Proposed amendments to the INCOME TAX ACT
- opportunities and pitfalls

BY SONJA CHONG

On December 21, 1992, the Minister of Finance of Canada proposed significant amendments to the rules in the Canadian Income Tax Act affecting immigrants and emigrants. Once passed, the rules will become effective from January 1, 1993. The new proposals would have wider application, and likely afford greater opportunities for creative tax planning. This article focuses on a number of the major changes, through a simple case study.

Existing rules

Section 48 of the Act contains rules that affect individuals departing from and entering Canada. On arrival, section 48 will deem an immigrant to acquire, at fair market value, all *capital* property he or she holds at that time, with the exception of certain property called taxable Canadian property (described later).

On departure, Canada will deem the emigrant to have sold all of his or her *capital* property (with certain exceptions including taxable Canadian property) at fair market value immediately before leaving. Currently, these step-up and deemed disposition rules only apply for purposes of computing capital gains and losses of capital property.

Taxable Canadian property includes such things as real estate situated in Canada, shares of Canadian private companies, and capital properties used in carrying on a business in Canada. Canada always retains the right to tax gains from the sale of taxable Canadian property, regardless of the residency status of the vendor. Hence, its exclusion from the applications of section 48.

Proposed amendments

Proposed new section 128.1 of the Act will allow all property (except for taxable Canadian property, inventory and goodwill of Canadian businesses) to be revalued at fair market value on arrival and to be potentially subject to the deemed disposition rules upon leaving Canada. This will now encompass accrued gains in inventory and goodwill of a foreign business as well as depreciation claims.

As it is not always possible to analyze all the tax changes in an article of this length, a case study is used to illustrate the effect of these rules on a new immigrant from Hong Kong.

A case study

Consider the following scenario. Mr Wong and his family will become residents of Canada on December 1, 1993. Shortly before arrival, he would gift a sizeable public company stock portfolio to a trust established in Guernsey ("non-resident trust") for the benefit of his family. Any income or gains realized by the non-resident trust would not be subject to Canadian tax for the first 60 months of Mr Wong's residency in Canada.

Mr Wong bought a rental property in Hong Kong in 1983 for C$500,000. It is estimated to be worth C$1.5 million in December, 1993. Mr Wong also has a jewellery business in Hong Kong. The major assets of the business are its inventory and goodwill.

Mr Wong wants to know how the proposed amendments will affect him upon arrival, and also in the event of him leaving Canada. He plans to stay in Canada for more than five years.

Let's examine the Canadian tax "lifecycle" for Mr Wong. In arriving at the net rental income from the Hong Kong rental property, Mr Wong could deduct depreciation for Canadian tax purposes. Under the existing rules, depreciation would be calculated based on the historical cost of the property, which is C$500,000. Under the proposed rules, depreciation would be calculated based on the fair market value of the property on arrival (ie C$1.5 million). This represents a significant benefit to Mr Wong.

The proposed amendments will allow Mr Wong to revalue the assets of his jewellery business. Any resulting capital gains or losses would be computed based on the value on arrival (not historical cost). The business therefore should be valued.

As discussed earlier, the non-resident trust would lose its tax-exempt status once Mr Wong has lived in Canada for 60 months. One creative approach which extends the benefit of the trust is to replace its non-resident trustees with Canadian residents. This must be done before 1998, otherwise the trust would be taxable for the entire 1998 year. Upon becoming resident in Canada, the trust will be deemed to have acquired the stock portfolio at the fair market value. The trust could then distribute the stock portfolio, on a tax-free basis, to its resident beneficiaries. Any gains on subsequent sales of the stock portfolio would be reduced accordingly.

In conjunction with the changes described earlier, under proposed subsection 128.1 (1) (a), a trust that becomes resident in Canada will, for the first time, be deemed to have a taxation year ending immediately before that time. Because of this new rule, the trust now has until November 30, 1998 to become resident in Canada. In situations where the trust assets would appreciate in value, this proposed rule can be of significant benefit in that there would be an additional 11 months (between January, 1998 and November, 1998) of appreciation in value, and accumulation of income, that would be free from Canadian tax.

To conclude, the proposed technical amendments regarding immigrants and emigrants cast a wider net than previously. But the good news is that the new rules offer more tax planning opportunities. ◆

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