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COMMENT

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BENEFICIARY BEWARE

Every taxpayer is responsible for paying his own income tax liability when it is due. To the surprise of many, there are situations when the Canada Revenue Agency has the right to utilize an alternative remedy if individuals or their representatives fail to comply. Even more shocking for some is that individuals named as beneficiaries under an RRSP or RRIF can unwittingly become indebted to the CRA.

The death of an RRSP or RRIF annuitant creates an income inclusion for the deceased equal to the fair market value of the property held within the RRIF or RRSP. This income amount is included in the annuitant's income for the year of death, adding to other tax liabilities that may arise in the final tax return. There are some rollover situations that create exceptions to the general rule. For example, when the deceased's spouse or financially dependent children or grandchildren are named as beneficiaries, the flow of the funds can create an offsetting deduction for the deceased and eliminate the tax liability that would otherwise arise from the deemed disposition at death of the RRSP or RRIF. Through these rollover exceptions, an amount equal to the RRSP "refund of premiums" or RRIF "designated benefit" (which is essentially the value of the plan at the date of the annuitant's death) offsets the deceased's income inclusion. Funds are then taxed in the hands of beneficiaries when withdrawn from the plan.

When a beneficiary receives RRSP or RRIF funds directly under the terms of the plan, and no rollover applies, that beneficiary becomes jointly and severally liable together with the deceased for the amount of taxes owing in respect of the proceeds received. If an estate receives the proceeds directly as the beneficiary of the plan, it is the estate that is liable for the taxes owing. A beneficiary of the estate who subsequently receives funds from the estate is not jointly liable.

The estate is normally responsible for paying the deceased's tax liability including that which arises from the deemed disposition of any RRSP and RRIF assets. When there is a deficiency of funds available within the estate, a beneficiary's joint and several liability extends the CRA's reach, providing a remedy for recovering amounts owing. The CRA cannot demand all of the RRIF or RRSP proceeds, but rather the remedy is limited to the collection of taxes owed in respect of the RRIF and RRSP proceeds.

In a June 2013 decision by the Tax Court of Canada, Justice Rowe reinforced a prior court's decision with respect to how the amount owing by a beneficiary under a joint and severable liability is to be calculated. The ruling sets out the degree of exposure that arises when an estate lacks sufficient resources to fund the tax liability specifically related to the RRIF or RRSP.

In *Higgins vs. the Queen* the facts are as follows:

- Arthur Higgins passed away on February 12, 2002.
- He had a non-registered segregated fund policy valued at $10,192, with his two daughters named as beneficiaries.
- He had a RRIF of $29,272, also with his two daughters named as beneficiaries. They were not financially dependent on him.
- He had a small bank account that was used to pay for funeral expenses.
- By the time the case was heard by the court, the estate owed taxes, interest and penalties totalling approximately $18,000.

The CRA assessed each of the sisters for $5,096 in respect of the property received as beneficiaries under their father's segregated fund policy, and $6,047 each in respect to the sisters' joint and several liability for tax in respect of their father's RRIF.

In determining a beneficiary's exposure to the annuitant's income tax liability in respect of an RRSP or RRIF, Justice Rowe reconfirmed a prior court's approach that utilized a two-step calculation. The first is to calculate the deceased's tax liability on his final tax return without the RRSP or RRIF proceeds reflected in the income calculation. Then, the tax liability is recalculated with the inclusion of the RRSP or RRIF proceeds. The difference between the income

tax liabilities arising under each scenario becomes the beneficiary's exposure under the joint and several liability provision for income taxes. In this case, the CRA was ordered to re-assess the two daughters' shared liability.

There remained the issue of the daughters' liability pursuant to their status as beneficiaries of the segregated fund. The judge undertook an extensive review of the word "transfer" and implications in respect of beneficiary designations under insurance policies. The bottom line of the judge's review is that the CRA could not assess the daughters for their father's income tax liability in respect of the funds they received as designated beneficiaries under the segregated fund policy. The funds received were considered life insurance proceeds payable to a named beneficiary and did not form part of the father's estate.

Very few people like to pay taxes, and even fewer people want to pay someone else's. Beneficiaries should be aware of the CRA's ability to collect taxes, particularly when the funds flow directly through a RRIF or RRSP beneficiary designation.

I/R 5401.06 and .07; 7401.00

CHANGING CIRCUMSTANCES

Many times a property is bought for one use, but the owner may later decide to put it to another use. This is often the case with a house: as the family's circumstances change, the use of the home may also change. For example, a family home may be rented out during a long-distance work assignment. A partial change might also occur. For example, new homeowners may rent out part of their basement to help cover the mortgage in the early years, and may later reclaim that basement space for personal use.

The general tax rule is that a change in use triggers a deemed disposition, in which case the property owner must report any resulting capital gain or loss on his or her income tax return in the year of the change. Of course, a capital gain on the disposition could be reduced by any available principal residence exemption. A change in use can be complete or partial.

There are exceptions to the general deemed disposition rule. The first exception allows the taxpayer to elect to defer the deemed disposition when changing from a principal residence to another use. This is achieved by preparing a signed letter in which the taxpayer clearly requests the election. The letter is submitted to the Canada Revenue Agency by filing it with the taxpayer's income tax return for the year in which the change in use has taken place. If the taxpayer uses e-filing, the request must be separately paper filed. The election is not available if there is only a partial change in use.

This election to defer is only available provided the taxpayer does not claim depreciation/capital cost allowance (CCA) during the time the property is used for income-producing purposes. Should the taxpayer decide to claim CCA on the property, it will cause the election to be rescinded on the first day of the year in which the CCA claim is made. Alternatively, should the taxpayer rescind the election in one of the subsequent years, a deemed disposition of the property on the first day of that subsequent year and immediate tax consequences would occur.

During the time that the election remains in effect, the property will continue to qualify as the taxpayer's principal residence for up to four years, even if the taxpayer or his or her family does not reside in the home. However, the taxpayer must continue to be a resident of Canada for tax purposes.

Rather than file the election to defer the gain resulting from the deemed disposition, the taxpayer could choose to report the gain and offset it by claiming any available principal residence exemption.

Consider the following example:

- Home bought in 2001 for $500,000 and used as a principal residence
- Change in use in 2005 to a rental property when the home was worth $600,000.A letter was filed with the 2005 tax return requesting a deferral of the deemed disposition.
- Home sold in 2014 when the home was worth $800,000.

The homeowners could recognize the deemed disposition in 2005 and report the resulting capital gain of $100,000 on their tax returns. They could claim the principal residence exemption and offset the income tax consequences of recognizing the capital gain.

The homeowners could elect to defer the gain in 2005 and wait until the year of disposition to report any resulting gain. In 2014 they would report a capital gain

of $300,000. The principal residence exemption could be applied to the years 2001 to 2009 for a total of nine years out of 14 years of ownership. The formula produces a principal residence exemption of approximately $214,300, derived as 10[1] ÷ 14[2] x $300,000. The couple would have a net income inclusion of $42,850 ($300,000 capital gain less $214,300 principal residence exemption x the capital gains inclusion rate of 50%). Notes: (1) 9+1 years of principal residence designation; (2) 14 years of ownership.

The second exception to the deemed disposition rule is when there is a change from a rental property to a principal residence. The taxpayer can elect to defer the gain, but only if no capital cost allowance has been claimed on the property that is being changed over from a rental to personal use property.

It should be noted that these deemed disposition rules can change the adjusted cost base of the property. This could have a big impact if the property is offshore, because the new adjusted cost base may exceed the $100,000 foreign property reporting threshold for the taxpayer.

As life changes, one's plans can change too. It is important to recognize what reporting has to be done from an income tax perspective, and equally important to know what options may be available.

I/R 7401.00

UNDOING WHAT'S BEEN DONE

The term rectification comes from the word "rectify," which has its roots in Medieval Latin and means "make right." Rectification is used by parties to a contract to modify the contract if there has been an obvious mistake that was not intended or the meeting of the minds was improperly documented. The courts have used the general principle that rectification is for the purpose of restoring a transaction to its original purpose.

Rectification is also being used in income tax situations to "correct" a mistake that has occurred. There has been a significant amount of jurisprudence in the area over the last several years, which has fined-tuned the legal principles involved from a tax perspective.

In order to be successful in rectifying a past transaction, the taxpayer must be able to prove in court that the objectives of the transaction were not satisfied because of the structure of the transaction.

Let's look at an example. One objective of a transaction could be to minimize the immediate income tax consequences. If the transaction were structured in such a way as to frustrate tax minimization, then the taxpayer could potentially go to court and request a rectification order to change the transaction.

> A shareholder transferred his operating company shares into a holding company, taking back a promissory note equal to $800,000 and common shares for the remainder of the value. One of the objectives was to set up a holding company, and another was to minimize any immediate income tax consequences. However, the $800,000 promissory note triggered an anti-avoidance measure, creating a deemed dividend. Rectification was granted in such a situation, and the promissory note was re-characterized into preferred shares.

The courts will need to see clear evidence as to the original intentions of the parties at the time of the transaction. Evidence that the parties would have done the transaction differently had they known about the income tax consequences will be considered irrelevant by the courts. Consider the following example:

> The transfer of a piece of land between related parties was completed on a tax deferred basis. However, subsequent to the transfer it became apparent that the transfer was subject to provincial land transfer tax. The rectification order in this situation was denied.

Rectification is available to avoid a tax disadvantage, which the parties had originally transacted to avoid; however, it is not available to avoid an unintended tax disadvantage, which the parties had not anticipated at the time of the transaction. Rectification is not intended as a cure for all that goes wrong in a transaction. That said, proper planning should involve clearly documenting the objectives of every transaction to ensure evidence could be produced in the future should the need arise.

I/R 2101.00

MEDICAL TAX SAVINGS

The medical expense tax credit provides financial relief for individuals who have incurred significant medical expenses for themselves and/or certain of their dependants. This tax credit is a non-refundable credit that reduces an individual's income tax liability.

The formula for the medical credit is comprised of two components:

- **Part one**: Medical expenses in respect of the taxpayer, the taxpayer's spouse or common-law partner, and their children under the age of 18.
- **Part two**: Medical expenses related to certain non-arm's-length individuals who are dependent on the taxpayer.

In part one the federal medical expense tax credit is 15 percent of the amount of the medical expenses in excess of the lesser of $2,152 (2013 figure) and three per cent of the individual's net income. The formula works to create a minimum threshold below which the legislators consider expenses to be normal expenses that should be paid out-of–pocket, without tax assistance.

In part two of the calculation, the medical expenses of the taxpayer's other dependants can be accumulated and reflected in the overall formula. This is a valuable and often missed opportunity where the definition of dependant is more far-reaching than anywhere else in the Income Tax Act. Dependants for this credit include the children of the taxpayer and taxpayer's spouse who are over the age of 18, parents, grandparents, aunts, uncles, nieces or nephews. Dependency is based on the facts of the situation but the CRA will look for evidence that the taxpayer is providing the dependant with the basic necessities of life such as food, shelter and clothing, on a regular and consistent basis. The breadth of this opportunity should not be overlooked. Seldom do we see the recognition of a dependant relationship to such a great extent.

The federal medical expense tax credit for this second phase is 15 per cent of the amount of the medical expenses in excess of the lesser of $2,152 (2013 figure), and three per cent of the dependant's net income. This second calculation is completed for each dependant, with medical expenses being claimed by the taxpayer.

Parts one and two of the calculation are added together, with the total applied as a reduction to the taxpayer's federal income tax liability.

Eligible medical expenses can be incurred in any 12-month period ending in the taxation year. By tracking expenses chronologically, taxpayers may alter the choice of the 12-month period in order to optimize the value of the credit. If, for example, total expenses incurred for the period November 2013 to October 2014 exceed the expenses for the period January 2014 to December 2014, the taxpayer has the ability to select the period that provides the most advantageous outcome. Provided the period ends in 2014 and the expenses have not been claimed for 2013, it is up to the taxpayer to optimize the strategy.

The federal medical expense tax credit is meant to provide tax assistance and, with careful planning, taxpayers can structure the claim in a way to maximize the outcome. Similar amounts may be claimed on provincial and territorial income tax returns.

I/R 7401.00

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