 2023 return, and she will pay tax on that income.

But in Alice’s case, she planned only to live in the property, not to sell it. So the gain isn’t business profit. It’s a capital gain. Since she never actually gets the condo and moves in, the principal-residence exemption can’t apply. She has to report the \$100,000 capital gain from the assignment (again minus expenses such as real estate commission and legal fees) on her 2023 tax return, and half of the capital gain is a “taxable capital gain” that is included in her income.

Of course, the CRA doesn’t know what Alice’s real intentions were. The CRA audits many assignment sales, and will usually propose to assess the taxpayer on the basis that the gain is business income. Alice may need to prove to the CRA, with whatever evidence she can muster from her personal life (such as photos, emails, texts, letters from professional advisers and friends), that she originally intended to live in the condo indefinitely.

(As well, under a proposal announced on November 3, 2022, if a buyer **assigns a residential purchase agreement within 12 months** of first signing it, then the gain will be treated as business income regardless of their original intention, unless they can show a change in circumstances that falls within a specific list (death, divorce, illness, etc.). Since joining another person’s household is on the list, Alice would be OK

even if she had signed the agreement only within the last 12 months.)

Conclusion

If you are considering assigning a purchase agreement for a new home or condo — or paying someone else to assign such an agreement to you — make sure you investigate the income tax and GST/HST consequences!

FINDING A MISTAKE IN A PAST YEAR’S TAX RETURN

What happens if you find a mistake in a past year’s tax return?

Mistake Where You Paid Too Much Tax

If you forgot to claim a particular deduction or credit, or over-reported your income, you can write to the Canada Revenue Agency and provide details of the amount you missed. You can file a Form T1-Adj (T1 Adjustment) to “adjust” your earlier return. It is easier, however, to use the CRA’s “My Account” online system and request the adjustment online.

You can also do this if you have determined that the CRA assessed you incorrectly, such as if you have realized since filing your return that you could have reported your income differently than you did.

If you are within the objection deadline for objecting to the assessment for that year’s return, then you may want to file a formal **Notice of Objection** to preserve your legal right to request these changes. The deadline for filing an objection is 90 days from the date of the last Notice of Assessment (or Reassessment) for the taxation year; or one

year from the *original* filing deadline for the return, whichever is later.

So if you (or your spouse) carry on business and your filing deadline is June 15, then you can object to your 2021 assessment until June 15, 2023, even if that assessment was issued more than 90 days ago. If you do not carry on business and your filing deadline is April 30, then you can object to your 2021 assessment until April 30, 2023. (If you miss an objection deadline, a 1-year extension is possible in certain circumstances.)

Filing an objection is a good idea if the deadline is looming, even if you think that the CRA will routinely accept your request. It gives you the legal right to force the CRA to listen to you. Also, the Appeals Division (which handles objections) is often more pleasant to deal with, and more responsive and accountable, than the Client Services Division or Tax Centre which processes adjustments. This is because Appeals is much smaller, and does not handle anywhere near the volume of transactions as Client Services or the Tax Centre. (The downside is that it may take 6 months or more for your objection to even be looked at by an Appeals Officer, while some adjustments, especially if filed online, are processed very quickly.)

Even if you are past the deadline for filing an objection and you just make an ordinary adjustment request, the CRA will normally review your request and accept it if it believes it to be correct. The CRA's guidelines for making these changes are found in Information Circulars 75-7R3 (recent year changes) and 07-1 (changes requesting refunds for years that are otherwise beyond the 3-year reassessment deadline). Notably, the CRA will *not* process a change that results from someone else succeeding in a Court case (unless you file a timely

objection, which forces the CRA to deal with the issue). The CRA also does not allow retroactive tax planning. It has to be a claim that you clearly would have made at the time you filed the return, if you had been aware of it.

These changes can legally go back up to **10 years** from the year in which you make the adjustment request. So if you're making a request in 2023, it can be for 2013 or any later tax year. If you request a change for an earlier year, the CRA has no legal authority to make the change, so even if it is justified, your request will be rejected. (This rule does not apply to objections — if for some reason you get a reassessment of your 2012 year today, you can file an objection to it on any valid ground.)

Mistake Where You Did Not Pay Enough Tax

What happens if you find that you inadvertently under-reported your income, or claimed a deduction or credit that you were not entitled to?

As with the case where you paid too much tax, you can file a T1-Adj adjustment form to report the correction, or you can make an adjustment request online using My Account.

If more than one year has passed since you filed the return, you may wish to make a **voluntary disclosure** to eliminate any penalties that may apply, and possibly reduce past years' interest as well. See Information Circular 00-1R6 or tinyurl.com/vdp-cra. To be accepted, a disclosure must be "voluntary" in the sense that you are not currently under any audit or enforcement action that might discover the error; and it must be "complete" in that you must disclose *all* errors in your tax filings for all years.

You can only do a voluntary disclosure if there are penalties possibly involved. If you filed your return on time and were not “grossly negligent”, normal mistakes will usually give rise to a requirement to repay the tax with interest, but not penalties.

What if you do not feel like reporting the correction to the CRA?

As long as the reassessment period is open (normally 3 years after the date of your initial Notice of Assessment), you are subject to the risk of audit and reassessment, if the auditor finds the mistake. If that happens, you will have to repay the tax plus interest. Even past that deadline, the CRA can reassess you if the auditor is of the view that you were careless or negligent in not reporting the income in question, or in overclaiming an expense or credit.

(In practice, the CRA usually does not audit more than 2 years back, unless they have reason to be looking for a particular problem in a past year, such as where they are investigating a taxpayer’s past real estate sales.)

However, there is no legal obligation in the Income Tax Act to go back and adjust a past return when you discover a mistake.

Note also that the rules determining whether you made a misrepresentation that was careless or negligent, so that the 3-year reassessment limit does not apply, are based on whether you were careless or negligent *at the time you filed your return*. Similarly, penalties for gross negligence or fraud are determined based on your knowledge and information *at the time you filed your return*. Failing to report a correction is not itself grounds for penalties, as long as you are not

currently providing misinformation to the CRA.

So if you discover a mistake from a past year and don’t think you will be audited, you’re not legally required to notify the CRA. But you’re taking the risk of being reassessed, and penalties and interest applying, if the CRA does audit you and find the error.

NOT PAYING INSTALMENTS CAN BE COSTLY!

Are you required to pay quarterly instalments?

You must pay instalments if the difference between your **tax payable for the year** — federal and provincial tax plus Canada Pension Plan premiums (including Quebec Pension Plan if you live in Quebec) — and amounts withheld at source is more than **\$3,000** in both the current year and either of the two preceding years.

For Quebec residents, since provincial tax is not collected by the Canada Revenue Agency, the threshold is **\$1,800** of federal tax instead of \$3,000 total. There is a separate obligation to pay Quebec instalments to Revenu Québec.

Quarterly instalments are due on March 15, June 15, September 15 and December 15. You then settle up any balance owing by the following April 30.

There are three possible ways to calculate your instalment obligations. You can choose any one of the three, and will not be penalized provided you correctly follow one of them.

The First Method is for your total instalments, paid in four equal payments, to

equal the **tax (and CPP) owing for the year** on your sources of income from which tax is not withheld. In other words, your instalments should equal the balance owing at the end of the year. Of course, if you are in business you might not know what your tax owing will be for the year until well after the end of the year!

The Second Method is for your quarterly instalments to equal the **tax (and CPP) owing on your previous year's** sources of income for which tax was not withheld. In other words, take the balance you had to pay last year after deducting any source withholdings, and pay that amount over the year in instalments.

The First Method requires you to estimate your current year's income. If you guess low, you can end up not paying enough instalments and be subject to interest and penalty. The Second Method lets you use the previous year's income, but on March 15, when the first instalment is due, you might not yet have calculated your previous year's total tax. For this reason, the Third Method was introduced.

Under the "no calculation" Third Method, your March and June instalments are each one-quarter of the total tax (and CPP) owing on income from which tax was not withheld for **two years ago**. Your *total* instalments for the year must still equal the total amount for one year ago, as with the Second Method. Therefore, the September and December instalments must be enough to reach this total.

The CRA will mail you a statement twice a year advising you of your quarterly instalment obligations under the "no calculation" Third Method.

EXAMPLE

David is self-employed as a consultant. His 2021 tax payable (combined federal/provincial plus CPP) was \$20,000. His 2022 tax payable was \$24,000. He expects his total 2023 tax bill will be around \$27,000.

David should pay quarterly instalments on March 15, June 15, September 15 and December 15, 2023, totalling \$24,000, his tax payable for the previous year. If he wishes, he may pay four instalments of \$6,000 each (i.e., using the Second Method).

The CRA will advise David in February 2023, however, that his March and June payments should be \$5,000 each — one-quarter of his 2021 tax payable, since his 2022 figures aren't yet known. If he makes these payments, and then pays \$7,000 on each of September 15 and December 15 (which the CRA will also advise him to do), he will have paid the required \$24,000 and will have met his instalment obligations under the Third Method.

The \$3,000 balance (assuming David's estimate of income for 2023 turns out to be correct) will then be due on April 30, 2024, although his return need not be filed until June 15, 2024.

If instalments are paid on time and in the correct amount as per any of the three Methods, no interest or penalty is payable. If instalments are not made when required or are deficient, **interest is assessed at the CRA's current "prescribed rate"** for late payments (currently 7%), compounded daily. All such interest is non-deductible.

You cannot *earn* interest by paying instalments early, but you can earn “**contra-interest**” at the same rate as applies to late payments, to offset interest that would otherwise be assessed on late instalments.

EXAMPLE

David, from the above example, does not make any instalment payments until June 15, 2023. On that day he makes a single payment of \$15,000. He then makes a \$2,000 payment on September 15, 2023 and a \$7,000 payment on December 15, 2023.

David should not owe any interest on instalments, if the prescribed interest rate stays constant through 2023 (or goes only down). His June 15 payment can be thought of as three parts: \$5,000 due in March, paid three months late; \$5,000 paid on time; and \$5,000 of the \$7,000 not due until September, paid three months early. The payment that is early will generate “contra-interest” to offset the interest that David would otherwise have to pay due to his being late with his March payment.

If the interest owing on late instalments is greater than \$1,000, you may be subject to an additional **penalty** of up to 50% of the interest.

So the bottom line is — although you can decide which Method to choose, do make sure you make your instalment payments! If you are not sure which Method to use, just follow the instructions given by the CRA, and you will be using the Third Method.

See “Around the Courts” below for an example of a couple who got this wrong.

If you are assessed interest and/or penalty on late instalments, they can be cancelled only in limited circumstances under the CRA’s “Taxpayer Relief” guidelines. Grounds for waiver include:

- a serious illness or accident that prevented you from making a payment on time
- serious emotional or mental distress, such as caused by illness or death in the immediate family
- disasters such as a flood or fire
- civil disturbances or disruptions in public services
- CRA processing delays that resulted in you not being informed, within a reasonable time, how much was owing
- incorrect information that you received from the CRA
- severe financial hardship: inability to pay the total owing due to the amount of accrued interest.

AROUND THE COURTS

Instalment penalty and interest imposed due to sale late in the year

In the recent *Gagnon* case, Mr. and Mrs. Gagnon paid quarterly income tax instalments during 2019 based on the income they expected to have that year (the First Method in the article above). They chose not to pay the higher amounts that the CRA suggested they pay under the Third Method, because they thought they knew how much tax they would owe for 2019.

Unexpectedly, on December 15, 2019, the Gagnons paid themselves a \$600,000 dividend from their holding company. This had not been planned, but due to “budget chatter” rumours they were worried that the tax rate on dividends would be increased in the upcoming federal budget.

As a result, their incomes were much higher for the year than they had expected. In late November, once they knew how much dividend would be paid, they paid more than enough additional instalments to cover their obligations for all of 2019.

The CRA assessed instalment interest, because the Gagnons' instalments paid in March, June and September were inadequate. They both appealed to the Tax Court of Canada, arguing that they could not possibly have known in March, June and September that this large dividend would come in December. They claimed the rumours of a pending increase in tax on dividend "created an unforeseen urgency, necessity and desirability to declare the dividend".

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 letter, which are appropriate to your own specific requirements.

The Tax Court judge dismissed their appeal. The Gagnons had chosen to pay instalments based on their forecast of their 2019 tax, and in doing so they took the risk of being wrong. If they had paid instalments based on their 2018 tax, or based on the amounts that the CRA suggested (combination of 2017 and 2018 amounts), no interest would have applied. But since they chose not to do so, they were out of luck.
