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Tax-Efficient Gifting to Canadians by Non-Residents: Some Issues and Considerations

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Tax-Efficient Gifting to Canadians by Non-Residents: Some Issues and Considerations

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Introduction

When gifting property to Canadian residents, non-residents of Canada should be aware that their generosity could come with a tax bill. While no Canadian jurisdiction currently imposes a "gift tax" *per se*, gifting property can trigger a number of taxes payable by both the donor and the recipient. Taxes on income and estate administration (commonly referred to as "probate fees") are among the most relevant for donors to take into consideration. This article will examine some of the more common tax issues relating to gifts by non-residents to Canadian residents, with particular emphasis on gifts of real estate in Ontario. We also touch on gifts and trusts for disabled Canadians.

Canadian Tax Affecting Gifts: Income Tax

The federal *Income Tax Act*[1] (hereinafter, the **"ITA"**) imposes tax on the worldwide income of Canadian residents and on the Canadian-source income of non-residents. Depending on the context in which a gift is made, income tax liability can be imposed on both the donor and recipient of a gift. For example, non-residents donors may face capital gains tax on their disposition of "taxable Canadian property" (which will be discussed in more detail below). Moreover, a non-resident benefactor may see the value of their gift eroded by income tax directly or indirectly imposed on the gift's recipient.

"Residency" for Canadian Income Tax Purposes

Residency under the ITA – "Ordinarily Resident"

To ascertain the tax consequences of his or her gift made to a Canadian resident, an individual must determine whether he or she is, in fact, resident in Canada. The charging provisions for the

[1] RSC 1985, c 1 (5th Supp)

imposition of income tax on persons who are not resident in Canada is found in subsections 2(3) and 115(1) of the ITA. These provisions stipulate that non-resident individuals are only required to pay income tax on income from i) employment in Canada, ii) a business the individual carried on in Canada; and iii) gains on the dispositions of "taxable Canadian property."

Unless explicitly provided otherwise by statute, the term "non-resident" is defined by negation. A person is a non-resident if he or she is not a resident. Therefore, the alleged "non-resident" must confirm that he or she does not fall within the definition of someone who is "resident in Canada." Subsection 250(3) of the ITA provides that, "a reference to a person resident in Canada includes a person who was at the relevant time ordinarily resident in Canada." As a starting point, it must be determined whether the individual will be "ordinarily resident" in Canada at the time of the proposed gift. The mere fact that an individual spends the majority of his or her time outside of Canada does not mean that she or she is not ordinarily resident in Canada. While the term "ordinarily resident in Canada" as it is used in subsection 250(3) has been the subject of a long line of jurisprudence, one of the most oft-cited explanation of the term is that a taxpayer is ordinarily resident "in the place where in the settled routine of his life he regularly, normally or customarily lives."[2]

Taxpayers who frequently or regularly visit Canada could be considered ordinarily resident in Canada if they have significant personal and economic ties there. Taxpayers who have left Canada may be considered to be ordinarily resident in Canada until they obtain confirmation that they have severed their residential ties with Canada. According to various case law and the interpretation thereof by the Canada Revenue Agency (**"CRA"**), residential ties are sorted into two categories: primary residential ties and secondary residential ties. Primary residential ties include having a spouse or minor children in Canada and owning residential real estate in Canada. Secondary residential ties include holding a Canadian driver's license, provincial health insurance, and memberships to various professional and social organizations.

When a Canadian resident individual severs all of his or her primary ties with Canada and substantially all of his or her secondary residential ties with Canada, he or she ceases to be a Canadian resident as a matter of fact. At this point, the individual is deemed to have disposed of

[2] *Thomson v. Minister of National Revenue*, [1946] SCR 209, 2 DTC 812 at page 231

almost all of his capital property for proceeds equal to fair market value for the purposes of the ITA. This deemed disposition ensures that Canada can effectively tax the portion of any capital gain that has accrued. Certain property, such as “taxable Canadian property,” is not deemed to have been disposed of on emigration since any future gain in the now non-resident’s hands continues to be taxable in Canada.

Residency under the ITA – “Deemed Resident”

Under certain conditions, an individual who is not “ordinarily resident” in Canada and therefore would otherwise not be resident in Canada can be deemed to be resident in Canada for the purposes of the ITA. One of the more notable of these conditions is the “183 day” rule. Under paragraph 250(1)(a) of the ITA, non-residents who “sojourn”[3] in Canada for a period of 183 days or more are deemed to be resident in Canada ***throughout*** that year for the purposes of the ITA. Assume, for example, Bob and Marge retired, sold their home and moved to the Bahamas from Canada five years ago. Since Bob and Marge’s only ties to Canada are their adult children and grandchildren, Canada no longer considers them to be ordinarily resident in Canada. Now assume that between February and December of Year 1, Bob and Marge will have spent more than 183 days in Canada. Further assume that Bob gifts his son valuable capital property (e.g., shares of an investment company) with an unrealized capital gain in January of Year 1. If Bob were a resident of Canada at the time of the gift, the gift would trigger capital gains taxable in Canada at the time of the gift. Since Bob will be deemed to have been resident in Canada ***throughout*** Year 1, Bob should be liable to pay tax on the capital gain on April 30 of Year 2.

Subsection 250(5) of the ITA provides that no person whom a Canadian tax treaty characterizes as resident in another jurisdiction can be resident in Canada. This provision effectively incorporates the result of a treaty tie-breaker into domestic legislation.

Taxation of Personal Trusts under the ITA

For the purposes of the ITA, a trust is a separate legal person who can earn income, incur loss and pay tax. Not all arrangements recognized as ”trusts” in other areas of law are recognized as “trusts” under the ITA. A bare trust, for example, is not a trust for the purposes of the ITA and

[3] Various exceptions exist (e.g. commuters)

any income arising from the property held in a bare trust is taxed in the hands of the beneficial owner. The types of trusts recognized under the ITA which are most germane to this article are personal trusts, specifically discretionary family trusts and testamentary trusts.

Income earned by a personal trust must be taxed in the hands of the trust, unless the income is paid or made payable to a Canadian beneficiary of the trust, in which case it is taxed in the hands of that beneficiary and a deduction of the same amount is available to the trust for the same amount. Most personal trusts are taxed at the highest federal and provincial income tax rates in order to prevent the deferral advantages that would otherwise arise when income is left the trust.

Income which has been retained by a personal trust and taxed in its hands is added to the capital of that trust. Distributions to Canadian resident beneficiaries in satisfaction of their capital interest in an irrevocable personal trust can usually be made on a tax-free basis. However, certain contributions into the trust can disqualify it from making tax-free distributions to anyone but the offending contributor and his or her spouse.

Since a trust is a taxpayer under the ITA, it follows that a trust must be characterized as a resident or a non-resident of Canada in order to determine the extent of its income tax liability. The Supreme Court of Canada has stated that, for the purposes of the ITA, a trust is resident in the jurisdiction where the authority vested in the trustees as such by the trust deed is actually exercised and that this is not necessarily the same place as where the trustees reside.[4] This pronouncement means that where a Canadian resident has in fact usurped a non-resident's role as the trustee of a trust (i.e., the major decisions are made by the Canadian resident and not the named non-resident trustee), the trust should be a factual resident of Canada. The trust will also be factually resident where the non-resident trustee has exercised the majority of his duties in Canada.

Prior to the release of the Supreme Court decision in *Fundy Settlement*, the Department of Finance released a new set of rules with respect to "deemed resident trusts." Subsection 94(3) deems a non-resident trust to be resident in Canada where at a particular time there is a "resident contributor" or a "resident beneficiary" to the trust. A resident contributor is someone who has contributed property to the trust and is resident in Canada. A "resident beneficiary" is a

[4] *Fundy Settlement v. Canada*, 2012 SCC 14 (CanLII), 1 S.C.R. 520, at para. 15

beneficiary who is resident in Canada when there is a “connected contributor” to the trust. A “connected contributor” to the trust is a person who has made any contributions to the trust at a time other than at a non-resident time. A contributor’s “non-resident time” is the time period which begins at the time of his or her contribution as a non-resident if the contributor was a non-resident throughout the 60-month period preceding the contribution and which ends on the earlier of i) the date occurring 60 months after the contribution and ii) the particular time. In other words, a contributor will not be a connected contributor if he or she made all of their contributions to the trust i) before becoming resident in Canada, ii) after five years of having ceased to be resident in Canada, or iii) some combination of the two. If a contributor makes a contribution to a trust within five years of becoming resident in Canada or ceasing to be resident in Canada, there is a connected contributor to the trust.

Capital distributions from trusts to Canadian resident beneficiaries generally occur on a tax-deferred basis pursuant to subsection 107(2) of the ITA. However, the ability of a trust to “roll out” property to Canadian beneficiaries is severely restricted where *any* property of the trust i) can be returned to the individual who contributed it to the trust, or ii) is still subject to some degree of control by the individual who contributed it. Where a trust has triggered these conditions and the contributor of the property has not yet died, the only Canadian resident beneficiaries to whom trust property can be “rolled out” are the contributor and his or her spouse. Where neither of these individuals are both a beneficiary under the trust and a resident of Canada, the trust cannot “roll out” its trust property to anyone and the trust must realize any gain on distribution of its capital. It is worth noting that this preclusion applies to both factually resident trusts and deemed resident trusts.

Gifts of Taxable Canadian Property

Generally speaking, non-residents are subject to Canadian income tax on capital gains to the extent that they are realized on dispositions of “taxable Canadian property.” The definition of “taxable Canadian property” (TCP) includes real estate situated in Canada and shares of private companies of which more than 50% of their value derives from real estate situated in Canada. Unless provided otherwise by a tax treaty, a capital gain realized on the disposition of any TCP is fully taxable in Canada.

When one person gifts capital property to another, the ITA generally deems the transferor to have disposed of, and the transferee to have received, consideration equal to the property's fair market value. Therefore, tax on the unrealized capital gain is triggered when TCP is gifted by a non-resident.

Further, the disposition of TCP by non-residents can give rise to fairly onerous filing obligations. Whenever a non-resident transferor disposes of TCP that is not excluded property, the transferee will be liable to withhold 25% of the purchase price unless the transferor can obtain a certificate under section 116 of the ITA in prescribed form which shows that the transferor does not owe income tax on any gain.

Taxable Canadian Property – Personal Residences

An important exception to the tax liability in respect of dispositions of taxable Canadian property is the "principal residence exemption" which is set out in sections 40 and 54 of the ITA.[5] Until very recently, non-residents could access the principal residence exemption on capital gains tax on the disposition of Canadian residential real estate if the real estate was held by a Canadian resident trust. As long as none of the beneficiaries of the trust designated any other property as his or her "principal residence" and at least one beneficiary of the trust or his or her spouse or minor children inhabited the property throughout the period the trust held the property, the trust could claim a capital gains exemption when the property was sold. Due to recent amendments to the principal residence exemption regime that came in to force on January 1, 2017, the tax advantages for a non-resident owning residential property through a Canadian trust have been significantly curtailed.

The principal residence exemption is calculated by multiplying the gain otherwise realized by one plus the number of years during which the taxpayer was resident in Canada and the property was designated as the taxpayer's principal residence and dividing the product by the number of years that the taxpayer owned the property. A taxpayer could designate a property as his or her principal residence if the property was "ordinarily inhabited" by the taxpayer or his or her spouse

[5] For a detailed overview of the new rules, see J. Bernstein and R. Santia "Principal Residence Exemption: Trusts and Non-Residents," co-authored with Jack Bernstein, *Canadian Tax Highlights*, Volume 25, Number 1, January 2017.

or minor children during the year. Where the taxpayer disposing of the property is a trust, a "specified beneficiary" or his or her spouse or minor children must have ordinarily inhabited the property during the year and no other "specified beneficiaries," their spouses or minor children designated a property as their principal residence.

As part of the recent changes, the formula to calculate the exemption has been amended for non-residents. The formula will not include an automatic "plus one" for years in which the taxpayer was resident in Canada and designated the property as his or her principal residence if the taxpayer was non-resident at the time the residence was purchased. As a result, a non-resident cannot benefit from the principal residence exemption if he or she was never resident in Canada.

Perhaps more significantly, only certain personal trusts can claim the principal residence exemption. These trusts include *alter ego* trusts, spousal trusts, joint spousal trusts, qualified disability trusts and trusts for minor children with deceased parents, all of which must have been settled in favour of a Canadian resident beneficiary. The newly limited scope of trusts which can claim the principal residence exemption precludes arrangements by which a non-resident can receive, as a distribution of trust capital, tax-free proceeds of the sale of real estate on which the principal residence exemption has been claimed.

Non-residents who have relied on a discretionary personal trust being able to claim the principal residence exemption may have to take action in light of the new rules. If the intention of the non-resident is to gift the residence itself to a Canadian resident beneficiary of the trust, the trustees of the trust could distribute the property to the beneficiary in satisfaction of his or her capital interest in the trust. Capital distributions to Canadian resident beneficiaries generally occur on a tax-free basis under subsection 107(2) of the ITA. Where a principal residence is distributed from a trust to a specified beneficiary, subsection 40(7) deems the beneficiary to have owned the property for the years that the trust actually owned the property. When the beneficiary eventually sells the property, he or she could claim the principal residence exemption for the years in which the beneficiary, his or her spouse or minor children ordinarily inhabited the property. However, it bears mentioning that the beneficiary (or the spouse or children of the beneficiary) to whom the property is distributed must also have ordinarily inhabited the property during the years in which it was owned by the trust in order to qualify for the exemption during those years. Where

such a distribution is not possible, the trustees should consider triggering the unrealized capital gains in the property prior to the accrual of any additional gain. Subsection 40(6.1) of the ITA provides that a non-qualifying personal trust will only be denied the principal residence exemption for value accrued on or after January 1, 2017.

Gifts to Disabled Canadian Residents

Non-resident relatives of disabled Canadian residents may wish to provide for them in their Wills or by *inter vivos* gifts. Care must be taken to ensure the gift does not adversely affect other benefits the individual receives. Each province provides benefits to individuals with disabilities – in Ontario, these benefits are part of the Ontario Disability Support Plan (ODSP). The benefits are generally income- and asset-tested.[6] A direct gift to the ODSP recipient that exceeds the annual limit will result in the erosion, if not cancellation, of the person's benefits. An inheritance to an ODSP recipient must be made through a testamentary discretionary trust, referred to as a "Henson" trust,[7] in order to protect the recipient's provincial benefits.[8] A Henson trust can also be an *inter vivos* trust, however, for a Canadian resident trust, income not paid or payable to the beneficiary will, as noted above, be taxed at the highest marginal tax rate. A non-resident *inter vivos* trust may avoid this issue, provided it i) has the restrictions required of a Henson trust, and ii) is not a deemed resident trust.

Amendments to the ITA that came into force on January 1, 2016 have a significant impact on planning for disabled Canadians. Prior to 2016, income that remained in a testamentary trusts was taxed at the same graduate rates as an individual. From 2016, income taxed in a testamentary trust is taxed at the top rate (like *inter vivos* trusts) with two exceptions – for the first three years

[6] In Ontario, an ODSP recipient can received an additional $6,000 from other sources over a 12-month period and can own up to $5,000 in assets (with certain exceptions, notably a residence and vehicle). See http://www.mcss.gov.on.ca/documents/en/mcss/social/directives/odsp/income_Support/4_1.pdf.

[7] The term derives from the 1987 decision of the Ontario court in *The Minister of Community and Social Services v Henson*, [1987] OJ No 1121, aff'd [1989] OJ No 2093 (Ont CA). The court held that the assets included in a discretionary trust established for a disabled beneficiary would not be considered part of the beneficiary's assets, as the beneficiary had no vested right to receive income or capital from the trust, thereby protecting her provincial disability benefits.

[8] All of the provinces have similar rules, although Alberta restricts the use of Henson trusts to protect benefits.

of an estate, provided the estate qualifies as a "Graduated Rate Estate"[9]or if the trust qualifies as a "Qualified Disability Trust" (QDT).[10] For purposes of this paper, it is important to note that a QDT must be a Canadian resident trust (the deeming provisions do not apply in this instance), and the beneficiary can elect to be a beneficiary of only one QDT in a taxation year. The "one QDT per year" rule can be problematic for divorced parents of a disabled beneficiary where both of them provide for a trust (which would likely be a Henson trust) for their child in their Wills, or where grandparents, aunts or uncles wish to provide for the child. Where one of the parents or the other relatives are non-residents, a trust for the disabled person, while falling under the tax rules of the other jurisdiction, could benefit the disabled person, without affecting the ability for another trust to be a QDT and, provided it conforms to the Henson trust rules and the distributions do not exceed the amounts allowed by the provincial program. Again, care must be taken, and Canadian advice sought, when setting up and implementing these structures.

Canadian Tax Affecting Gifts: Estate Administration Tax/Probate Fees

In certain provinces, probate taxes are charges as a percentage of the assets that are dealt with under the Will that is being probated. Ontario, British Columbia and Nova Scotia charge the highest percentage at approximately, 1.5%,[11] 1.4% and 1.7%,[12] respectively. Probate planning techniques are often undertaken in these high probate jurisdictions in order to reduce the tax.

Joint Tenancy

A probated Will is generally required by third parties and transfer agents in order to transfer assets to beneficiaries. Real estate held in joint tenancy with right of survivorship can be transferred to the surviving joint tenant without the requirement to produce a probated Will – in Ontario, ta "Certificate of Appointment of Estate Trustee." Similarly, bank and investment accounts should be able to pass to the surviving joint tenant without probate. However, where the joint tenancy was established by, for example, a parent with a child to allow the child to deal

[9] See R. Santia and E. Esposto "The Income Tax Act and Estate Planning: The Law of Unintended Consequences," *Ontario Bar Association Annual Institute-Trusts and Estates Law Section*, February 9, 2017.
[10] See R. Blumenfeld, "The New Qualified Disability Trust Regime," January 2016, *STEP Inside*.
[11] Ontario charges 0.5% on the first $50,000 of value and 1.5% thereafter. The only deduction is for a mortgage registered on title. See Blumenfeld, Rachel and Hastings, Nicole, "Ontario's Estate Administration Tax," Ontario Tax Conference, October 2015.
[12] Nova Scotia charges $1,002.65 on the first $100,000 of value for estates exceeding $100,000 in value and $16.95 for each additional $1,000 of value.

with the parent's assets, the property may fall back into the parent's estate to be distributed in accordance with his or her Will.[13] While the financial institution or land transfer registrar may permit the transfer of the account or property to the survivor, for purposes of calculating estate administration tax, the value of the asset likely must be included. Individuals who wish to put assets in joint title in order for their estate to avoid EAT on those assets should carefully document their intention to transfer the legal and beneficial interest in the property. This can be achieved by having a deed of gift signed by the transferor. If the intention is that the child is holding the property in trust for the parent (and ultimately for his or her estate), in Ontario, it is important that there be a separate Will dealing with the property. With only one Will, if probate is required to deal with other assets, the value of all of the assets dealt with under the Will are included in the calculation of the tax.[14] (See further discussion below.)

Where the intent is to create a "true" joint tenancy with right of survivorship, tax and other consequences must be considered. As was mentioned previously, an outright gift usually gives rise to income tax consequences to a non-resident donor where the subject of the gift is TCP. If a non-resident were to transfer real estate into joint tenancy with another, the non-resident would realize a disposition on the portion of his or her interest that was gifted at that time. When the non-resident eventually dies, the remainder of her interest would be deemed to have been disposed of for proceeds equal to fair market value pursuant to subsection 70(5) of the ITA.

There are significant disadvantages to transferring assets into joint tenancy. Some of these disadvantages arise from the fact that the recipient acquires an interest in the property at the time of the gift.[15] The recipient can therefore impede the transferor from dealing with the property held jointly as the transferor wishes during his or her lifetime. Further, the property can become subject to the creditors of the new joint owner. Other disadvantages arise from the fact that the recipient receives an absolute interest in the property on the death of the transferor. This can be particularly problematic where the transferor intended for the recipient to share the property with siblings or relatives after the transferor's death.

[13]See *Pecore* v. *Pecore,* [2007] 1 S.C.R. 795, 2007 SCC 17
[14] If probate was obtained in another jurisdiction and an ancillary grant is being obtained in Ontario, only the value of the Ontario assets are included.
[15]Provincial land transfer tax may be payable on the transfer.

Trusts

A probate-planning alternative to putting assets in joint title which avoids these problems is to transfer assets into a trust. A non-resident could settle a trust in favour of him or herself during his or her lifetime and provide that the intended recipients of the gift have a remainder interest in the trust. While the non-resident should still realize income tax consequences on the disposition of his or her interest in taxable Canadian property, the value of non-resident's beneficial interest in the property would not be subject to EAT since the beneficial interest disappears on the death and therefore does not form part of his or her estate.

It should be noted that, where the gifted property is real estate, any encumbrances on gifted property will be deemed to be consideration paid by the recipient for the purposes of Ontario's land transfer tax regime and land transfer tax would be paid on a percentage of the value thereof.

Multiple Wills

The Ontario EAT is only imposed on the value of a probated estate. Some assets, such as bank accounts and real estate situated in Ontario, effectively need to form part of a probated estate in order to be legally transferred. Many other types of assets do not need to be probated in order to be transferred to the heirs of the deceased owner. These assets include most receivables, shares of a private corporation (particularly where the company is owned only by the testator and his family) and beneficial interests in personal trusts. Accordingly, the implementation of "multiple wills" is a popular probate-planning strategy for individuals who possess significant wealth in the form of assets which do not require probate to be transferred. Additionally, where assets are located in different jurisdictions, a multiple Will strategy is implemented in order to ensure that the estate administration tax is payable only on the assets located in Ontario.

When implementing multiple Wills, an individual will generally divide his or her estate into two categories of assets: the assets that require a Certificate of Appointment in order to be transferred and the assets that do not. Assets which need to be probated are dealt with in the individual's "Primary" Will and the assets that do not need to be probated are dealt with in the individual's "Secondary Will." The terms of the secondary will specifically exonerate the executors from any

responsibility to have the secondary will probated. Thus, on the individual's death, only the Primary Will is submitted for probate.

The tax savings associated with the use of multiple Wills can be significant for a wide variety of taxpayers. Take, for example, an individual whose Canadian assets are shares in a Canadian small business which are worth $2,000,000 and a cottage property worth $1,000,000. If governed by only one Will, the estate of the individual would be liable for approximately $45,000 in EAT. If the distribution of the private company shares is governed by a Secondary Will, the EAT would be calculated only on the value of the cottage (approximately $15,000). If the cottage is held in a trust or by a corporate entity (whether Canadian or US),[16] the EAT could be eliminated. It bears mentioning that, from a Canadian income tax perspective, there is no distinction between a US LLC and any other business corporation. Unless the property is held by the corporation as a bare trustee for an individual, Canadian residents who are shareholders of the corporation and use the property may be assessed a "shareholder benefit" pursuant to subsection 15(1) of the ITA.

Some Family Law Considerations

While this paper deals primarily with tax issues, it is important for non-residents to be cognizant of potential family law implications of their gifts to Canadian residents. Each province has its own family law regime and there are significant differences among them, so it is important to obtain advice in the province of residence. In Ontario, for example, the *Family Law Act*[17] provides an exclusion for gifts and inheritances received during marriage. However, the income from such gifts and inheritances are only excluded if specific language is included in the deed of gift or Will of the donor or testator. Non-residents who wish to benefit Ontario residents should ensure that such language is included.

[16] Americans often hold Canadian vacation property through US LLCs. Care must be taken if a Canadian resident is to become a member of the LLC.
[17] RSO 1990, c. F.3, s. 4 (2)

Conclusion

As has been demonstrated above, non-residents gifting property to Canadian residents should pay heed to a number of tax considerations. In order to give due consideration to these tax issues, non-residents must be able to answer a number of questions including, but not limited to the following:

1. If I previously lived in Canada, have I severed my ties there?
2. If I am gifting through a trust, will I be able to distribute the gifted property to the recipient on a tax-free basis?
3. Is the subject of my gift "taxable Canadian property"?
4. If the subject of my gift is "taxable Canadian property," will I be able to claim the principal residence exemption on any portion of the capital gain triggered by the gift?
5. Is it worth putting any assets into joint title with the intended recipients of my gift?
6. Do I have a secondary will to deal with my interest in any assets that do not require probate?

Non-resident donors should be keenly aware of the issues associated with answers to these questions, lest they inadvertently add the Canada Revenue Agency to their list of legatees.