Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Unwinding the deemed disposition for returning Canadian residents

Special tax election creates tax-deferral resulting in possible tax savings

If you moved back to Canada this year and still own property that was subject to the Canadian "deemed disposition" tax rules in the year you moved away, there is a special tax election you can file. The tax election unwinds the deemed disposition that triggers unrealized capital gains on the property. The result is a tax-deferral of the income tax paid on the unrealized capital gains on the property, and the possibility of a lower tax liability when the property is actually sold.

This article explains:

- The deemed disposition tax rules that apply to property you own when you move from Canada;
- The deemed disposition and reacquisition tax rules that apply to property you own when you move to Canada; and
- The special election you can file to unwind the tax liability on a deemed disposition when you return to Canada.

The information in this article is not intended to provide legal or tax advice. The strategy outlined may not apply to your particular financial circumstances. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax advisor before acting on any of the information in this article.

When you move from Canada

When you move from Canada, you may be subject to the **deemed disposition** tax rules. These rules will cause you to realize accrued capital gains and losses on certain property you own as if you sold the property for proceeds equal to the fair market value (FMV) of the property on the date you cease Canadian residency.

Certain types of property are exempt from the deemed disposition rules, such as property you hold in registered accounts (e.g. RRSPs, RRIFs, TFSAs), employee security options subject to Canadian tax and life insurance policies. Taxable Canadian property (TCP), such as real estate located in Canada, is also exempt unless you elect to have the deemed disposition tax rules apply.

You may defer paying your Canadian tax liability resulting from the deemed disposition by providing adequate security to the Canada Revenue Agency (CRA).

When you move to Canada

When you move to Canada, you may be subject to the deemed disposition and reacquisition tax rules. These rules deem you to have disposed of and reacquired certain property you own for proceeds equal to its FMV immediately on the date you become a Canadian resident. The rules do not trigger Canadian tax. Instead they establish the adjusted cost base (ACB) of your property for Canadian tax purposes. The ACB of your property is therefore, the FMV of your property on the date you establish Canadian residency. Property that would be exempt from the deemed disposition and reacquisition tax rules is the same types of property that would be exempt from the deemed disposition tax rules (discussed earlier) when a resident of Canada moves from Canada to another country.

The deemed disposition and reacquisition tax rules ensure that any unrealized gains on the property that accrued during the period of non-residency in Canada is not taxable in Canada. Accordingly, any unrealized losses on the property that accrued during this period cannot be deducted in Canada.

Election to unwind the deemed disposition

A special tax election to unwind the deemed disposition is available if you return to Canada. To qualify, you had to have ceased Canadian residency after October 1, 1996 and still own the property that was subject to the deemed disposition tax rules when you moved from Canada.

The election is applied on a property by property basis. If you make the election for TCP, you can choose to reduce the capital gain reported on your Canadian tax return for

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the year you moved by an amount you specify, up to the amount of the capital gain you elected to report.

For property other than TCP, the election reduces both the deemed proceeds of disposition (POD) of the property on the date you ceased Canadian residency, and the deemed ACB of the property on the date you re-establish it. The amount of the reduction is calculated as the least of:

a) The unrealized capital gain of the property that accrued up to the time you moved from Canada (i.e. the capital gain reported on the deemed disposition)

b) The fair market value of the property on the date you return to Canada; and

c) An amount you specify that is not greater than the lesser of a) and b)

The election effectively unwinds the deemed disposition that was triggered when you leave Canada, potentially resulting in a refund of the Canadian tax you previously paid. Therefore, the Canadian tax refunded on the unrealized gains accrued on your property before your move is deferred until the property is actually sold. In addition, if your marginal tax rate in the year the property is sold is lower than it was when you moved from Canada, you will incur less Canadian tax on the eventual sale of the property. If your marginal tax rate is higher in the year the property is sold, you will pay more tax.

Numerical example 1

Gary ceased Canadian residency on May 9, Year 1. He owned 1,000 units of XYZ mutual fund in his non-registered account. The ACB is $15,000 and the FMV is $25,000 so he has an unrealized capital gain of $10,000. Gary's marginal tax rate in Year 1 is 40% and the capital gains inclusion rate is 50%.

Gary files a Canadian part-year income tax return in Year 1. He is deemed to dispose the XYZ mutual funds he owns for deemed proceeds of $25,000. This will trigger tax on the unrealized capital gain of $10,000 ($25,000 FMV – $15,000

ACB) in Year 1. He incurs a $2,000 Canadian income tax liability on the capital gain reported (i.e. $10,000 net capital gain x 50% inclusion rate x 40% marginal tax rate = $2,000).

A few years later on February 24, Year 4, Gary returns to Canada and establishes Canadian residency. He still owns the XYZ mutual fund units. The FMV immediately before his Canadian residency is $80,000.

If the special tax election is not filed, the deemed ACB of XYZ for Canadian tax purposes is $80,000 under the deemed disposition and reacquisition tax rules. If the election is filed, he can reduce the deemed proceeds he reported in Year 1 and the deemed ACB in Year 4 by the amount calculated to be least of the following:

a) The unrealized capital gain on the property accrued up until he moves from Canada (i.e. $10,000)

b) The FMV of the property on the date Gary returns to Canada (i.e. $80,000)

c) A lesser amount he can specify that is no greater than the lesser of a) and b) (i.e. an amount not greater than $10,000)

Since Gary did not specify an amount for c), the reduction amount, which is the least of a), b) and c) is $10,000.

This table illustrates Gary's tax situation depending on whether he makes the tax election.

	Without election	With election
Deemed POD (XYZ mutual fund) in Year 1	$25,000	$15,000 (A)
ACB in Year 1	$15,000	$15,000
Capital gain in Year 1	$10,000	$0
Taxes payable in Year 1	$2,000	$0
Deemed ACB upon return to Canada in Year 4	$80,000	$70,000 (B)

(A) $25,000 – $10,000 (lesser of $10,000 or $80,000) = $15,000

(B) $80,000 – $10,000 = $70,000

If the election is filed, the unrealized capital gain that was taxed in Year 1 is revised from $10,000 to nil. Gary is entitled to a refund of the $2,000 in taxes paid in Year 1. The ACB of XYZ in Year 4 is adjusted due to the $10,000 reduction. Therefore, instead of an $80,000 deemed ACB upon returning to Canada, the ACB of XYZ mutual fund is $70,000. This creates a deferral of the taxation of the unrealized capital gain of $10,000 that is triggered by the deemed disposition tax rules. If Gary later sells the mutual funds, this deferred capital gain will be taxable. Depending on his marginal tax rate at the time of sale, he may pay more or less than $2,000 of tax on the gain.

Numerical example 2

There may be circumstances where it may make sense for Gary to specify an amount below $10,000 for c) in the calculation of the reduction. Assuming the same facts as example 1, in Year 1 Gary also sold units of ABC mutual fund before his move from Canada and triggered a capital loss of $7,000.

In Year 1, Gary is taxed on a net capital gain of $3,000 (i.e. $10,000 unrealized capital gain on the XYZ mutual fund realized on the deemed disposition on his move from Canada less the $7,000 capital loss from the sale of ABC mutual fund).

When he moves to Canada in Year 4, Gary makes the election and specifies $3,000 as the amount for c). The reduction amount is $3,000, which is the least amount of a), b) and c). Therefore, the deemed POD for XYZ mutual fund is reduced by $3,000 resulting in a revised deemed POD of $22,000 and tax on an unrealized capital gain of $7,000. This capital gain is offset by the $7,000 capital loss on the ABC mutual fund. Gary must also decrease the deemed ACB of XYZ mutual fund in Year 4 by $3,000. The revised deemed ACB of XYZ would be $80,000 less $3,000 (or $77,000).

This table illustrates Gary's tax situation depending on whether he specifies an amount for the election.

	Without election	With election
Deemed POD (XYZ mutual fund) in Year 1	$15,000	$22,000 (C)
ACB in Year 1	$15,000	$15,000
Capital gain in Year 1	$0	$0 (D)
Taxes payable in Year 1	$0	$0
Deemed ACB upon return to Canada in Year 4	$70,000	$77,000 (E)

(C) $25,000 – $3,000 (elected amount under c)) = $22,000

(D) $7,000 - $7,000 = $0, the capital gain is offset by the capital loss realized on the sale of ABC mutual fund in Year 1

(E) $80,000 - $3,000 = $77,000 (A) $25,000 – $10,000 (lesser of $10,000 or $80,000) = $15,000

Previously deferred tax

If Gary posted security with the CRA to defer paying tax on the deemed disposition of XYZ mutual funds, when he moved from Canada, he will receive some or all of the security back if he makes the tax election. If he does not make the election, he may now have to pay the deferred tax.

Filing requirements

There is no prescribed form issued by the CRA to make the special election. The election is made by sending the CRA a request in writing (a letter). The election must be filed on or before your tax filing-due date for the year you re-establish Canadian residency for tax purposes.

The letter must include:

- A list of the properties and their FMV you want to file the election for;
- The taxation year in which the deemed disposition occurred and the actual date you ceased Canadian residency;
- A statement that you are making an election under section 128.1(6)(c) of the Income Tax Act with respect to property you owned throughout the period you were a non-resident of Canada that was at the time of emigration subject to a deemed acquisition; and
- The revised deemed POD for the year of departure, the revised ACB, and the date that Canadian residency was re-established.

It is possible for the CRA to accept a late filed election. If your income tax filing due date has passed, speak with a qualified tax advisor for assistance with filing a late election.

Evaluate your options

If you moved back to Canada with property that was subject to the deemed disposition tax rules when you moved from Canada, you should evaluate the potential benefits of filing a special tax election to unwind the tax implications. This strategy may create a tax deferral and may result in the potential for tax savings when the property is eventually sold. As with any tax strategy, make sure you consult with a qualified tax professional before taking action.

Wealth Management

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