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TAX UPDATE

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Proposed Changes for Claiming the Principal Residence Exemption

On October 3, 2016, the government announced legislative proposals related to the principal residence exemption. Generally, if a property qualifies as the taxpayer's principal residence, the taxpayer can use the exemption to reduce or eliminate any capital gain otherwise occurring for income tax purposes. The proposed legislative changes will limit the principal residence exemption amount when the taxpayer is a non-resident.

The principal residence exemption allows only one property to be designated as a principal residence in any given tax year. However, the rules recognize that a taxpayer can have two houses in the same year, including where one house is sold and another is acquired in the same year. The tax rules contain a rule that provides relief in this case. The one plus ("one plus rule") in the formula to calculate the principal residence exemption allows taxpayers one extra year of exemption room.

Under the proposed legislation, for dispositions that occur after October 2, 2016, for a taxpayer to be eligible for the one plus rule, the taxpayer must be resident in Canada during the year of acquisition of the property that is the principal residence of the taxpayer. Therefore, if a taxpayer is a non-resident throughout a taxation year in which the property was acquired, the taxpayer will not be eligible for the extra year in calculating the principal residence exemption amount.

Information credit: Canada Revenue Agency

More information follows in this Tax Update.

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CHANGES TO PRINCIPAL RESIDENCE RULES FOR NON-RESIDENTS

On October 3, 2016, the Department of Finance released draft legislation that proposes to amend the principal residence exemption. Most of the amendments relate to non-residents owning or acquiring homes in Canada, and to trusts claiming the exemption.

The amendments come on the heels of various media reports that indicated that some non-residents were avoiding paying capital gains tax on Canadian homes in an inappropriate manner. There was speculation that this non-resident activity partially fueled the heated real estate market in some areas such as Vancouver. (Readers may also be aware of the 15% purchase tax recently introduced for certain non-residents purchasing homes in Metro Vancouver, which is a separate tax issue from that described here.)

The "one-plus" rule

Under the principal residence exemption, the tax-exempt portion of the gain on the sale of a home is determined by multiplying the gain by the following fraction:

1 + B / C
where
B = the number of years the home is your principal residence and you are resident in Canada; and
C = number of years of ownership

Therefore, if you sell a home that was your principal residence for all years of ownership or all years but one, the entire gain is exempt. Since you can designate only one home as your principal residence for any one year, the "one-plus" rule is required if you sell a home and acquire another home in the same year. That is, only one of those homes can be your principal residence for that year, so the one-plus ensures that exemption is not lost on the other home.

The Department of Finance indicated that the one-plus rule was not intended to apply to non-residents. As a result, for dispositions occurring after October 2, 2016, the one-plus rule will apply only if the person is resident in Canada in the year in which the person acquires the property.

Trusts owing property

A Canadian resident personal trust that owns a property can qualify for the principal residence exemption when it sells the property. Generally speaking, under the current rules, a home owned by the trust can qualify as a principal residence for a particular year if a beneficiary of the trust, or a spouse or child of that beneficiary, ordinarily inhabited the home during the year. Although the trust must be resident in Canada, the beneficiary, spouse or child is not required to be resident in Canada.

Under the draft legislation, the type of trust that can qualify for the principal residence exemption will be restricted. In general terms, only the following

types of trusts will be able to designate a home as a principal residence:

- Certain spousal or common-law partner trusts, joint spousal or common-law partner trusts, and alter ego trusts. These trusts provide that the relevant beneficiary must be entitled to all of the income of the trust and that no one else may use the capital of the trust during their lifetime;

- A qualified disability trust. This type of trust must have a beneficiary who is eligible for the disability credit, among other conditions; and

- A trust where the beneficiary is under the age of 18, whose parents are both deceased, and one of the parents was a settlor of the trust. (This is sometimes called an "orphan trust".)

In each case, the relevant beneficiary must be resident in Canada in the year in which the trust designates the home as its principal residence. (There are more specific requirements that must be met.)

The new trust rules apply for taxation years beginning after 2016.

A transitional rule applies if a home owned by a trust qualified for the principal-residence exemption before 2017 under the current rules but does not qualify for exemption under the new rules. Basically, on a later sale of the property, the gain is separated into two components – one reflecting the gain accrued to the end of 2016 (which may be exempt under the current rules), and the second portion reflecting the gain that accrued after 2016.

NEW REPORTING RULE FOR PRINCIPAL RESIDENCE

Related to the changes discussed in the preceding section, the Canada Revenue Agency (CRA) is changing its administrative policy with respect to the designation of a principal residence. The changes apply to all taxpayers, including those who have always been resident in Canada.

Under the Income Tax Act, you are technically required to file Form T2091 to designate your home as a principal residence for any particular year. The form must be filed with your tax return for the year you sell the home. On the form, you designate which years the home was your principal residence.

Despite this rule, until now, the CRA did not require you to file the form if the entire gain from your home was exempt under the principal residence exemption. Because of the policy, most Canadians selling their homes did not file the form, and did not report the gain.

Beginning with the 2016 taxation year, if you sell your home, you will be required to report the sale and report the gain (or loss), along with the principal residence designation, on Schedule 3 of your income tax return. This reporting is required even if the entire gain is exempt from tax under the principal residence exemption. If the entire gain is not exempt, you must also file the form T2091.

If you do not report a sale of real property (whether or not it is your residence) and any portion of the gain is taxable, the CRA will be able to reassess you to impose that tax indefinitely, rather than only for 3 years after your Notice of Assessment, as is normally

the case. (If you discover the error and report it later, the CRA will have 3 years from when you do report it.)

The CRA specifically states that for the sale of a principal residence in 2016 or later, it will allow the principal residence exemption only if you report the sale and designation of principal residence in your income tax return. If you do not make the principal residence designation in the year of the sale of your home, you can later request that the CRA amend your income tax return for that year to accept a late designation. Under the proposed amendments released on October 3, 2016, the CRA will be allowed (not required) to accept a late designation in certain circumstances, but even if it does accept it, a penalty will normally apply. The penalty is the lesser of the following amounts:

1. $8,000; or
2. $100 for each complete month from the original filing due date to the date your request was made in a form satisfactory to the CRA.

Because of this significant change, the CRA states that it will focus on communicating to taxpayers the requirement to report the sale and designation of a principal residence in the income tax return. Accordingly, for dispositions during this communication period, including those that occur in the 2016 taxation year, "the penalty for late-filing a principal residence designation will only be assessed in the most excessive cases".

INCOME ATTRIBUTION RULES

The income attribution rules prevent many forms of income splitting among family members. But for the rules, a high-income spouse could easily shift investment income to a low-income spouse or low-income minor child and save tax (since lower tax rates apply to lower levels of income).

For transfers between spouses (or common-law partners), the basic rule provides that where you lend or transfer property to your spouse, any subsequent income from the property will be attributed to you and included in your income (rather than in your spouse's income). Similarly, any taxable capital gains from the property will be attributed to you. (Conversely, if there is a loss from the property or capital loss, that loss will also be attributed back to you.)

For minor children, the basic rule provides that where you lend or transfer property to a non-arm's length child (including a niece or nephew) under the age of 18, any subsequent income from the property will be attributed to you. Attribution stops as of the year the child turns 18. The attribution rule does not apply to capital gains, so you can legitimately split capital gains with your minor children or grandchildren.

The attribution rules can apply even if the property lent or transferred is replaced with another property (under the "substituted property" rules). For example, if you give your spouse some stocks and she sells them and uses the proceeds to purchase bonds, the interest on the bonds will continue to be attributed to you. The substituted-property rules can go on indefinitely, so that attribution will continue even if your spouse continues to sell the property or properties and use the proceeds to buy replacement properties.

Exceptions

Fortunately, there are various exceptions, where attribution does not apply. These are some of the significant exceptions:

- Attribution does not apply to gifts or transfers of property to adult children. So you can easily income split with your children who are 18 or older. (There is an anti-avoidance rule that can apply to loans to non-arm's length adults, if it can be shown that one of the main reasons for the loan is to lower your tax. But it does not apply to transfers other than loans.)

- Attribution does not apply to business income. Therefore, you can give cash or other property to your spouse or minor child and they can use it to earn business income that will not be attributed to you.

- Attribution does not apply if you lend money at the prescribed rate of interest (under the Income Tax Act) that applies at the time of the loan. Currently, the rate is 1%. Thus, for example, you could lend money to your spouse at 1% interest, and if she invested it and earned a 6% return, there would be no attribution. But you would include the 1% interest in your income, and she would deduct that 1% interest expense. Effectively, 5% of the 6% return would be taxed to her and 1% to you. Interestingly, the loan can be of any duration. For example, the exception could apply for 20 years if it was a 20-year loan. Note, however, that this exception applies only if your spouse (or child) actually pays you the interest during each year of the loan or by January 30 of the following year. If your spouse or child is late with even one interest payment, this exception no longer applies to that loan.

- The attribution rules do not apply if you sell the property to your spouse or child for an amount that is equal to or greater than the fair market value for the property. Similar to the loan exception described above, if the consideration given to you is indebtedness, you must charge at least the prescribed rate of interest in effect at the time of the sale. Your spouse or child must pay you the interest during each year or by January 30 of the following year. In the case of a sale to your spouse, this exception applies only if you elect out of the tax-free spousal "rollover" that otherwise applies automatically to transfers between spouses. This means that the transfer of the property will normally take place at fair market value, which could generate a capital gain for you if the value exceeds your cost of the property.

- Attribution does not apply to re-invested (secondary) income. So if your spouse or child re-invests income from the money or property that you lent or transferred, the income earned on that reinvestment will not be subject to attribution.

- The attribution rules in respect of your spouse do not apply after a divorce. The income from property attribution also ceases on separation, although the capital gains attribution ceases upon separation only if you and your separated spouse make a joint election.

- The attribution rules do not apply if you pay your spouse's personal expenses, including your spouse's income tax. But by doing so, your spouse may be able to use her own funds to purchase investments, and the income from those investments will not be attributed to you.

• If your spouse has a tax-free savings account (TFSA), you can give your spouse cash to put into that TFSA and there will be no attribution on any subsequent income earned in the TFSA (simply because the income is not subject to tax while in the plan or upon withdrawal).

• If you contribute to your spouse's registered retirement savings plan (RRSP), there is no attribution if the funds and income are withdrawn by your spouse, generally as long as no withdrawal takes place in the year during which you made the contribution or the two subsequent years.

KIDDIE TAX ON MINORS

The so-called kiddie tax is not an income attribution rule because it applies to a minor child rather than attributing income back to a parent of the child. However, since it applies at the highest marginal rate of tax, it is just as detrimental as (or worse than) the attribution rules.

The kiddie tax applies to the "split income" of a child under the age of 18. Split income includes shareholder benefits and dividends received from shares of private corporations. It does not include dividends from public corporations or mutual funds.

It also includes income of the child from a trust or partnership that is derived from services or property provided to a business in which a parent is involved (more specific conditions apply). It can also apply to income from a trust or partnership where the trust or partnership provides services to a third party and the parent is actively involved in the provision of the services.

Split income also includes a minor child's gain on the sale of shares of a private corporation to a non-arm's length person. The gain is deemed not to be a capital gain, but rather a dividend that is included in split income. The gain therefore cannot qualify for the capital gains exemption, which otherwise exempts from tax the gains on the sale of shares in certain small business corporations.

The tax on split income does not apply as of the year in which the child turns 18. Additionally, it does not apply to income or gains from property inherited from the child's parent, or from anyone else if the child is enrolled full-time in post-secondary education or is disabled.

In many cases, the parent of the minor child will be jointly and severally liable to pay the tax on split income. This means the CRA can proceed to collect the tax from the parent along with the minor child or instead of the minor child.

NEW RULES FOR "LINKED NOTES"

The March 2016 Federal Budget proposed new rules that deal with the taxation of "linked notes". In general terms, a linked note is a debt obligation, often issued by a corporation, which pays "interest" that is linked to a reference point such as the value of a stock market index, commodity index, or some other index or property. The interest on the note is typically paid on maturity rather than on an annual basis.

For example, a three-year note could repay the principal and pay the accrued interest on maturity,

with the interest being computed with reference to the increase in the value of a stock index over the three-year period.

There are interest accrual rules under the Income Tax Act that apply to debt instruments that do not pay interest annually. However, when applied to linked notes, the rules are difficult to apply because the accrued interest is not known at the end of each year that the note remains outstanding. As a result, some taxpayers who sell linked notes before their maturity at a gain take the position that the accrued gain is a capital gain rather than interest income. That position is significant, since only one-half of capital gains are included in income, while interest income is fully included in income.

In basic terms, the new rules will provide that the pre-transfer accrued gain on a transfer of a linked note will be deemed to be interest and not a capital gain.

The new rules are now scheduled to take effect for dispositions of linked notes after 2016. (This was originally announced as starting October 2016, but was extended 3 months by a Department of Finance news release on September 16, 2016.)

PRESCRIBED INTEREST RATES

The CRA recently announced the new prescribed interest rates that apply to amounts owed to the CRA and to amounts the CRA owes to individuals and corporations. The amounts are subject to change every calendar quarter.

The following rates are in effect from October 1, 2016 to December 31, 2016, and remain unchanged from the last several quarters.

- The interest rate charged on overdue taxes, Canada Pension Plan contributions, and Employment Insurance premiums is 5%, compounded daily.

- The interest rate paid on late refunds paid by the CRA to corporations is 1%, compounded daily.

- The interest rate paid on late refunds paid by the CRA to other taxpayers is 3%, compounded daily.

- The interest rate used to calculate taxable benefits for employees and shareholders from interest-free and low-interest loans is 1%.

AROUND THE COURTS

Employee pharmacist could not deduct legal fees to preserve employment

Under the Income Tax Act, an employee can deduct legal fees that are incurred to collect, or to establish a right to, an amount that would otherwise be included in the employee's income from employment. For example, if you take legal action against your employer or former employer for wages that are owed to you, the legal fees are deductible.

In the recent Ross case, the taxpayer was employed as a pharmacist for several years at various pharmacies. In one year, she was disciplined for misconduct by the provincial College of Pharmacists, and her license as a pharmacist was suspended for six months. She incurred legal fees in defending herself against the misconduct charges.

The taxpayer argued that she should be able to deduct the legal fees, since they were necessary for her to establish her right to continue to be employed as a pharmacist and earn employment income. The CRA denied the deduction.

On appeal to the Tax Court of Canada, the Court upheld the CRA decision. The Judge held that the legal fees were not incurred by the taxpayer to collect or establish a right to salary or wages, but rather to allow her to preserve a future right to work as a pharmacist. These two reasons were different; under the former, the legal fees would be deductible, whereas under the latter reason the legal fees were not deductible because the deduction did not fall into the specific wording of the Income Tax Act.

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.

& Davidson Company
CHARTERED PROFESSIONAL ACCOUNTANTS

1200 - 609 Granville Street,
PO Box 10372, Pacific Centre
Vancouver, B.C. Canada V7Y 1G6

Tel: (604) 687-0947

Davidson-Co.com