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### TAX LETTER

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#### PRINCIPAL RESIDENCE EXEMPTION MOVING EXPENSES CARRY-BACK OF ESTATE LOSSES NON-ARM'S LENGTH TRANSFERS TAX-FREE ROLLOVERS BETWEEN SPOUSES NON-RESIDENT TRUSTS AROUND THE COURTS

#### PRINCIPAL RESIDENCE EXEMPTION

Many readers are likely aware that the principal residence exemption means that most people do not pay tax on gains realized when they sell their homes.

Generally speaking, you will not have to pay any tax on your gain if the home was your principal residence for all years of ownership, or all years but one. In particular, there is a formula that provides that the portion of the gain from the home that is exempt from taxation equals:

$$\text{Gain} \times \frac{(1 + \# \text{ years it was your principal residence and you were resident in Canada})}{(\# \text{ years you owned it jointly or otherwise})}$$

Thus, for example, if the home was your principal residence during 9 calendar years out of the 11 years that you owned it, then 10/11ths of your gain would be exempt from tax. The other 1/11<sup>th</sup> of your gain would be a capital gain, one-half of which would be included in your income as a taxable capital gain.

One of the limitations of the exemption is that you and your family (your spouse or common-law partner and unmarried minor children) can designate only one home per year as a principal residence (for years after 1981). Therefore, if you own both a home and a cottage, you cannot each designate one property as your principal residence in a given year. You can only designate one per year.

In this regard, any home that you or your spouse or child “ordinarily inhabits” in a year can be designated as your principal residence for the year. The threshold is relatively low. For example, if you inhabit your cottage for 2 or 3 weeks during a year, you can meet the “ordinarily inhabits” threshold so that you could designate the cottage as your principal residence for that year.

Furthermore, the home does not have to be in Canada. A home, condominium, cottage etc. outside of Canada can qualify as your principal residence in a year, as long as you ordinarily inhabit the property in the year.

The designation of the property as your principal residence is made in a prescribed form with your tax return for the year in which you sell it (Form T2091). However, if the entire gain is exempt under the principal residence exemption, you do not have to file the designation form.

### **Exceptions to “ordinarily inhabit” rule**

If you inhabit your home but subsequently move out and rent it out to a third party, you can make an election that allows you to designate the home as your principal residence for up to 4 years while you are not ordinarily inhabiting the home. However, you can still only designate one home per year as a principal residence.

Furthermore, if you moved out of your home as a consequence of the relocation of your employment or your spouse’s employment, you can designate the home as your principal residence for more than 4 years, if you move back into the home during your (or your spouse’s) employment or by the

end of the taxation year following the year in which the employment is terminated.

Conversely, if you own a rental property and subsequently move into the home and ordinarily inhabit it, you can make an election that allows you to designate the home for up to 4 years of the prior rental period as your principal residence. However, you cannot make this election if you previously claimed capital cost allowance (tax depreciation) in respect of the property.

### **MOVING EXPENSES**

If you move to a new home to enable you to carry on business or employment, you can deduct certain moving expenses if the home is at least 40 kilometres closer to the work location than your former home is (to the new work location). The deduction of the expenses is limited to your income from the business or employment in the new work location in the year of the move. Any excess expenses can be carried forward and deducted in the next year, but still only from that source of income.

The deductible moving expenses include:

- travel costs, such as gas costs and the cost of meals and hotels, in the course of moving you and your family to the new home;
- the cost of transporting (e.g. moving vans) or storing your household effects in the course of the move;
- the cost of meals and lodging near your former home or your new home for a period not exceeding 15 days – say, if you have moved out of the former home and the new home is not yet ready to be inhabited;
- if you rented your former home, any lease cancellation cost you incurred;

- if you owned your former home, your selling costs of that home (e.g. commissions, legal costs);
- if you sold your former home and purchased your new home, your legal costs incurred in respect of the purchase and of any tax (except GST or HST) imposed on the transfer or registration of title to the new home (e.g. land transfer tax); and
- if you and your family members have moved out of the former home and you are trying to sell it (making “reasonable efforts” to sell), any mortgage interest, property taxes, insurance premiums and the cost of heating and utilities in respect of the former home, to a maximum of \$5,000.

However, as noted in our February 2012 letter, the CRA allows a “simplified method” for claiming vehicle and meal expenses incurred in the move. This method allows you to claim a flat rate, instead of the actual vehicle and meal expenses. For moves that occurred in 2011, the flat rate for meals was \$17 per meal per person, to a maximum of \$51 per day (3 meals a day). The flat rate for vehicle costs is based on the number of kilometres driven in the course of the move, and depends on the province from which the travel originated. The flat rates for moves made in 2012 will be announced early in 2013.

If your employer reimburses you for your moving expenses, you will normally not be required to include a taxable benefit.

If your employer reimburses only *part* of your moving expenses, you can deduct the remaining eligible moving expenses.

## **CARRY-BACK OF ESTATE LOSSES**

### **Capital losses**

A deceased person’s estate is considered a trust and a separate taxpayer for income tax purposes. As such, it can realize income or capital gains or incur losses.

If the estate has capital losses in excess of capital gains in its first taxation year, the executor or administrator of the estate can elect that any part of the excess losses be carried back and reported in the deceased’s final taxation year (“terminal year”). One-half of the excess would be considered an allowable capital loss for the deceased, and could be used to offset taxable capital gains and other forms of taxable income in the terminal year.

The carry-back can be beneficial to offset any deemed taxable capital gains arising as a result of the death. That is, when you die, you are deemed to have disposed of most of your capital properties at their fair market value, which will normally trigger capital gains in your terminal year.

The carried-back loss can be used in the terminal year. It cannot be carried back further to a previous taxation year of the deceased, and also it must be filed by the estate’s first taxation year filing deadline.

### **Private company shares**

The carry-back mechanism can be employed in some cases where private company shares are held by the deceased and left to the estate, to prevent double taxation on the shares.

As noted, the shares will be deemed to have been disposed of at fair market value. The estate will be deemed to acquire the shares at a cost equal to this fair market value.

If the corporation is required to redeem some or all of the shares by distributing cash or other property to the estate, the estate will normally receive a deemed dividend. The estate will also realize an accompanying capital loss, owing to the stepped-up cost base of the shares upon the death of the deceased (because, for tax purposes, the deemed dividend reduces the value received for the shares on redemption). The capital loss can be carried back to offset the deceased's capital gain on the shares. In effect, the deceased's capital gain is replaced by a dividend to the estate.

The attractiveness of this option depends on whether the total of the estate's tax on the dividend and the corporation's tax on the distribution of property, if any, (after adjusting for certain tax accounts of the corporation) is less than the tax that would be paid by the deceased on the capital gain.

If the corporation had life insurance on the deceased and paid out the proceeds to the estate upon the redemption of the shares, the deemed dividend to the estate will be tax-free. However, in such case only half of the resulting capital loss on the redemption of the shares can be carried back to the deceased's terminal year.

### **Terminal loss**

If the estate disposes of depreciable property in its first taxation year and incurs a terminal loss, part or all of the loss can be carried back and claimed in the deceased's terminal year. The amount carried back cannot exceed the estate's non-capital loss for the year (generally meaning its ordinary losses, including the terminal loss, in excess of its ordinary income).

The amount carried back can be used to reduce the deceased's income in the terminal year, but not earlier taxation years.

A terminal loss occurs when the depreciable property is sold for proceeds less than the "undepreciated capital cost" of the property (generally, the part of the cost that had not been depreciated for tax purposes). There must be no properties remaining in that class of depreciable property.

### **NON-ARM'S LENGTH TRANSFERS**

There are special rules in the Income Tax Act that apply to transfers of property between non-arm's length persons. An exception is made for transfers to spouses, as noted in the next article below.

If you transfer property to a non-arm's length person ("transferee") for proceeds that are less than the property's fair market value (FMV), your proceeds will be bumped up to the FMV. However, the transferee's cost of the property will not be bumped up. In other words, it is a one-sided adjustment, which can lead to double taxation.

#### **EXAMPLE**

You sell a property to your child for \$1,000. Your cost of the property was \$1,000 but the fair market value of the property is \$1,800.

You will be deemed to have disposed of the property for \$1,800. Therefore, you will report an \$800 capital gain (one-half of which is taxed). However, your child's cost of the property will remain \$1,000. Therefore, for example, if your child sells the property to a third party for \$1,800, your child will also report an \$800 capital gain, resulting in double taxation.

A corollary rule provides that if you acquire a property from a non-arm's length person ("transferor") at price greater than its fair market value, your cost of the property will be ground down to the FMV. However, the transferor's proceeds will not be ground down and will remain the actual price you paid.

For these purposes, non-arm's length persons include most related persons, such as you and your parents, grandparents, children, grandchildren, siblings, siblings-in-law and parents-in-law. They do not include cousins, nieces and nephews, although in any given situation, two people can also be found to be not dealing at arm's length as a question of fact.

A separate rule applies to gifts of property. This rule applies to both arm's length and non-arm's length transfers. It provides that a person making a gift of property is deemed to receive FMV proceeds for the property. The person acquiring the gift is deemed to acquire the property at a cost equal to that FMV. Thus, although the person making the gift may realize a capital gain, there will be no double tax as in the above example.

The deemed disposition at fair market value, where it occurs, could lead to a capital loss. If the transfer or gift is made to an individual other than your spouse or common-law partner, the superficial loss rules in the Act will not apply to deny the loss.

### **TAX-FREE ROLLOVERS BETWEEN SPOUSES**

As noted, the deemed disposition rules discussed above do not normally apply to transfers between spouses (or common-law

partners). Instead, there is an automatic tax-free "rollover".

A transfer or gift of a capital property to your spouse is deemed to take place at your tax cost of the property. Therefore, there will be no gain or loss on the transfer. Your spouse will take over the property at your tax cost. These rules apply regardless of the amount of consideration paid by your spouse for the property, if any.

A similar rule applies where you leave property to your spouse upon death. There is a deemed disposition of the property at its tax cost.

As noted in our May 2012 letter, a similar rollover applies to transfers to certain qualifying spousal trusts.

### **Election out of the rollover**

You may elect out of the rollover, in which case the rules discussed above apply (see "Non-arm's length transfers"). For example, if you elect out of the rollover, you are deemed to have disposed of the property at fair market value and your spouse will be deemed to have acquire the property at a cost equal to the same FMV. This may be beneficial if you have losses that can offset your gain on the gift, because the gift will generate a bumped-up cost for your spouse. A gift of "qualified small business corporation shares" may also be beneficial, since you can shelter any gain with your capital gains exemption (up to your lifetime limit of \$750,000).

Unfortunately, if the transfer leads to a capital loss, the loss will normally be denied under the superficial-loss rules, assuming your spouse continues to own the property at the end of the 30-day period after the

transfer. However, the amount of the denied loss would be added back to the cost of the property.

## **NON-RESIDENT TRUSTS**

Canadian residents are taxed on their worldwide income. Non-residents are taxed in Canada only in respect of Canadian-sourced income. As such, it could be beneficial to set up an offshore trust to earn foreign investment income in order to avoid Canadian taxation. (The trust would have to be actually managed and controlled outside Canada; if the trustee simply follows the directions of someone in Canada, it will be considered resident in Canada.)

Unfortunately, tax planning is not so easy. There are rules in the Income Tax Act that may deem the trust to be resident in Canada for most purposes and therefore subject to tax on its worldwide income. Furthermore, the current rules in the Act will be tightened up with pending draft legislation, which is expected to be effective retroactive to 2007.

The non-resident trust rules are very complex. However, in general terms, a non-resident trust will be subject to the rules if a person resident in Canada contributed to the trust. An exception generally applies if the contributor has been resident in Canada for less than 60 months.

The rules can also apply if there is a Canadian resident beneficiary of the trust and a “connected contributor” to the trust. A connected contributor can include any contributor to the trust, although an exception is normally made if the contributor has never been resident in Canada or is not resident at the time of contribution or within 60 months after the contribution. As above, an exception also generally applies if the

contributor has not been resident in Canada for 60 months or more.

Amendments to the rules announced in August 2010 will effectively split the trust’s property into a “resident portion” and a “non-resident” portion. Generally, the resident portion will include property contributed by resident contributors and connected contributors, while the non-resident portion will include other property. World-wide income of the trust from the resident portion will be subject to tax in Canada, while only Canadian-source income from the non-resident portion will be subject to tax in Canada.

Lastly, in many cases the contributor and resident beneficiaries of the non-resident trust will be jointly and severally liable, along with the trust, to pay the trusts’ Canadian income tax.

If you are considering setting up an offshore trust, you should proceed with great caution and adequate professional advice.

## **AROUND THE COURTS**

### **Deduction allowed for stock issued to employees**

If an employer corporation issues its stock to its employees under an employee stock option plan or otherwise, the employer cannot normally take a deduction for the amount of the issued stock. In particular, the Income Tax Act disallows the deduction where the employer corporation “has agreed to sell or issue securities” to its employees.

In the recent *TransAlta Corporation* case, TransAlta issued stock to its employees and some employees of its subsidiary as part of paying the bonuses to the employees for

services rendered. TransAlta deducted the fair market value of the issued stock as an expense for income tax purposes. The CRA denied the deduction, based on the above-noted provision.

TransAlta appealed, and the Tax Court of Canada allowed the deduction. The Court found that the issuance of the stock as part of the bonuses was a discretionary move by the corporation, and not one dictated by a binding “agreement” with the employees. As such, it could not be said that the corporation “agreed” to sell or issue securities as per the above provision. Therefore, the deduction was allowed.

### **Moving expenses allowed even though same work location**

As discussed above under “Moving Expenses”, if you move to carry on business or employment, you can deduct certain moving expenses if your new home is at least 40 kilometres closer to the work or business location than was your old home. In the recent *Wunderlich* case, the taxpayer was allowed to deduct moving expenses incurred in a move to a new home after he received a promotion at his work, even though he continued to work at the same work location.

The employer was located in Burlington, Ontario. The taxpayer began work with the employer in 2004 when he lived in Toronto. In 2007, after receiving a promotion, he decided to move to Oakville so as to be closer to the employer with his new responsibilities (50 kilometres closer). The CRA denied the deduction of his moving expenses on the grounds that there was no “new” work location.

On appeal, the Tax Court of Canada allowed the deduction. The Court looked at the wording of the relevant provision, which allows a deduction where the person’s move to a new home “enables the taxpayer to carry on a business or to be employed at a location”. The Court ruled that this wording did not require that there be a new (different) work location from that in which the employee worked before the move. The Court also cited previous cases that allowed a deduction where employees moved in order to be closer to their work, even though the move took place several years after they commenced to work at the location. On both grounds, the Court concluded that the taxpayer’s moving costs should be allowed.

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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.