TAX, RETIREMENT AND ESTATE PLANNING

CI GLOBAL ASSET MANAGEMENT

FORMAL TRUSTS, REAL PROPERTY AND THE PRINCIPAL RESIDENCE EXEMPTION

Many Canadians consider the use of a living trust when creating their estate plans. More commonly known as inter vivos trusts in tax and legal circles, because assets transferred to the trust would normally bypass the estate of a deceased settlor, the trusts can be effective in reducing estate administration (i.e., probate) fees, avoiding complex estate settlements and ensuring confidentiality upon death of its settlor. In some cases, these benefits can extend to a principal residence transferred to the trust, and when combined with the principal residence exemption (PRE), can be a tax-efficient way to achieve multiple objectives. Consider the following example:

Kelsie, age 70, is a widow with two children. As part of an estate plan, she is considering the use of an alter ego trust, a type of living trust available to seniors age 65 or older. Her plan is to transfer her assets – particularly those that would otherwise be subject to estate administration fees – to the trust to achieve efficiencies and simplify the settlement of her estate on her death. One of the assets to be transferred to the trust is her home, a property she has occupied as her principal residence for each of the 30 years she has owned it.

With alter ego trusts, Kelsie understands that she can transfer assets to the trust on a tax-deferred basis. She also understands that from that point forward, the trust would own the assets, subject to attribution rules that would see future income and capital gains from the assets taxed in her hands until her death and to the trust at the top marginal tax rate thereafter. In considering the transfer of her home to the trust, Kelsie has the following questions:

i) If her home is transferred to the trust, given that the trust will then own the home, will the PRE continue to be available to shelter the home from tax?

ii) If the home does not fully qualify for the PRE at the time of a subsequent sale, who would be taxed on any resulting gain? Kelsie, at graduated tax rates? Or the trust at the top marginal rate?

iii) If the trust still owns the home at the time of Kelsie's death, will the property be taxable at that time? If yes, who will be taxed?Kelsie, on her terminal return (the final return submitted following her death)? Or the trust?

Subject to conditions, tax legislation has, for many years, permitted personal trusts to claim the principal residence exemption in respect of qualifying property owned by the trust. Provided that a "specified beneficiary" – defined as one who is beneficially interested in the trust and occupies the home as a principal residence – designates no other property as such, the trust would be permitted to claim the property as a PRE thereby sheltering it from tax for the years designated. This would be the case even if the ownership period was shared between the settlor and the trust. Since the trust would be deemed to own the home for the entire period it was owned by either the settlor or the trust, the trust would be in a position to claim the exemption, even for years prior to the rollover to the trust.

On October 3, 2016, the Department of Finance Canada announced a number of changes to the PRE rules designed to improve compliance and administration of the tax system. As a part of the changes, the types of trusts eligible to claim the PRE were reduced. Effective January 1, 2017, the types of trusts eligible to claim the PRE are as follows:

- Spousal or common-law partner trusts
- Alter ego, joint partner or other self-benefit trusts
- A qualified disability trust (for a spouse or child of the settlor provided the spouse or child is eligible for the federal disability tax credit)
- A trust for minor children of a deceased parent, subject to conditions

Also, in each case, the beneficiary must be a resident of Canada.

Understanding the above, answers to Kelsie's questions are as follows:

i) If Kelsie's home is transferred to the trust, given that the trust will then own the home, will the PRE continue to be available to shelter the home from tax?

Given that Kelsie's trust will be an alter ego trust, it will be eligible to claim the PRE in respect of a home transferred to the trust provided that Kelsie continues to occupy the home as her principal residence and no other home is designated as such. In fact, as the federal Income Tax Act would deem the trust to have owned the home for each year it was owned by Kelsie, the home can be fully sheltered from tax for all years of ownership even if the trust owns the home for only a short period of time prior to a sale after the rollover to the trust

ii) If the home does not fully qualify for the PRE at the time of a subsequent sale, who would be taxed on any resulting gain? Kelsie, at graduated tax rates? Or the trust at the top marginal rate?

If the home is not used as a principal residence for each year of ownership – perhaps if it becomes a secondary property, or at some point is used primarily to earn rental income – then a subsequent sale of the property by the trust would normally trigger some tax. The PRE would be available to the trust for the period the home was used as a principal residence with capital gains tax being payable for the period the home was used as a secondary or rental income property. In other words, in the case of a partially sheltered gain on the sale of the home by the trust, once the PRE is applied by the trust, the remaining capital gain would be taxable, typically in the hands of the settlor, Kelsie in this case. With an alter ego trust, any income or gains realized by the trust prior to the death of its settlor is normally taxed to the settlor under section 75(2) of the Income Tax Act (similar rules apply to joint partner trusts established for the benefit of a settlor and his or her spouse or common-law partner). This rule would apply to the net gain resulting from the sale of Kelsie's home prior to her death, resulting in taxation in her hands at graduated tax rates.

iii) If the trust still owns the home at the time of Kelsie's death, will the property be taxable at that time? If yes, who will be taxed? Kelsie, on her terminal return? Or the trust?

When the settlor of an alter ego trust dies, the trust is deemed to dispose of the trust's assets at the end of the day of the settlor's death. This results in taxation of any gains to the trust at the top tax rate which applies to most trusts. If Kelsie's home is owned by the trust at the time of her death, and if the PRE cannot be used to fully shelter the home from tax, the net gain would be taxed to the trust at the top tax rate of the province in which the trust resides.

Trusts are commonly considered in estate planning. In light of recent changes to both the taxation of trusts and the principal residence exemption, understanding the new rules will allow financial advisors and clients to better understand the pros and cons of certain trust-related strategies.

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Published August 9, 2021

21-08-422424_E (08/21)