Gifts, Attribution and Death

Non-Arm's Length Transfers (Gifts)

Determining Proceeds

- Transfers to arm's length person (unrelated) are assumed to be at FMV
- Transfers to a non-arm's length person (related), must be at FMV to avoid negative tax consequences.
  - In this case, FMV would need to be determined.
- Unrelated people can be acting non-arm's length

Arm's Length Sales

- Proceeds of Sale assumed to be FMV

- Each party has incentive to act towards their own best interest.

Example: Jake sells a piece of land to a man who responded to his advertisement. The land cost $50,000 to Jake and he will sell it for $100,000. The two men don't know each other.

Jake's proceeds of disposition $100,000

Stranger's adjusted cost base after purchase $100,000

Non-Arm's Length Transfers

When transferring property to a related person, CRA requires that the transaction happen at fair market value (FMV). If this doesn't happen, they will punish individuals using double taxation. The chart below shows how

Price Transacted	Proceeds to Vendor	ACB to Purchase
FMV	FMV	FMV
Over FMV	Proceeds	FMV
Under FMV	FMV	Proceeds
Gift ($0)	FMV	FMV

Non-Arm's Length - FMV

- IF proceeds of sale are equal to actual FMV
- No adjustment required, parties are transacting at arm's length.

Example: Jake sells a piece of land to his brother. The land cost $50,000 to Jake and an appraiser says it is worth $100,000. His brother agrees to pay $100,000 for it.

Jake's proceeds of disposition $100,000

Brother's adjusted cost base after purchase $100,000

Non-Arm's Length - FMV

Jake's proceeds of disposition $100,000

Brother's adjusted cost base after purchase $100,000

Jake: $100,000 - $50,000 = $50,000 gain

Brother: $100,000 ACB on future sales

If Brother sold immediately for FMV $100,000 - $100,000 = $0

Non-Arm's Length –More than FMV

- If proceeds of sale are greater than actual FMV
- Proceeds equal to price paid, cost equal to FMV.

Example: Jake sells a piece of land to his mother. The land cost $50,000 to Jake and an appraiser says it is worth $100,000. His mother agrees to pay $150,000 for it because she knows Jake needs the money.

Jake's proceeds of disposition $150,000
Mother's adjusted cost base after purchase $100,000

Non-Arm's Length – More than FMV

Jake's proceeds of disposition $150,000

Mother's adjusted cost base after purchase $100,000

Jake: $150,000 - $50,000 = $100,000 gain

Mother: $100,000 ACB on future sales

If Mother sold immediately for FMV $100,000 - $100,000 = $0

Non-Arm's Length – Less than FMV

- IF proceeds of sale are less than actual FMV

- Proceeds equal to FMV, cost equal to price paid.

Example: Jake sells a piece of land to his son. The land cost $50,000 to Jake and an appraiser says it is worth $100,000. Jake agrees to accept $80,000 from his son since he knows he's short on cash.

Jake's proceeds of disposition $100,000
Son's adjusted cost base after purchase $80,000

Non-Arm's Length –Less than FMV

Jake's proceeds of disposition $100,000

Son's adjusted cost base after purchase $80,000

Jake: $100,000 - $50,000 = $50,000 gain

Son: $80,000 ACB on future sales

If Son sold immediately for FMV $100,000 - $80,000 = $20,000

Non-Arm's Length – Gift

- IF proceeds of sale are zero
- Proceeds equal to FMV, cost equal to FMV.

Example: Jake gives a piece of land to his sister. The land cost $50,000 to Jake and an appraiser says it is worth $100,000.

Jake's proceeds of disposition $100,000

Sister's adjusted cost base after purchase $100,000

Non-Arm's Length – Gift

Jake's proceeds of disposition $100,000

Sister's adjusted cost base after purchase $100,000

Jake: $100,000 - $50,000 = $50,000 gain

Sister: $100,000 ACB on future sales

If Sister sold immediately for FMV $100,000 - $100,000 = 0

Comprehensive Example

Sigmund owns shares which he purchased for $30,000. Their current fair market value is $70,000.

He's always wanted to give something to his father as a gift to show how successful he's become, but his father insists on paying him something.

Sigmund sells the shares to his father for $50,000.

One year later, his father sells the shares for $90,000.

Calculate the impact on each individual's income from the sales.

Calculate the impact if they'd transacted at FMV.

Comprehensive Example – Proceeds **$50,000**

Sigmund and his father are non-arm's length (related).
Disposition occurred at less than FMV.

70,000 Proceeds to Sigmund (FMV)
(30,000) Sigmund's Cost

40,000 total gain x 50% = 20,000 Taxable Income to Sigmund.

90,000 Sale price of father
(50,000) Price paid to Sigmund by father = ACB

40,000 total gain x 50% = 20,000 Taxable Income to Father

Comprehensive Example – Proceeds **$70,000**

Sigmund and his father are non-arm's length (related).
Assuming disposition occurred at FMV.

70,000 Proceeds to Sigmund (FMV)
(30,000) Sigmund's Cost)

40,000 total gain x 50% = 20,000 Taxable Income to Sigmund.

90,000 Sale price of father
(70,000) Price paid to Sigmund by father = ACB

20,000 total gain x 50% = 10,000 Taxable Income to Father

Inter-Vivos Spousal Transfers

No deemed disposition when property transferred to spouse

Can be gifted without proceeds & no tax consequences

However, income the spouse earns continues to belong to the "giftor" – attributed back

Must pay tax on transfer in order for future income to be taxed in recipients hands. (elect out of rollover)

Inter-Vivos Spousal Transfers

Non-Depreciable Capital Property

Proceeds of disposition = Capital Cost of Vendor

Cost basis to purchaser = Capital Cost of Vendor

Depreciable Capital Property

Proceeds of disposition = UCC pool balance of vendor

UCC addition of purchaser = UCC balance of vendor*

Capital cost of purchaser = Capital Cost of vendor*

Means that if sold, same recapture & capital gain as if the transferor still owned it.

Inter-Vivos Spousal Transfers

<u>Reasons to elect out of rollover (& Trigger Tax)</u>

Capital losses that the vendor wishes to use.

Wish for future income to be taxed in the hands of the purchasing spouse.

Wish to realize income to take advantage of tax brackets.

Spousal Transfers - Example

Ex. Joe gifts land to his spouse Mary and doesn't file any elections. Joe's cost is $10,000 and the FMV is $50,000

What is the impact to each of them on the transfer?

73(1) applies, spousal rollover applies

Joe $10,000 proceeds - $10,000 cost = $0 gain

Mary $10,000 ACB going forward

Spousal Transfers - Example

Ex. Joe gifts land to his spouse Mary and files an election to avoid 73(1). Joe's cost is $10,000 and the FMV is $50,000

What is the impact to each of them on the transfer?

73(1) does not apply – no spousal rollover

Joe $50,000 proceeds - $10,000 cost = $40,000 gain x 50% = $20,000 taxable capital gain

Mary $50,000 ACB going forward

Spousal Transfers - Example

Ex. Joe gifts his rental property to Mary and doesn’t report a gain since she is his wife. Mary earned $50,000 in rental income the following year.

Who will pay tax on the rental income?

Because the property rolled tax free to Mary, and Mary did not pay FMV consideration, the income still belongs to Joe.

Joe will pay tax on the $50,000 rental income.

Spousal Transfers - Example

Ex. Joe sells his rental property to Mary for its FMV of $400,000 and reports a taxable gain on the sale. Mary earned $50,000 in rental income the following year.

Who will pay tax on the rental income?

Because the property was sold by Joe to Mary at its FMV, and the sale was reported at FMV to achieve a gain, future income is considered to belong to Mary.

Mary will pay tax on the $50,000 rental income.

Spousal Transfers - Example

Ex. Joe gifts his rental property to Mary. Joe had purchased the rental property for $300,000 and had $200,000 left in UCC in the Class 1 CCA pool.

What will be Mary's addition to the UCC pool after receiving the property?

Mary's UCC pool for Class 1 will be increased by $200,000. The same UCC as Joe had prior to the transfer.

Inter-vivos Farm or Fishing Transfers

- Tax free inter-vivos transfer to children, grandchildren, great grandchildren, and their spouses.
- Child must be resident of Canada.
- Property must be in use as a farm or fishing business operated by the taxpayer, their spouse, or children.

Image obtained November 11, 2013 from: http://www.williamkentinc.com/wny-farm-appraisal

Attribution

Attribution - Overview

Goal of Tax Planning: To split income with family members and use lower marginal tax rates.

Goal of Attribution: to prevent income splitting where no economic basis for it.

What this means: Income "split" with a family member is taxed in the hands of the original owner of it.

How we say it: Income is "attributed" back to the original owner

Attribution - Rules

<u>Requirement 1</u>: An individual has transferred property (cash or income earning assets)

<u>Requirement 2</u>: To a specified person (spouse or minor child, grandchild, niece or nephew)

<u>Requirement 3</u>: Income earned by the specified person on that property is attributed back to the individual.

Attribution - Exceptions

<u>Active Business Income (If related person not involved)</u>

Effort required to earn it. Not a real result of the transfer but of the efforts of the current owner.

<u>Second Generation Income</u>

Compound income (or income, on the first generation of income earned).

Attribution - Exceptions

Income Subject to Kiddie Tax

Already penalized (discussed next) so not punished again.

When FMV is paid for the property

Triggering a taxable gain on sale

Collecting CRA prescribed interest rates on a loan

Capital Gains

Only when

1) specified person was minor child.

2) sold to spouse at FMV

Attribution - Example

- Dave loans $1,000,000 to his wife, Audra, and charges no interest. The prescribed rate is 1%. Audra earns $25,000 in investment income on the loan proceeds.

- What is the impact caused by attribution?

As interest is not being charged at least at the prescribed rate (1%), FMV consideration has not been paid and attribution applies.

Audra's earnings of $25,000 will be included in Dave's taxable income and NOT in Audra's.

Attribution - Example

- Dave loans $1,000,000 to his wife, Audra, and charges 1% interest. The prescribed rate is 1%. Audra earns $25,000 in investment income on the loan proceeds.

- What is the impact caused by attribution?

As interest is being charged at least at the prescribed rate (1%), Audra's earnings of $25,000 will be included in her taxable income and she can deduct interest paid to Dave. ($25,000-$10,000 = $15,000 taxable income)

Dave must include interest received in his income $10,000.

Attribution - Example

- Dave gives a rental building to his son, Tris (age 14). The rental building earned $15,000 in net income during the year and was sold by Tris to another investor for a gain of $40,000.

- What is the impact caused by attribution?

  Dave has transferred property to a specified person (minor child). Income earned is taxed in his hands. Dave's taxable income = $15,000.

  Exception for capital gains to minors. Tris pays tax on taxable capital gains of $20,000 ($40,000 x 50%).

Attribution - Example

- Dave gives a rental building to his wife, Audra. He makes no elections. The rental building earned $15,000 in net income during the year and was sold by Audra to another investor for a gain of $40,000.
- What is the impact caused by attribution?

Dave has transferred property to a specified person (spouse). Income earned is taxed in his hands. Dave's taxable income = $15,000.

Exception for capital gains where tax paid on rollover. However, no election filed in this case, tax deferred rollover to spouse. Income attributes back to Dave.

$15,000 Rental Income + $20,000 taxable gain = $35,000 Dave's income

Attribution - Example

- Dave gifts shares in RBC to his son, Greg (age 21). The shares earned $20,000 in dividends during the year.

- What is the impact caused by attribution?

Dave's transfer was not to a specified person – Greg is an adult child.

No attribution will occur.

Attribution - Example

- Dave gifts a GIC worth $1 million to his son, James (age 12). The GIC earns interest at 2%. In year 1 James earned $20,000 and reinvested his earnings. In year 2 James earned $20,400.

- What is the impact caused by attribution in year 2?

  Dave's transfer was to a minor child – income is attributed to him.

  Compound interest does not attribute. $400 taxable to James & $20,000 taxable to Dave.

Death

That's Right… Death

- Full Stop!
  - Immediate Year End Triggered.
  - Only income from January 1 – Death of Death reported on personal tax returns.

  - If income occurs after DOD, can be reported on an Estate Return (essentially a trust)

Definitions

Executor

- The person you've chosen to look after your estate.
- They coordinate the payout of your assets, the filing of your tax returns, and go to probate court if necessary.
- They are also responsible for any financial issues that go wrong with the estate.

Will

- Sets out who is your executor
- Sets out what assets you'd like to go to whom

Definitions

Administrator

- The overseer of your estate if you die without a will (intestate)
- Without a will, your estate is distributed based on common law principles.

Probate Court

- Means to 'validate' a will in court. Must go before a judge.
- Makes public your list of assets, charges a fee on their value.

Clearance Certificate

- A certificate that says CRA is fine with all Estate filings
- Executor/Administrator cannot be held liable after getting one.

Tax Returns

- Final Return
  - Income from January 1 – Date of Death reported on a personal tax return
  - Deemed disposition of all assets occurs at FMV

- Return for Rights or Things
  - If filed, must include all rights or things due to the taxpayer at death but not yet paid (such as unpaid employment income)
  - Includes OAS, unpaid dividends, certain farming or artist inventory, WIP for professionals
  - Gets an extra set of marginal tax rates & personal tax credit

Tax Returns

- Return for a Partner or Proprietor
  - If deceased passed away after the year end of a partnership or proprietorship to which they were a part.
  - This return can report that stub period income.

Example:

Jim belongs to a law partnership that has a March 31, 2020 year end. He passes away on May 20, 2020. Income from April 1 to May 20, 2020 can be reported on the Return for a Partner.

Tax Returns

- Return for Income from a Testamentary Trust
  - If the deceased was earning income from a testamentary trust, that had a year end before the date of death.
  - This return can report the stub period income until the date of death.

Example:

Jim earns income from his mother's estate which has a March 31 year end. He passes away on May 20. Income from April 1 to May 20 can be reported on the Return for Income from a Testamentary Trust.

Year of Death – Deemed Disposition

Deemed Disposition on All Assets:

- Property deemed sold at it's FMV, less Cost or UCC.

$100,000	FMV of portfolio investments
(50,000)	Cost of portfolio investments

50,000 x 50% =

$25,000 taxable capital gain on death

Year of Death – Deemed Disposition

Deemed Disposition on All Assets:

- RRSPs, RRIFs, included in income 100%

$100,000 FMV of assets in RRSP
(50,000) Cost of assets in RRSP

$100,000 taxable income on death – why?

Withdrawals would be 100% taxable

Year of Death – Deemed Disposition

Exception from deemed disposition:

- By giving assets to a spouse OR spousal trust.
- RRSP's & RRIF's can be left to a dependent child until they reach the age of 18.
- Farm and Fishing Property can be transferred to a child, grandchild, or great grandchild living in Canada

Year of Death – Example

Sheena is doing some estate planning and wants to know how much tax will be triggered if she were to pass away. The assets listed below are outlined in her will.

Description	Cost	FMV	Beneficiary
Home	150,000	200,000	Son (Adult)
Car	500	800	Son (Adult)
Non-registered investments (A)	160,000	250,000	Husband
Non-registered investments (B)	90,000	140,000	Daughter (Adult)
RRSP	170,000	300,000	Daughter (Adult)

Consider

- What the asset is
  - Capital or full income inclusion
- Who the asset was left to
  - Spousal rollover or not
- Whether other exemptions exist.
  - Principle Residence
  - Qualified Farm Property

Retrieved November 13, 2014 from: http://rodgers-associates.com/newsletters/planning-on-leaving-your-legacy-to-your-children-make-sure-they-can-handle-it-first/

Year of Death – Example

What are the tax consequences?

Description	Cost	FMV	Beneficiary	Income
Home	150,000	200,000	Son (Adult)	$0 Principle Residence
Car	500 (deemed $1,000)	800 (deemed $1,000)	Son (Adult)	$0 Personal Use Property
Non-registered investments (A)	160,000	250,000	Husband	$0 Left to Spouse, rollover
Non-registered investments (B)	90,000	140,000	Daughter (Adult)	$25,000 taxable capital gain
RRSP	170,000	300,000	Daughter (Adult)	$300,000 full inclusion

Year of Death – Special Rules

No restriction on how much of your charitable donations you can use in the year of death (usually 75% of income)

Medical expenses can be claimed for any 24 month period ending in the year of death (instead of the ordinary 12)

Capital Losses can be applied against any income in the year of death (instead of only capital gains).

What This Means for Will Planning

<u>Consider estate intentions</u>.

- Is intent to grant equal assets to each children?
- If so, must use after tax value of each asset to calculate their estate interest.

<u>Example:</u>

Family Home worth $1,000,000

&

RRSP worth $1,000,000

Is it fair to leave one asset to each child?

What This Means for Will Planning

<u>Consider estate intentions</u>.

Retrieved November 13, 2014 from: http://www.amazon.com/SentrySafe-SFW123GDC-Cubic-Electronic-Fire-Safe/dp/B005P12C5A

- Is intent to leave assets to the children while caring for the remaining spouse while they live?
- If so, a spousal trust is likely a good option

Spousal Trust

A legal agreement:

1) The Spouse is entitled to receive all income from the assets in the trust

2) No person except the spouse is entitled to receive any income or capital from the trust while the spouse is alive

3) Property rolled to a spousal trust for the benefit of the deceased's spouse is not subject to a deemed disposition.

Other Testamentary Trusts

Generally, permits other beneficiaries such as children to have access to the income of the trust and sometimes the capital of the trust.

Deemed disposition still occurs before the trust acquires assets from the estate.