Planning in Uncertain Times – FAQ's

Principal Residences

If 40% principal residence is rented out, will the house be eligible for principal residence exemption?

According to CRA Income Tax Folio S1-F3-C2, in order for a house to qualify for the principal residence exemption for each year it is owned, it must be ordinarily inhabited in the year by a person (that is, the taxpayer, the taxpayer's spouse, common-law partner, former spouse, former common-law partner or child). This determination must be resolved on the basis of the facts in each particular case. If the main reason for owning a housing unit is to gain or produce income from it, then that housing unit will not generally be considered to be ordinarily inhabited in the year by the taxpayer where it is only inhabited for a short period of time in the year. With regard to whether the main reason for owning a housing unit is to earn income, a person receiving only incidental rental income from a housing unit is not considered to own the property mainly for the purpose of gaining or producing income. The term "incidental" is not defined by CRA in the Income Tax Folio; however, when determining whether there is a change in use or partial change in use (i.e. from principal residence to income-producing) the Income Tax Folio says that the entire property retains its nature as a principal residence, where all of the following conditions are met:

- the income-producing use is ancillary to the main use of the property as a residence;
- there is no structural change to the property; and
- no CCA is claimed on the property

The CRA has also commented, in various Technical Interpretations, that:

"Whether a property is being used by a taxpayer as the taxpayer's principal residence and/or whether use of a portion of the property as a (rental) operation is ancillary to the main use of the property as the taxpayer's principal residence are ultimately questions of fact. In respect of a completed transaction, such matters would be dealt with by the particular taxpayer's tax services office ("TSO") during the course of their review/examination of the taxpayer's income tax return for the particular taxation year."

Unfortunately, there is no clear rule as to whether 40% represents "*ancillary*" or "*incidental*" use. The taxpayer could try to get an Advanced Income Tax Ruling on this from the CRA. Further information with respect to this process can be found here: https://www.canada.ca/content/dam/cra-arc/formspubs/pub/ic70-6/ic70-6-9-19e.pdf

Superficial Losses

For superficial losses, is it 30 calendar days or 30 business days?

For purposes of the superficial loss rule, the Income Tax Act (ITA) looks at calendar days. A capital loss is deemed a superficial loss where you or an affiliated person buy the same or identical property during the period 30 calendar days before or after the settlement date of the sale (61 days total) and you or an affiliated person still owns the same property 30 calendar days after the settlement date of the sale. Affiliated persons include individuals including yourself or your spouse, corporations or partnerships controlled by you or your spouse, or trusts where you or your spouse are a majority beneficiary such as your RRSP, RRIF, TFSA or RESP wherein you or your spouse is a subscriber.

Provided identical property is not acquired or reacquired during the period that begins 30 calendar days before or 30 calendar days after a disposition, the superficial loss rule will not apply, allowing the taxpayer to immediately claim their capital loss. Where identical property is acquired or reacquired during this period, the taxpayer's capital loss would be suspended – that is, the loss would be denied at that time, but added to the adjusted cost base of the acquired/reacquired property, which allows for the loss to be claimed on a future sale, subject to the same superficial loss rule.

Can you please talk about 'superficial loss' and mutual funds? Especially: if we buy a new fund, is that an issue under the substituted property" rules?

A capital loss is deemed a superficial loss where you or an affiliated person buy the same or identical property during the period 30 calendar days before or after the settlement date of the sale (61 days total) and you or an affiliated person still owns the same property 30 calendar days after the settlement date of the sale. "*Identical property*" is the same in all material respects.

Affiliated persons include individuals including yourself or your spouse, corporations or partnerships controlled by you or your spouse, or trusts where you or your spouse are a majority beneficiary such as your RRSP, RRIF, TFSA or RESP wherein you or your spouse is a subscriber.

Some considerations with regard to superficial losses and fund investors:

- Switching to a different fund altogether will not trigger application of the superficial loss rules.
- Superficial loss rules will not be triggered where an investor switches between trust and corporate class funds (or vice versa). These are not identical properties due to difference in legal structure and in rights conferred on each investor.
- If you want to sell a mutual fund or ETF yet maintain exposure to an asset class or sector without waiting out the superficial loss period, purchase a different fund invested in the same asset class (e.g. global equity).
- Don't buy an index fund that tracks the same underlying index (i.e. S&P/TSX Composite Index) as an index fund sold within the superficial loss period. This applies even if the investments come from two different fund companies.
- Beware of automatic purchases! Pre-Authorized Contributions (PACs), reinvested distributions, Dividend Reinvestment Plans (DRIPs) or even automatic employee share purchases inside the superficial loss period can trigger the superficial loss rules. Pause a PAC or time a sale to circumvent.

Our article Superficial Loss Rules and How to Plan Around Them provides additional detail with regard to application of these rules for investors. If you seek additional clarity on this matter, please send your questions to Vincent and he will direct them to our team.

What about switching from an index fund tracking a different index, such as S&P 500, over to US total Market?

As per the CRA's interpretation bulletin IT-387R2, identical properties are properties which are the same in all material respects such that a prospective buyer would not have a preference for one versus another. The bulletin goes on to say, in determining whether properties are identical, it is necessary to compare the inherent qualities or elements that give each property its identity, understanding that such a determination is a question of fact based on the details of each situation.

With respect to your specific question, the CRA has indicated that where two index funds track different indices (e.g., S&P 500 vs a non-S&P 500 index), these properties would not be identical properties for purposes of the superficial loss rule, regardless of whether these products are offered by the same or different financial institutions. On the other hand, where two funds track the same index, they would normally be considered identical properties regardless if offered at the same or different institutions. Below are comments from the CRA via technical interpretation #2001-0080385.

"Subject to an analysis of all the relevant facts, in our view, a TSE 300 Index Fund, for example, would generally not be considered identical to a TSE 60 Index Fund. Whether any other investment instruments are identical properties is a question of fact as discussed above. However, as indicated in paragraph 1 of Interpretation Bulletin IT-387R2, Meaning of "Identical Properties", it is our view that " 'Identical properties...are properties which are the same in all material respects, so that a prospective buyer would not have a preference for one as opposed to another." Accordingly, an investment in a TSE 300 index-based mutual fund of a financial institution would, in our view, generally be considered identical to an investment in a TSE 300 index-based mutual fund of another financial institution."

Prescribed Rate Loans

Will the prescribed rate be lowered?

We are expecting the CRA prescribed rate to be lowered to 1% on July 1, 2020. The prescribed rate of interest is set on a quarterly basis based on the average of the Government of Canada three-month Treasury Bill yield for the first month of the previous quarter. Given the low rates for April 2020 (i.e. the first month of the previous quarter) the rate on July 1, 2020 should be lowered to 1%. Note that the rate can never be zero as the formula requires that the rate be rounded to the next highest whole percentage point. Since April 1, 2018, the interest rate has been 2%.

Would prescribed rate notes apply to a loan from a corporation?

Loans between family members that are payable at the prescribed rate allow for income splitting from a higher income earner to a lower income earner, provided all other criteria are met. Having a

corporation loan an amount to a shareholder could cause adverse tax consequences due to the shareholder loan rules described below.

Where a corporation loans money to:

- a shareholder of the corporation,
- a person not dealing at arm's length with or affiliated with a shareholder of the corporation,
- a member of a partnership that is a shareholder of the corporation, or
- a beneficiary of a trust that is a shareholder of the corporation

the debtor, is required to include in their taxable income the full amount of the loan (i.e. not just the interest) unless they meet certain exceptions, the most common of which is that the loan is repaid by the end of the corporation's fiscal year-end following the year in which the loan was advanced. For example, assume a corporation with a December 31 year end loans it's sole shareholder $100,000 on January 1, 2020 (i.e. during the corporation's Dec. 31, 2020 year end). The loan would need to be repaid by Dec. 31, 2021 otherwise the shareholder would have an income inclusion of $100,000 in their 2020 taxation year. There are a couple things to note with this example:

- The shareholder would have to include a deemed interest benefit based on the prescribed rate in effect while the loan was outstanding. If the prescribed rate were 2% throughout, then the shareholder would have to include $2,000 in their taxable income in both 2020 and 2021 (i.e. since the loan was outstanding from Jan. 1, 2020 to Dec. 31, 2021).
- Given the repayment may not occur until 2021 (i.e. well after the shareholder's personal tax filing due date has passed) if the shareholder is unable to repay the loan, they would have to re-file their 2020 tax return, include $100,000 of income and pay the applicable taxes. Given they are re-filing and the tax payment will be late, there will also be interest and penalties.

Estate Planning

Husband dies in January holding a RIF with wife as full beneficiary. Assets transferred to wife's RIF. Wanted to withdraw $40,000 of investments before transferring them to wife. T4RIF slip was issued in wife's SIN and want that income to go to her husband because he died so early in the year. Is there an election that can be done to have it included in husband's income instead of wife's?

When an RRSP or RRIF annuitant dies with a surviving spouse or common-law partner (CLP), the CRA generally allows the couple to structure their tax affairs in a manner that allows for the least amount of tax payable legally allowed under tax law. This includes, where it makes sense, full, partial or nil rollovers to the surviving spouse or CLP – there are procedures to allow for this. However, these procedures normally require the planning or desired option to be communicated to financial institutions before the settlement (i.e., payout from the RRSP/RRIF) occurs. Once the payout occurs and tax slips are issued, options become limited.

For more information respecting RRSP/RRIF settlements at death and whether or not tax-deferred rollovers make sense please see: http://trep.ci.com/estate-planning/death-rrsp-annuitant

What are your thoughts on "thawing and refreezing" estates at this time?

Although a thaw and refreeze is not appropriate in all cases it is something that should be discussed with your business owner clients given the current market. A thaw involves the unwinding of an estate freeze. It may or may not be followed by a refreeze, where the corporation is refrozen at a lower fair market value then used in the original freeze.

Assuming the corporate documents or trust documents which originally froze the corporate value do not limit the directors or trustees and the costs incurred in a thaw and refreeze are not prohibitive given the upside value which may be achieved there are several potential benefits of a refreeze including:

- A thaw and refreeze is often considered where the market value of the corporation originally frozen has fallen in value below the originally frozen value but where it is anticipated the corporation's value will recover over time. Typically, the original owner of the business has retained preferred shares which can be exchanged for new preferred shares equal to the new current market value. New common shares can be issued to the new generation and/or, if a trust is being used to the trust. Thus, the original owner's share value has decreased and with it the taxes which will be owing at death. In provinces where probate is a concern it will also mean probate savings, particularly in Ontario and British Columbia where dual Will strategies may be utilized;
- One of the purposes of an estate freeze is it allows income held within the corporation to be paid to various family members through dividends, assuming Tax on Split Income (TOSI) is not a concern. However, in corporate law where the value of the corporation has fallen to a level below the frozen value, there may be limitations on the ability to declare dividends due to the "maintenance of capital test". A refreeze can ensure this consequence is avoided;
- Where the original freeze utilized a trust, that trust will be subject to the 21-year rule where the assets in the trust are deemed disposed of and repurchased at fair market value every 21 years.

The tax arising out of this deemed disposition will be subject to tax. However, a thaw and refreeze provides an opportunity to defer this 21-year period to some extent by utilizing a new trust as part of the refreeze; and

- A refreeze provides the opportunity to review the client's family situation and consider whether further planning is required due to changes in family membership since the original freeze. For instance, in Ontario a gift may be protected from a claim in a separation or divorce if the gift was made after the marriage of the receiver and the deed of gift provides that it is excluded from family property. Therefore, if the original owner's children have married since the original freeze, a thaw and refreeze may enhance the protection of the family's assets.

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