MINDEN GROSS LLP


Spring 2016



**BUYER BEWARE:**

# The Sale *of* Your Principal Residence MAY NOT BE TAX-FREE *After All*

*Most homeowners in Canada know* that when they sell their principal residence, any resulting gain will not be subject to tax in Canada. The "principal residence exemption," the basis for this tax-free disposition, can generally be claimed by an individual so long as he or she owned the principal residence and lived in it. While the exemption's application can be tricky sometimes – when multiple properties are owned, or when principal residences are owned for a short period of time, for example – the principal residence exemption claim is fairly straightforward in most circumstances.

What many homeowners in Canada don't know is that while the sale of a principal residence may be tax-free in Canada, tax may be owing in the US on the disposition or transfer of a principal residence by a US citizen living in Canada. US citizens, no matter where they live, are taxed on their worldwide income, and only the first USD$250,000[1] gain on a sale of a principal residence will be free of tax in the US. Any gain in excess of this amount will be taxed in the US at a rate of up to 24%, assuming the property has been held for more than one year and has not been used as a rental residence. This is a rude awakening for many US citizens living abroad who, if the circumstances permitted, might have otherwise been able to avoid such tax. The good news is that it still may not be too late.

[1] All dollar amounts in this article are in US dollars.

***The easiest way for US citizens to avoid US taxes*** on the sale of a principal residence is, of course, for the US citizen to not have owned the principal residence in the first place. Where, for example, a US citizen living in Canada is married to a non-US citizen, title to the principal residence can be taken from the outset in the name of the non-US citizen spouse only. This planning, however, would have had to be implemented at the outset.

If the US citizen spouse already owns the principal residence in his or her name, either wholly or partially (i.e., as joint tenants or tenants-in-common), there are steps that may be taken to avoid the US tax altogether. One such way would involve a gift by the US-citizen spouse of his or her interest in the principal residence to the non-US citizen spouse. The gift could occur in

Canada without the incurrence of any income taxes and, unless other consideration passed in connection with the gift, there would not be any land transfer tax in Canada, either. From a US tax perspective, the subsequent sale by the non-US citizen spouse of the principal residence will not result in any US income taxes either so long as the Internal Revenue Service does not "step" together the gift followed by the sale. While the gift of the US citizen spouse's interest in the principal residence to a non-US citizen spouse may not result in US taxes at the time of the gift, such gift would result in a reduction in the US citizen's US estate tax exemption upon death.

***Generally, US estate taxes are levied*** on the death of its citizens, regardless of their residency, based on the value of their worldwide estate. (US estate implications for non-US citizens are ignored for the purposes of this article.) US citizens are entitled to an exemption from US estate tax on the first $5.45 million of worldwide assets they own (as of 2016, indexed to inflation), and any assets owned in excess of this amount are subject to US estate taxes at a rate of up to 40%. The US estate tax regime works hand-in-hand with the US gift tax regime so that gifts made by US citizens during their lifetimes in excess of annual exemptions ($148,000 for spouses and $14,000 for children) are exempt from tax up to a certain lifetime limit (also, $5.45 million in 2016, indexed to inflation) but each such gift in excess of the annual exemptions causes a corresponding deduction to the individual's US estate tax exemption on death.

No matter the US citizen's financial situation, it will almost always make sense to gift an interest in a principal residence prior to its sale in order to avoid the US tax that might otherwise arise upon its sale. When a sale is not imminent, however, an immediate gifting strategy may not be the best solution.

Take Casey, for example. Casey is a US citizen living in Canada and his assets include a 50% interest in his principal residence that he owns with his wife, Joan, a non-US citizen. Casey obtained his interest in the principal residence for $1 million, but it is now worth $2 million.

Casey and Joan have decided to sell their principal residence. If steps are not taken prior to the sale of the principal residence, US taxes of up to $180,000 will arise upon its sale. However, if Casey gifts his interest in the property to Joan prior to its sale, he can avoid this $180,000 of taxes in its entirety – albeit at the expense of a reduction to his US estate tax exemption upon death in an amount equal to the fair market value of his interest in the principal residence. This reduction, however, is unlikely to have any effect on Casey's estate as he would have otherwise used the proceeds from the sale to either purchase a replacement residence and/or invest and, as a result, his estate would – absent any other planning - be left with the $2 million of assets upon his death.

If the sale of Casey and Joan's principal residence was not imminent, one alternative to consider – instead of an immediate gift of the entire interest in the principal residence - involves an annual gift by Casey to Joan of a portion of his interest in the principal residence valued at the annual exemption available for spouses. Each annual gift of a $148,000 interest in the principal residence will reduce Casey's US estate tax exposure by up to $59,200, and after 14 years (ignoring any increases in the principal residence's value in each year), Casey will have divested himself of all of his entire interest in the principal residence. If the principal residence was then sold, there would be no resulting US taxes and, as a bonus, Casey's estate will have relieved itself of up to $800,000 of US estate taxes that would have otherwise been owing upon his death. Even if the principal residence was sold in year five of the strategy, for example, the five annual gifts will have resulted in up to $296,000 of US estate tax savings upon death. Of course, prior to the sale, Casey would gift all of his remaining interest in the principal residence to Joan, resulting in the avoidance of the balance of US taxes that would have otherwise arisen upon the sale of the principal residence.

***As with any estate plan,*** the facts of each particular circumstance must be considered. If you or anyone you know is a US citizen and owns an interest in a principal residence, consider the options carefully.

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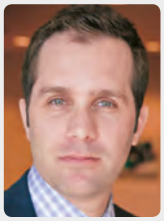

# Sell Now!

## How the 2016 Budget Will Impact Business Owners' Exit Strategies

Back in 2014 I wrote an article reviewing the significant impact on business owners of potential changes to the taxation of Eligible Capital Property ("ECP")[1] that had been floated in the 2014 Federal Budget.[2] The 2014 Budget papers were somewhat light on details and included a promise to hold consultations about the proposed changes.

Although the consultations never took place and the status quo continued for the past two years under the former Conservative government, this has all changed as part of the new Liberal government's ambitious 2016 Federal Budget. In particular, the 2016 Budget includes in its Notice of Ways and Means Motions ("NWMM") detailed legislative proposals to eliminate the current ECP regime ("Current Regime") by causing ECP to be taxed in essentially the same manner as ordinary depreciable capital property ("New Regime") effective January 1, 2017.

Since my 2014 concerns will likely now become a reality in 2017, I thought it would be worth bringing some items to your attention.

Assuming legislation released with the 2016 Budget to implement the New Regime is enacted substantially as proposed, then beginning in 2017, business owners' exit strategies will become much less tax effective. While at first glance, a move from the Current Regime seems completely logical and relatively innocuous,[3] it is the change to how ECP is taxed upon its disposition that should cause owner-managers who are considering selling their businesses to start thinking about selling a lot more seriously.

For many clients, ECP and, in particular, goodwill will be the single biggest asset that they will have to sell. The shift from the Current Regime to the traditional capital gains regime applicable to other depreciable property under the New Regime will result in a significant loss of tax deferral in situations where the owner-manager has no personal need for the full amount of the proceeds of sale.

To better understand the impact of these proposed tax changes assume that an individual named Ely has been carrying on a hat business through a corporation named Ely's Caps Limited. Ely wants to sell his interest in Ely's Caps but he

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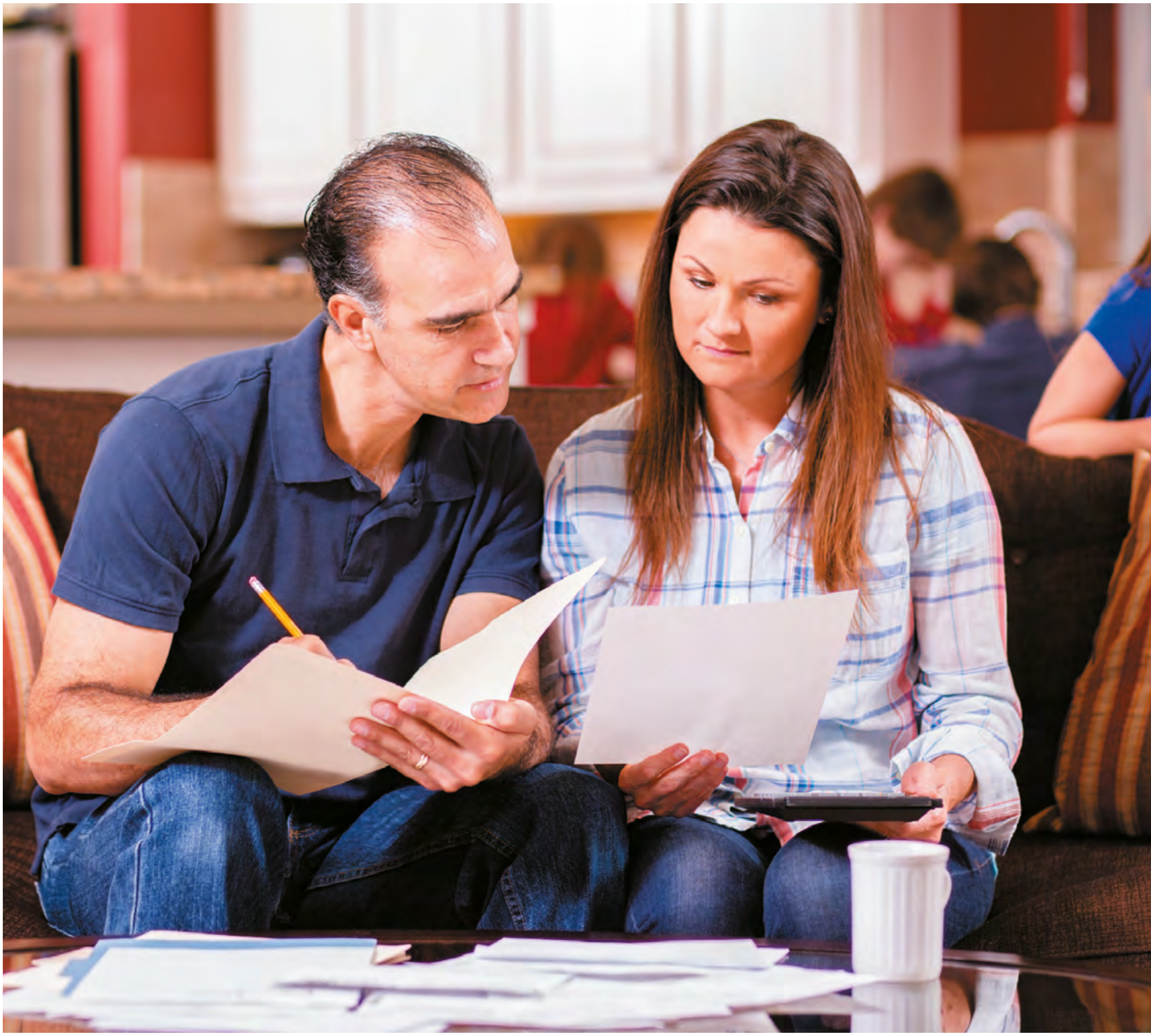
[1] ECP encompasses a broad range of property that can include: goodwill, customer lists, milk quotas, marketing quotas and farm quotas, licences of an unlimited duration, taxi and other government licenses, perpetual or indefinite franchises, certain trademarks which do not give rise to deductible expenses, other intellectual property such as from copyrights and trade secrets and property resulting from incorporation and certain other qualifying corporate reorganization expenses. A good summary of the broad class of property that can comprise ECP is found in Brent Kerr, "Eligible Capital Property: Update on the Rules," 2006 British Columbia Tax Conference, (Vancouver: Canadian Tax Foundation, 2006), 17:1-29 at 13.

[2] See *Tax Notes* No. 614, March, 2014 as well as *The Estate Planner* No. 230, March, 2014, both published by Wolters Kluwer (CCH) Limited.

[3] In some cases the impact of the changes may even be positive. For example, vendors with capital losses will now be able to offset capital gains on a sale of ECP against their capital losses, which would not have been the case under the Current Regime.



can't find a purchaser who will buy his shares. However, he has received an offer to buy all of Ely's Caps' goodwill for $10 million.

Under the Current Regime, if Ely's Caps agrees to accept the offer, the sale would give rise to $10 million of taxable income. Assuming this income will all be subject to the general corporate tax rates in Ontario, about $1.325 million in tax will be payable by Ely's Caps. In addition, after the end of Ely's Caps' current taxation year, the sale will give rise to a $5 million addition to Ely's Caps'[4] capital dividend account, which will allow Ely to remove $5 million of cash from Ely's Caps for his *personal use* with no additional taxation.

Under the New Regime, the full $10 million of proceeds would be taxed at corporate capital gains tax rates, which would give rise to a total corporate tax liability in Ontario of slightly more than $2.5 million. As was the case under the Current Regime, this sale would immediately generate an

[4] To the extent that Ely's Caps has not used up its full small business deduction limit, the first $1 million of proceeds could have been taxed at rates as low as 7.5% in 2016

addition to Ely's Caps'[4] capital dividend account of $5 million, which could be distributed to Ely tax free.

Assuming Ely is happy living off the $5 million from the capital dividend account and is willing to leave any remaining after-tax proceeds in Ely's Caps, then the result of the change from the Current Regime to the New Regime is that Ely's Caps would lose its ability to "defer" nearly $1.2 million in taxes.

The "cost" of the loss of this deferral should not be understated since, as a practical matter, most owners in Ely's situation and in situations involving more modest sales than Ely's would likely not draw more than the capital dividend account balance out of Ely's Caps for a very long time, *if ever*. So, in many cases the loss of the corporate deferral under the New Regime will really amount to an effective 12% tax on Ely's Caps, which is almost double the corporate tax that Ely's Caps would have paid under the Current Regime.

Assuming the New Regime becomes law, then it would certainly appear that given the massive transition of wealth that is set to occur over the next number of years this new 12% tax will likely be a significant revenue generator for the Canada Revenue Agency, though for reasons that I still can't understand, the Department of Finance still hasn't touted the change in this manner.

Although the New Regime is not yet law, business owners who were already thinking about selling would be advised to carefully reconsider the timing of their exit because now may be a very good time to sell. At the very least, consideration should be given to implementing strategies that may allow business owners to enjoy the benefits of the Current Regime while they still can.

*A more detailed version of this article was published in Tax Notes No. 639, April, 2016, published by Wolters Kluwer Limited.*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[5] The 2016 Budget papers do show an increasing positive fiscal impact from these changes (2016-17 $30 million and 2017-2018 $190 million of new revenue). Query if even these numbers are too modest.

[6] A discussion of such transactions, which are often referred to as goodwill (ECP) bump or "crystallization" strategies is beyond the scope of this article.

[7] Assuming the New Regime is legislated, expect a return to the old status quo of vendors having a very strong preference to sell shares (it appears that the CCA rate for new ECP acquisitions will be set to emulate the existing eligible capital expenditure rates with some slightly more favourable variations for existing ECP, so that the New Regime should be relatively tax neutral for purchasers). Due to the low tax rates applicable to ECP sales, this may not have always been the case in the more recent past, even for vendors whose shares would otherwise have qualified for capital gains exemption treatment. In some situations it has been possible for both vendors and purchasers to achieve the best of both worlds from a tax perspective by employing so-called "hybrid" sale structures, whereby transactions are structured to allow vendors to sell their shares and also sell assets of the corporation. For more on hybrid sale structures see, for example, Charles P. Marquette, "Hybrid Sale of Shares and Assets of a Business" *in Canadian Tax Journal* (2014), vol. 62, no. 3, 857-879.

Please note that once the New Regime is in place much of the deferral benefit that was enjoyed by vendors through the use of hybrid structures will be lost. Still purchasers will still want to purchase assets and vendors will want to purchase shares so perhaps these structures will continue to be viable.

## Firm News

**Minden Gross LLP** was ranked as One of Ontario's **Top 10** Regional Firms by *InHouse Magazine* in its March 2016 edition.

## Professional Notes

**Irvin Schein** was named Chair of the Canadian Region of Meritas in addition to his ongoing position as Co-Chair of the North American Litigation Section of Meritas. Irvin published four blog posts on *irvinschein.com*, including "Is There A Place for Rough Justice in the law of constructive trust?" on January 21, 2016.

**Matt Maurer** was named Chair of the Young Lawyers Committee for the Toronto Lawyers Association and published four blog posts on *Slaw* including "No Limitation Period for Continuing Breach of Contract" on March 15, 2016.

**David Ullmann, Ryan Gelbart, Reuben M. Rosenblatt, Q.C., LSM,** and **Timothy Dunn** spoke at sessions for the Ontario Bar Association's Institute 2016 held on February 2-4, 2016 where David was also a Program Chair for the session on Insolvency Law for Uncertain Economic Times and Reuben released the article "Lessons from the Trenches - Tips and Traps for the Wary."

**Reuben M. Rosenblatt, Q.C., LSM**, was a panelist for an Osgoode Professional Development program on ethical and professional issues in litigating real estate disputes held on February 10, 2016.

On February 17, 2016, **Joan Jung** moderated the STEP Toronto seminar "Post Mortem Planning – Private Corporation Shares" and published "Gifts and Support Orders" in the January 2016 issue of *STEP Inside*.

**Stephen Posen** and **Angela Mockford** (who joined the firm in January 2016) presented at the Law Society of Upper Canada on February 18, 2016. Stephen lectured on "Tenant's Remedies for Landlord's Termination of a Lease in Good Standing" and Angela spoke on "Rights of First Refusals to Purchase in Leases."

On January 20, 2016, **Matthew Getzler, Rachel Goldman,** and **Eric Hoffstein** presented "Will Planning and the Duties of an Executor/Trustee" at the Professional Development Consortium. Matthew also presented "New 2016 Rules for Trusts and Estates" at the North York District Chartered Professional Accountants Association on February 26, 2016, and at Gluskin Sheff & Associates on the topic "Tax Planning Opportunities for High Net worth Clients" on February 29, 2016.

**Michael Goldberg** and **Samantha Prasad** presented "A Sampling of Business Owner Planning Tax Traps" on March 31, 2016, at the Wealth Management Services Team Conference sponsored by RBC.

**Michael Goldberg** hosted the third session of Tax Talk: Year 3 on February 24, 2016. He published Part 1 of a series in the March 2016 edition of *Tax Notes* titled "NRT Tax Traps and the Non-Specialist Advisor" and published "Sell Now! How the 2016 Budget Will Impact Business Owners Exit Strategies" in the April 2015 edition of *Tax Notes*.

**Samantha Prasad** published two articles in *The Fund Library* including "Severance, retiring allowances, and the CRA tax muddle." She was also re-appointed to the Meritas Member Engagement Committee for 2016-2017.

**Michael Horowitz** spoke on "Advanced Real Estate Metrics" at the CRIS/CROS Summit on March 2, 2016.

**Catherine Francis** was quoted in *The Globe and Mail* article "A year after Target bolted Canada, creditors still face uncertainty" on January 14, 2016.

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**Hartley R. Nathan, Q.C.,** and **Ira Stuchberry** published the lead article in *Directors' Briefing* on "De Facto Directors" in January 2016.

**Stephen Messinger** moderated a session at the January 2016 ICSC Whistler Conference on Retail Trends.

On January 27, 2016, **Eric Hoffstein** presented the webinar "Litigating Efficiently and Avoiding Disputes" for the Canadian Association of Gift Planners (CAGP). He also published a paper with former articling student Lindsay Firestone entitled "Trustee Liability: The Enforceability of Exculpatory Clauses," which appeared in 3 parts in *Money & Family Law* from January to March 2016, respectively.