

Unwise RRSP Strategies

It's not tax-efficient to hold small business shares and employee stock options within an RRSP.

By **Jamie Golombek**

A self-directed RRSP can hold a variety of different investments, ranging from the more common securities such as stocks, bonds and mutual funds to more esoteric investments, including the mortgage on a home (see “Refuge in an RRSP,” December 2002, RRSP Survival Guide, page 9). However, not all investments that can be legally placed inside an RRSP make sense

from a tax perspective. The following two investments can be held inside an RRSP, but when you think about it, it is likely more tax-efficient if they are held outside a registered plan.

Shares of small business corporations

Jack is considering investing in shares of a small business corporation inside his RRSP but certain conditions must be met. First, the small business corporation must be Canadian and nearly all of its assets must be used in an active business in Canada. Second, Jack cannot own (together with related persons and his or her RRSP) 10% or more of any class of shares of the corporation. However, if Jack deals at arm's length with the corporation and the total cost of all shares of the corporation Jack (and related persons) owns is under \$25,000, then the 10% limitation can be ignored.

So if Jack's investment meets these criteria, is the RRSP the best place to hold small business corporation shares? Because of the high

risk associated with investing in small business corporations, Jack would expect to earn higher than average returns, which, on the surface, may make small business corporation shares appear to be an ideal investment for a long-term retirement savings program. However, Jack should keep in mind that there is a lack of liquidity associated with small business corporation shares, which must be taken into account, especially as he approaches retirement and the RRSP matures.

Jack may be better off holding small business corporation shares outside an RRSP. The main reason is that any gain upon sale of small business corporation shares would be taxed as a capital gain where only 50% is included in income. More important, outside an RRSP, the capital gain on the sale of the small business corporation shares may be eligible for the \$500,000 capital gains exemption on qualifying small business corporation shares making the entire gain tax-free. If this gain is realized within an RRSP, the entire amount will be subject to tax at full marginal rates when withdrawn.

Finally, consider the possibility of loss. If Jack's small business corporation shares become worthless, outside the RRSP he would generally be able to claim a capital loss on the shares, which would be available to offset capital gains either in the current year, carried back three years or carried forward indefinitely. Furthermore, if the capital loss qualifies as an "allowable business investment loss," it (i.e., the allowable portion of 50%) could be deducted against all sources of income and not merely against capital gains.

Employee stock options

Employee stock options, which provide employees with the right to acquire shares in their employer for the exercise price, can be another investment alternative for an RRSP. Employee stock options are qualified investments for an RRSP provided the underlying shares that may be acquired are also qualified investments. Options on publicly traded shares will generally qualify as will options on private company shares, assuming the conditions discussed above are met.

Donna has been granted options from her employer to purchase 1,000 shares for \$15 per share—their fair market value on the day the options were given to her. If Donna transfers employee stock options to her RRSP and does not exercise them, there are no immediate tax consequences. This is consistent with the general tax treatment of options whereby tax is only paid either when the options are exercised or on private and certain public company options that qualify for the special \$100,000 deferral rule, when the underlying shares acquired upon option are sold. As Donna has limited funds to make her annual RRSP contribution this year, she decides to contribute the options to her RRSP on January 15, 2003, when the shares are trading at \$25.

Donna will be entitled to claim an RRSP deduction equal to the fair market value of the option, calculated as the difference between the fair market value of the share on the day the option is contributed to the RRSP and the exercise price. The value of her options being contributed, which constitutes the amount of her RRSP contribution receipt, is \$10,000— $[1,000 \times (\$25 - \$15)]$. She can claim this amount on her 2002 or 2003 tax return, provided she has the contribution room.

When the RRSP exercises the option, Donna must then include in her income an employment benefit equal to the difference between the fair market value of the shares on the day the options are exercised and the exercise price. In July 2003, the shares have increased in value to \$30 and Donna decides to have her RRSP exercise the options. Assuming the options qualify (most options generally do since they are not issued "in the money"), the employee can claim a 50% deduction on his or her tax return, the net effect being that the employment benefit is taxed at the same rate as a capital gain.

Upon exercise, she will report a stock option employment benefit of \$15,000— $[1,000 \times (\$30 - \$15)]$, which would only be taxable at 50% or \$7,500 because these were qualifying options. Under the tax rules, since the RRSP now owns the shares, this benefit must be reported in the year the options are exercised and cannot be deferred until



Outside an RRSP, the capital gain on the sale of the small business corporation shares may be eligible for the \$500,000 capital gains exemption.



the year the shares are sold. This is where the first problem arises since the tax is due immediately, and the employee must come up with the funds from another source to pay for this tax liability.

The second problem with this strategy is much more serious and occurs later on. When Donna retires and withdraws from her RRSP the proceeds from the ultimate sale of the shares (assuming they were still worth \$30,000), she has to include the entire amount in her income again, resulting in double taxation on the portion of the withdrawal that has already been taxed as an employment benefit.

The CCRA is aware of this issue. In fact, there is a section of the Income Tax Act intended to provide relief when an amount from a particular source is included in income more than once. However, according to the CCRA, since the stock option benefit is included as employment income and the RRSP withdrawal is from a source other than employment income, "there is no double taxation of the same source of income." In other words, the safety rule above doesn't apply and the individual is indeed taxed twice.

From a planning point of view, it is much better for an employee to exercise his or her options (assuming he or she has the cash or the borrowing capability to fund the exercise of the options) before contributing them "in kind" to his or her RRSP. By doing so, the employee can get an RRSP receipt for the fair market value of the shares contributed and there will be no double taxation when the shares are ultimately sold by the RRSP and the proceeds are paid out upon retirement.

Finally, note that if the share price declines dramatically such that the options are never ultimately exercised by the RRSP and simply expire, there will never be an employment benefit income inclusion. In this situation, the employee would have been able to claim the RRSP deduction without any outlay of cash and no corresponding tax liability.

Jamie Golombek, CA, CPA, CFP, TEP, is vice-president, tax & estate planning, for AIM Funds Management Inc.

RRSP DEADLINE EXTENDED!

The RRSP deadline is typically the 60th day in the year. Since in 2003 the 60th day falls on a Saturday, the 2002 deadline has been extended to Monday, March 3, 2003.

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