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PRINCIPAL AND COTTAGE RESIDENCE PLANNING
A REVIEW OF SELECTED ISSUES - PART I

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Introduction

For some members of the public their first introduction to the taxation of so called "principal residences" under the *Income Tax Act* (Canada)[1] may be a rather unpleasant one. Despite popular understandings of the issue, the proceeds derived from the sale of one's primary residence are not simply received as of right "tax free" and unfortunately increasingly many Canadian taxpayers are learning this the hard way. Recent media coverage of the efforts of the Canada Revenue Agency (the "CRA") to investigate the sale of condominium units in Canada's largest cities has heightened the public's awareness that what is often viewed as one of the few ways to pocket large sums of money tax free, may not be so tax free.[2] However, the issues surrounding the taxation of principal residences are not limited to "condo flips". In fact, the taxation of principal residences and cottage residences abounds with complexities and issues for which there often are no perfect answers. Therefore, it falls on tax advisers to wade through the complex regime governing the taxation of residences (be they a principal residence or a secondary residence) and to provide their clients with ways of achieving their desired outcomes without triggering adverse tax consequences. This is often a harder task than it might seem.

This paper aims to highlight some of the complexities surrounding the taxation of principal and cottage residences under the Tax Act by taking somewhat of a potpourri approach. In particular, this paper will employ a case study to illustrate some of the complexities arising from the use of *inter vivos* trusts to hold cottage residences. In addition, this paper will discuss some of the non-income tax issues to be considered when establishing an *inter vivos* trust as well as a few alternatives to the *inter vivos* trust. The paper will then provide an overview of the recent *Cassidy* case[3] which clarified the computation of the principal residence exemption as it relates to "excess land", and finally this paper will consider the issue of ownership in the context of the sale of condominium units when the sale occurs during the occupancy period prior to the transfer of actual legal title. This paper is not a comprehensive review of the tax regime governing principal and cottage residences and it is beyond the scope of this paper to achieve this[4]; however it is our hope that this paper will provide tax practitioners with some resources to address some of the complexities that we ourselves have dealt with in our practice in these past few years.

The Use of Trusts to Hold Principal or Cottage Residences: A Case Study

One might ask why a taxpayer would want to hold a residence through an *inter vivos* trust. In fact there are many situations which might call for this very solution. In addition, to avoiding the estate administration tax[5], the use of an *inter vivos* trust may be helpful in administering a property such as a cottage where many generations of a family intend to use the property. A trust can also be a way to administer a property where the owner is no longer mentally or physically capable. In order to illustrate the complexities of the taxation of a personal residence owned by an *inter vivos* trust, we have developed a simple case study which is detailed below.

The Widower and His Cottage

Mr. Smith is a seventy-five year old widower. His spouse died a short while ago. Mr. and Mrs. Smith owned a residence in Aurora, Ontario and a cottage on Georgian Bay; both of which were acquired after 1982. Mr. Smith held both residences as personal use property[6] and as a joint tenant by right of survivorship with his wife. Upon the death of Mrs. Smith, Mr. Smith acquired the property pursuant to subsection 70(6) (the spousal roll-over on death provision) on a tax deferred basis. Mr. Smith currently resides in the Aurora residence; however, if Mr. Smith's health declines further he may have to move into a retirement residence or a nursing home. Mr. Smith has four children all of whom are adults and resident in Canada. No one is a U.S. Person under applicable U.S. tax law.

Mr. Smith has read about the use of trusts to hold cottage property in the media and has asked his advisers whether it would be desirable to employ such a strategy with respect to his cottage. Mr. Smith may need to rent out the property in order to pay for the cost of staying in a nursing or retirement home. Alternatively, if he is healthy enough he may continue to use it. His children and their families have used the cottage at various times in the summer. He wishes that they would be able to continue to use the property. Mr. Smith is also interested in minimizing any tax liability that might arise as a consequence of his death.

The Options

Mr. Smith has requested that his tax advisers consider the use of a trust to hold his cottage. However, his advisers believe that there are other options which may meet Mr. Smith's needs. Mr. Smith has identified several goals including: being able to use the cottage himself, if healthy, allowing his children and grandchildren to use the property, to minimize his taxes on death with respect to the cottage, and to facilitate the management of the cottage.

There are several tools which might assist Mr. Smith in achieving his desired objectives which includes tax and non-tax objectives. One option, the one raised by Mr. Smith, is the use of a trust. Another option would be to combine the use of a continuing power of attorney for property in order to manage the cottage with another method to minimize estate administration tax. Another alternative might be for Mr. Smith to gift the cottage to his children and enter into a long-term lease for nominal rent combined with a continuing power of attorney for property.

First, the use of a trust will be considered in detail, and then alternatives to the trust will be briefly reviewed. Once the options are explained it will be up to Mr. Smith to decide which of these choices best achieves his objectives.

Use of a Trust

Mr. Smith has indicated that he would like to consider the use of a trust in his planning related to his cottage on Georgian Bay. There are many issues which need to be considered. First the non-tax issues surrounding the use of an *inter vivos* trust will be examined and then in turn the tax issues.

The Terms of the Trust and Non-Tax Issues

Trust Law Issues

The terms of the trust as set out in its constating document[7] and applicable law govern the operation of the trust during its existence. It is beyond the scope of this paper to delve into the complex law of trusts; however, it would be helpful to provide a simplistic overview of trust law. Tax practitioners are aware that for tax purposes a trust is, in respect of trust property, deemed to be an individual. However, for legal purposes a trust is simply a legal relationship whereby certain persons (trustees) hold assets for the benefit of other persons (beneficiaries).[8] Trustees are fiduciaries[9] and thus the responsibilities exercised by trustees should not be taken lightly as actions taken by the trustees can result in personal liability. The terms of the trust will provide for who the trustees are, whether additional trustees can be appointed and whether existing trustees can be removed, and by whom these powers are to be exercised. The trust deed must also provide for beneficiaries and address the distribution of income and capital while the trust is in existence and at the time of termination.

Given Mr. Smith's situation, it is likely that he would desire an equal distribution of the assets of the trust among his children and the trust document should see that these wishes are implemented. The trust document can also serve as a management tool. For example, a trust can provide rules governing the use of the cottage, as well as the payment of expenses and the operation of the property (including the compensation of the trustees).

Family Law Issues

A trust can also help protect the cottage from Family Law Act[10] claims in certain circumstances. In general terms, the FLA provides for the equalization of "net family property"[11] on the divorce and separation of a married couple. The FLA also provides for the equalization of net family property at the time when the first spouse to die passes away. Certain property is excluded from "net family property" including the following:

(a) Property, other than a matrimonial home, that was acquired by gift or inheritance from a third person after the date of the marriage.

(b) Income from property referred to in paragraph (a), if the donor or testator has expressly stated that it is to be excluded from the spouse's net family property.

(c) Property, other than a matrimonial home, into which property referred to in paragraph (a) and (b) can be traced.[12]

Whether an interest in a trust or property distributed or derived from a trust is included or excluded in "net family property" depends on the facts of the case. The following excerpt summarizes the issue:

> where a trust interest is established prior to marriage, the value of the interest at the marriage date is deducted and the value of the interest at the date of separation is included in the calculation of net family property. However, where a trust interest is established during the marriage, the value of the interest is excluded in calculating net family property, assuming the interest otherwise qualifies as excluded property under the definition in s. 4(2). Similarly, where there is a distribution from a trust where the party's interest was established prior to marriage, the value of the distribution during the marriage which still exists at the date of the separation is included. The value of the trust interest, as at the date of marriage, will be deducted. However, where there is a distribution from a trust where the party's interest was only established after the date of marriage, the value of the distribution will excluded from the party's net family property, assuming it otherwise qualifies as excluded property under the definition in s. 4(2).[13]

It is standard practice to include appropriate wording in the trust deed to try to ensure that to the maximum extent possible property arising or derived from a trust remains excluded from the "net family property" of any of the beneficiaries. Furthermore, provisions can be inserted into the trust allowing the trustees to remove any unmarried beneficiary if the beneficiary does not enter into a marriage contract, in respect of the trust property.

Land Transfer Tax

It should be noted in passing that as the conveyance of the cottage by Mr. Smith to the trustees of the trust will be for no consideration, land transfer tax should not be exigible on registration of the deed of land effecting the conveyance[14]: that is to say the transfer of the cottage to the trust will not trigger land transfer tax.

Choice of Trust: *Alter Ego* or "Ordinary" *Inter Vivos*

Once, Mr. Smith's tax advisers have decided upon the use of a trust, the next decision that needs to be addressed is what type of *inter vivos* trust will be employed to hold the cottage. The ordinary rule with respect of the transfer of ownership to a trust for no consideration is that such a transfer constitutes a disposition for the purposes of the Tax Act[15] at fair market value.[16] However, pursuant to subsection 73(1) property may transferred by a Canadian resident individual (other than a trust) on a tax deferred basis to a trust that is resident in Canada if the circumstances to which the rules in subsection 73(1.01) apply.

Subparagraph 73(1.01)(c)(ii) provides generally that 73(1) applies to a transfer of property to a trust by an individual where the individual is entitled to receive all of the income of the trust that arises before the individual's death and no person except the individual may, before the individual's death, receive or otherwise obtain the use of any of the income or capital of the trust. In addition, pursuant to paragraphs 73(1.02)(a) and (b) such a transfer must occur only with respect to a transfer to a trust created after 1999 and where the individual has attained the age of 65 at the time the trust was created. A trust which complies with the foregoing requirements is referred to as an *alter ego* trust[17], provided that the trust does not make the election under subparagraph 104(4)(a)(ii.1).

One alternative to an *alter ego* trust would be to create an *inter vivos* (referred to herein as an "ordinary *inter vivos* trust") that does not meet the requirements to be an *alter ego* trust to hold the property and whose beneficiaries would be Mr. Smith and family members. Such a trust would not qualify for the deferral pursuant to subsection 73(1.01) but would not require the restrictions on who may access the income and capital of the trust and would not require the transferor to be 65 years or older.

The other alternative to an *alter ego* trust would be a so called "self-benefit trust". Like the *alter ego* trust the self-benefit trust provides for rollover treatment under the Tax Act[18] however, although the restrictions on age are removed there are several other limitations imposed pursuant to paragraph 73(1.02)(b)(ii). A self-benefit trust for Mr. Smith would need to meet the requirements as set out in subparagraphs 73(1.01)(c)(ii) and 73(1.02)(b)(ii).

Subparagraph 73(1.01)(c)(ii) (which also applies to *alter ego* trusts) provides that the trust must have been created after 1999, the trust must have been created during the lifetime of the settlor, the settlor must be entitled to receive all the income of the trust that arises before the settlor's death, and no person other than the settlor may receive or otherwise obtain the use of any of the income or capital of the trust before the settlor's death. Paragraph 73(1.02)(b)(ii) (which is

unique to self-benefit trusts) requires that no change in beneficial ownership of the property occur at the time of the transfer of the property to the trust and or at any time thereafter.[19]

The restrictions contained in paragraph 73(1.02)(b)(ii) will prevent any contingent beneficiary being named in the trust document. Unfortunately, this will generally result in the trust assets reverting to Mr. Smith at his death. This would seem to preclude the use of a self-benefit trust for probate tax planning, among other complications. As such the use of a self-benefit trust is not recommended for Mr. Smith.

Thus, Mr. Smith's tax advisers are left with the choice of either an ordinary *inter vivos* trust for which no rollover treatment is available under the Tax Act or a trust which will qualify as an *alter ego* trust. This choice will require consideration of whether the principal residence exemption can and should be claimed. A transfer to an ordinary *inter vivos* trust will trigger tax on the accrued gain on the cottage which will either have to be paid or the principal residence exemption will need to be employed. As such the tax advisers will need to weigh the advantages of an ordinary *inter vivos* trust against the immediate tax consequences including whether claiming the principal residence exemption will optimize the tax savings for Mr. Smith in light of the fact that he also owns a residence in Aurora which may be worth more than his cottage.

Regardless of the type of *inter vivos* trust selected, the trust should be resident in Canada for the purposes of the Tax Act.

An *Alter Ego* Trust

Given Mr. Smith's circumstances, the choice of an *alter ego* trust may seem to be the most logical given that the Tax Act provides for a roll-over upon transfer of the cottage to the trust and as such it will not be necessary to use the principal residence exemption to shelter the gain. The exemption will then be available to shelter the gain on the Aurora residence. An *alter ego* trust will not be advisable if Mr. Smith were to elect not to have subsection 73(1) apply.

However, this alternative presents its own difficulties. The first is that Mr. Smith wishes to allow his family members to use his cottage. This desire may run afoul of the requirements concerning the use of income and capital contained in the rollover provisions pursuant to subsection 73(1.01). The second issue relates to the potential renting of the cottage to Mr. Smith's family members and to third parties and the potential change in use this might trigger. Thirdly, there are issues surrounding the claiming of the principal residence exemption by the trust when Mr. Smith passes away.

Ensuring subsection 75(2) does not apply to the transfer

It should be noted in passing that as with any transfer to a trust, subsection 75(2) could potentially apply and Mr. Smith's tax advisers would most likely prefer that 75(2) should not apply to Mr. Smith's *alter ego* trust as this could result in adverse tax consequences to Mr. Smith.[20] It is beyond the scope of this paper to address subsection 75(2) but careful consideration should be given to the terms of the trust to ensure that subsection 75(2) is not applicable. In

particular, it may be advisable that Mr. Smith not be a trustee, and the trust deed must provide that the cottage and any substituted property cannot revert (be returned) to Mr. Smith.

Tax issue one: allowing Mr. Smith's family to use the cottage

As noted earlier, the rollover rule contained in subsection 73(1.01) which allows for a tax deferred transfer of property to a trust requires that Mr. Smith be entitled to receive all the income that arises before his death and that no person except Mr. Smith receive or otherwise obtain the use of the income or capital of the trust before his death. Mr. Smith wishes to allow his family members the use of his cottage. However, this use might jeopardize the tax-deferred transfer of the cottage to the trust since that use by his family members could potentially constitute use of the capital of the trust by someone other than Mr. Smith. In addition, because the trust document will contain the restrictions in subparagraph 73(1.01)(c)(ii), any such use of the cottage by Mr. Smith's family members could also constitute a breach of trust by the trustees.

There is very little guidance on this matter beyond the language of subsection 73(1.01). However, the CRA has stated in IT-305R4 (which deals with spouse trusts to which similar rules concerning the use of income and capital apply) that,

> In interpreting that the requirement that no person except the spouse may, before the spouse's death, receive or otherwise obtain the use of any of the income or capital of the trust, the renting of real estate at market value or the lending of money on commercial terms, does not generally mean that the person renting the real estate or borrowing the money has received or has the use of that property as the term is used in this requirement.[21]

This statement seems to imply that the payment of market rent by Mr. Smith's four children and grandchildren might avoid any issue surrounding Mr. Smith's entitlement to the use of all the income and capital of the trust. However, this in turn presents its own problems, as the charging of rent by Mr. Smith may, if Mr. Smith is not using the cottage himself, result in a change of use.

With respect to the breach of trust issue, the trustees of Mr. Smith's *alter ego* trust could face litigation from an aggrieved beneficiary, in this case likely Mr. Smith or a beneficiary who believes that he or she is not being treated fairly.

Finally, it is possible that pursuant to subsection 105(1) the use of the cottage by Mr. Smith's family members may constitute a taxable benefit to them.[22] The CRA has an administrative position that the use by a beneficiary (or a person related thereto) of personal-use property (including real property) owned a trust will not constitute a benefit within the meaning of subsection 105(1).[23] However, it is unclear whether this administrative position will be extended to the case of an *alter ego* trust where another provision of the Tax Act possibly has the effect of limiting such use.

Tax issue two: charging rent and change of use rules: the 45(2) election

The trustees may end up charging rent for two reasons. The first is to prevent the tainting of the rollover of the cottage to the trust under subsection 73(1.01).[24] The second reason that the trustees might charge rent is because Mr. Smith may be forced to move to a retirement or nursing home on a permanent basis. As result, Mr. Smith may no longer be able to use the cottage and the trustees may rent out the cottage from time to time to non-family members to pay for his care.

The charging of rent may result in a change of use from personal-use property to income producing capital property[25] and pursuant to paragraph 45(1)(a) the trust will have been deemed to have disposed of the property at fair market value and reacquired it immediately thereafter at the same amount. The CRA's administrative practice is not to apply the change of use rule if the income producing use is ancillary to the main use of the property as a residence and no capital cost allowance is claimed. This administrative practice may be relevant to Mr. Smith's situation.[26] If there is a "complete change of use", the only way to avoid this disposition would be to make an election pursuant to 45(2). Subsection 45(2) provides that,

> For the purposes of this subdivision and section 13, where subparagraph (1)(a)(i) or paragraph 13(7)(b) would otherwise apply to any property of a taxpayer for a taxation year and the taxpayer so elects in respect of the property in the taxpayer's return of income for the year under this Part, the taxpayer shall be deemed not to have begun to use the property for the purpose of gaining or producing income except that, if in the taxpayer's return of income under this Part for a subsequent taxation year the taxpayer rescinds the election in respect of the property, the taxpayer shall be deemed to have begun so to use the property on the first day of that subsequent year.

Therefore, provided that the trust files an election pursuant to subsection 45(2), it can defer the recognition of the accrued gain, that is the deemed disposition, until the trust rescinds its election. (However, there are issues surrounding the interaction between the principal residence exemption and the 45(2) election which will be examined later on this section.)

Tax issue three: having the alter ego trust claim the principal residence exemption

In the ordinary course when Mr. Smith dies, the *alter ego* trust will be deemed to have disposed of its assets and reacquired the cottage at fair market value[27]. This deemed disposition will then occur every 21 years thereafter.[28] This trust can elect in its tax return for its first taxation year by virtue of clause 104(4)(a)(ii.1) not to have paragraph 104(4)(a) apply. As a result, the deemed disposition will occur on the day that is 21 years after the day on which the trust is created and every 21 years thereafter.[29] However, if the election is made then the rollover in subsection 73(1) would not be available. Therefore, in this case, making the election would not be advisable.

When this deemed disposition occurs or if the trustees decide to sell the cottage, the trust will either have to pay the tax on the accrued gain on the cottage or employ the principal residence exemption. There are several legal tests which must be met in order to claim the exemption and we will examine each one in turn.

The bulk of the rule pertaining to the claiming of the principal residence exemption is contained in the definition of principal residence in section 54. This definition as it relates to a trust provides that the principal residence,

> of a taxpayer for a taxation year means a particular property that is a housing unit, a leasehold interest in a housing unit or a share of the capital stock of a co-operative housing corporation acquired for the sole purpose of acquiring the right to inhabit a housing unit owned by the corporation and that is owned, whether jointly with another person or otherwise, in the year by the taxpayer, if
>
> > (a.1) where the taxpayer is a personal trust, the housing unit was ordinarily inhabited in the calendar year ending in the year by a specified beneficiary of the trust for the year, by the spouse or common-law partner or former spouse or common-law partner of such a beneficiary or by a child of such a beneficiary.

Therefore in order for Mr. Smith's *alter ego* trust to qualify for the principal residence exemption in respect of the cottage property three elements are required: the trust must be a personal trust, the trust must have owned a housing unit, and the housing unit must have been ordinarily inhabited in the year by a specified beneficiary of the trust or by a spouse or common-law partner or former spouse or common-law partner of such a beneficiary or by a child of such a beneficiary. However, the principal residence exemption will only be available if the conditions in paragraph (c.1) of the definition of principal residence in section 54 are satisfied.

Requirement One: Ownership of a Housing Unit

The first element of the test in paragraph (a.1) of the definition of "principal residence" is clearly satisfied as the *alter ego* trust will own a housing a unit, namely, the cottage on Georgian Bay.

Requirement Two: A Personal Trust

The second test relates to the nature of the trust. As noted above, in order to qualify for the principal residence exemption in respect of the cottage property, the *alter ego* trust must be a "personal trust" within the meaning assigned by the Tax Act. A personal trust is defined in subsection 248(1) to include an *inter vivos* trust no beneficial interest in which was acquired for consideration payable directly or indirectly to the trust or any person or partnership that has made a contribution to the trust by way of transfer, assignment or other disposition of property.[30] For the purposes of the Tax Act an *inter vivos* trust is a trust other than a testamentary trust.[31] Mr. Smith's *alter ego* trust should comply with the foregoing requirements.

Requirement Three: Ordinarily Inhabited by a Specified Beneficiary

Provided that Mr. Smith's *alter ego* trust is a personal trust and owns the housing unit, the third element of the test which must be satisfied relates to who ordinarily inhabited the cottage. As noted earlier, paragraph (a.1) of the definition of principal residence in section 54 requires the housing unit owned by the trust to have been ordinarily inhabited by a specified beneficiary of

the trust for the year, by the spouse or common-law partner or former spouse or common-law partner of such a beneficiary or by a child of such a beneficiary. Subparagraph (c.1)(ii) of the definition of principal residence states that a specified beneficiary of a trust for the year is an individual who,

(A) is beneficially interested in the trust, and

(B) except where the trust is entitled to designate it for the year solely because of paragraph (b) [provision applicable to 45(2) elections], ordinarily inhabited the housing unit or has a spouse or common-law partner, former spouse or common-law partner or child who ordinarily inhabited the housing unit.

Thus, in the case of Mr. Smith's *alter ego* trust, a specified beneficiary for a year will be any named beneficiary under the trust who ordinarily inhabited the trust during the year.

Whether a particular person ordinarily inhabited the cottage in any particular year depends on the facts. The CRA has provided its views on this matter in the Principal Residence Folio.[32] No commentary by the CRA was found as to whether a person who pays rent on a cottage held in a trust could be considered to ordinarily inhabit the cottage during the rental period. Clearly an argument could be made that a person who pays rent can be considered to be ordinarily inhabiting the cottage.

Conditions in Paragraph (c.1)

Finally, a trust can only claim the principal residence exemption in respect of a particular property for a year if four conditions are satisfied.[33]

First, the particular property must be designated by the trust in prescribed form (Form T1079) and manner to be the taxpayer's principal residence for the year. The designation is filed with the trust's T3 Trust Income Tax and Information Return for the year in which the property was disposed of or an option to acquire the property was granted.[34]

Second, the trust must specify in the designation each individual who, in the calendar year ending in the year, is a specified beneficiary of the trust for the year.

Third, no corporation (other than a registered charity) or partnership can be beneficially interested in the trust at any time in the year.

Fourth, no other property may have been designated for the purpose of the definition of principal residence for the calendar year ending in the year by

- any specified beneficiary of the trust for the year,
- by a person who was throughout that calendar year the specified beneficiary's spouse or common-law partner (other than a spouse or a common-law partner who was throughout

that calendar year living apart from, and was separated pursuant to a judicial separation or written separation agreement from the beneficiary),

- by a person who was the specified beneficiary's child (other than a child who was during that calendar year a married person or a person who is in a common-law partnership or a person 18 years or over) or, where such a beneficiary was not during that calendar year a married person or a person who is in a common-law partnership or a person 18 years or over, by a person who was the specified beneficiary's
    - mother or father, or
    - mother or sister, where that brother or sister was not during that calendar year a married person or a person 18 years or over.[35]

The CRA has an administrative practice that provides that an individual (other than a trust) is not required to complete and file the principal residence designation form except in certain circumstances.[36] No such administrative practice is provided with respect to a trust.[37] Therefore a trust must file the form as described above.

The Test as a Whole and Deemed Ownership

Assuming that each required element of the test detailed in the definition of principal residence contained section 54 has been satisfied, Mr. Smith's *alter ego* trust will be able to claim the principal residence exemption in respect of the cottage during its years of ownership. However, Mr. Smith's *alter ego* trust will also be able to claim the principal residence exemption in respect of the years during which Mr. Smith owned the cottage exclusively and the years during which Mr. and Mrs. Smith owned the cottage as joint tenants by right of survivorship.

Subsection 40(4) contains two independent sets of deeming rules which will have the effect of deeming the trust to have owned the property during Mr. and Mrs. Smith's years of ownership, and will further deem the cottage to have been the principal residence of the trust during the years it would have been the principal residence of Mr. and Mrs. Smith, respectively.

The first deeming rule relates to Mrs. Smith's years of ownership in respect of the cottage. As stated earlier, Mr. and Mrs. Smith owned the cottage as joint tenants by right of survivorship. This means that during Mrs. Smith's lifetime Mr. Smith was not the sole owner of the property and could not be said to have owned the whole of the cottage. When Mrs. Smith passed away Mr. Smith acquired Mrs. Smith's interest in the cottage at cost pursuant to the spousal rollover ruled contained in subsection 70(6). However, paragraph 40(4)(a) provides that where a property has been disposed to an individual in circumstances to which subsection 70(6) applies (the spousal rollover provision), the individual, in our case Mr. Smith, shall be deemed to have owned Mrs. Smith's interest in the cottage throughout the period during which the taxpayer (in our case Mrs. Smith) owned it. Furthermore, pursuant to paragraph 40(4)(b) that interest in the property is deemed to have been the individual's (in our case Mr. Smith's) principal residence. Therefore, in the ordinary course, by virtue of subsection 40(4), Mr. Smith will be deemed to have owned Mrs. Smith's interest in the cottage during her years of ownership and furthermore

that interest will be deemed to have been Mr. Smith's principal residence for those years it was Mrs. Smith's principal residence. The effect of this is that for the purposes of claiming the principal residence exemption Mr. Smith is treated as having owned the whole of the cottage and for the whole of the cottage to have been his principal residence, during those years that he owned it as a joint tenant by right of survivorship with his late wife.

A second deeming rule will then deem the trust to have owned the cottage and for the cottage to have been the trust's principal residence, during the years that the cottage was owned and was Mr. Smith's principal residence (keeping in mind that Mrs. Smith's interest in the cottage was previously deemed to be Mr. Smith's and that Mrs. Smith's interest in the cottage was deemed to have been Mr. Smith's principal residence for the years it was Mrs. Smith's principal residence). This second deeming rule is also contained in subsection 40(4) and that subsection will apply where a taxpayer has disposed of property in circumstances to which subsection 73(1) applied (subsection 73(1) being the rollover provision applicable to *alter ego* trusts). If subsection 40(4) applies, then pursuant to paragraph 40(4)(a) the trust will be deemed to have owned the cottage throughout the period during which Mr. Smith owned it. Furthermore, by virtue of paragraph 40(4)(b) the cottage will be deemed to have been the trust's principal residence for any taxation year for which it was Mr. Smith's principal residence.

As a result of the operation of these two deeming rules, the *alter ego* trust should be able to claim the principal residence exemption in respect of both the trust's years of ownership as well as the years during which Mr. Smith owned the cottage exclusively and the years during which Mr. and Mrs. Smith owned the cottage as joint tenants by right of survivorship.

More Complicated Scenarios

Unfortunately, although ordinarily the foregoing analysis may complete the analysis, there are several complicating factors which might preclude Mr. Smith's *alter ego* trust from claiming the principal residence exemption in respect of one or more years. First, the gain on the Aurora residence may be larger than that on the cottage and it might be preferable to claim the exemption in respect of the Aurora residence for one more years.

Secondly, with respect to years when the trust is in existence, the trust will not be able claim the principal residence exemption during any year when any specified beneficiary of the trust or certain related persons who ordinarily inhabited the cottage in the year made a designation in respect of a property. For example, if any of these individuals paid rent to use the cottage in the year and then actually used it, these individual might be considered to have ordinarily inhabited the cottage.

Third, a property that is designated by the trust as its principal residence for a particular year, is deemed to be a property designated as the principal residence of each specified beneficiary of the trust for the calendar year in the particular year.[38] As a result of this deeming rule, it is advisable that the trust deed contain a provision prohibiting the making of a principal residence designation for any year by the trustees unless each specified beneficiary consents in writing.

Another complication relates to the interaction between the rules governing the principal residence exemption and the 45(2) election. If the trust elected under subsection 45(2) in respect of a change of use, the definition of principal residence[39] will restrict the claiming of the principal residence exemption to a maximum of four years.

As demonstrated by these "complications", tax practitioners must be cautious and ensure that all the conditions for claiming the exemptions are present and the *alter ego* trust hasn't run afoul of one of the anti-avoidance rules contained in the Tax Act.

Tax issue four: transferring the assets from the alter ego trust to the beneficiaries

At some point following the death of Mr. Smith, the trust will need to be wound up, and the terms of the *alter ego* trust will provide for ultimate beneficiaries to whom the trust property should be distributed; this presents both tax issues, and non-tax issues. With respect to the tax consequences, pursuant to subsection 107(2), the cottage may be rolled out on a tax-deferred basis to capital beneficiaries of the trust. It should be noted that by virtue of subsection 107(4), the cottage cannot be distributed on a rollover basis to beneficiaries (other than Mr. Smith who by the terms of the trust would not be entitled to a return of the cottage) while Mr. Smith is alive.

The terms of the trust document will determine who the beneficiaries of the trust are. It should be noted that trust documents generally provide for distribution rights at two times: at any time before the so called "time of division" (generally speaking the time at which the trust is mandated by its own rules to distribute its property), and prior to the time of division. The terms of the trust deed will mandate who, at what time, and in what proportions the property of the trust is to be distributed to beneficiaries.

In the case of an *alter ego* trust the terms of the trust will need to provide that the ultimate beneficiaries, in our case Mr. Smith's four children, cannot receive the trust property until the death of Mr. Smith. Tax practitioners should ensure that any distribution complies with the governing trust law as the trustees can be liable to beneficiaries who had an entitlement under the trust and whose entitlement was ignored.[40] In addition, tax practitioners should verify the residence of any beneficiaries as special rules govern distributions to non-residents and there may be implications under foreign tax legislation (particularly so in the case of U.S. beneficiaries). These international tax issues are beyond the scope of this paper but tax advisers ignore them at their own peril.

An Ordinary *Inter Vivos* Trust

The less obvious choice would be for Mr. Smith's tax advisers to transfer his cottage to an ordinary *inter vivos* trust rather than an *alter ego* trust. As noted earlier, an ordinary *inter vivos* trust is a much more flexible vehicle as compared to an *alter ego* trust in that it need not restrict access to the income and capital exclusively to Mr. Smith and as a result Mr. Smith can add his other family members as immediate beneficiaries of the trust (that is these beneficiaries can access the income and capital of the trust during Mr. Smith's lifetime). The downside of course is that transferring the cottage to an ordinary *inter vivos* trust is a disposition within the meaning of the Tax Act and will trigger a tax liability in respect of any accrued gains.

Claiming the Principal Residence Exemption upon the transfer of the cottage to the trust

Supposing that Mr. Smith's tax advisers choose to transfer the cottage to an ordinary *inter vivos*, consideration will have to be given to claiming the principal residence exemption in respect of the cottage. This will involve weighing the benefit of claiming the exemption in respect of the cottage rather than in respect of the Aurora residence in the relevant years, supposing those years are still available. It seems doubtful that Mr. Smith taxpayer would want to incur a significant tax liability on such a transfer.

The definition of principal residence contained in section 54 provides that a principal residence,

> means a particular property that is a housing unit, a leasehold interest in a housing unit or a share of the capital stock of a co-operative housing corporation acquired for the sole purpose of acquiring the right to inhabit a housing unit owned by the corporation and that is owned, whether jointly with another person or otherwise, in the year by the taxpayer, if
>
> > (a) where the taxpayer is an individual other than a personal trust, the housing unit was ordinarily inhabited in the year by the taxpayer, by the taxpayer's spouse or common-law partner or former spouse or common-law partner or by a child of the taxpayer,

In Mr. Smith's case claiming the principal residence exemption upon the transfer to an ordinary *inter vivos* trust is a fairly simple matter, assuming he wishes to sacrifice the principal residence exemption in respect of his Aurora residence. Mr. Smith clearly owns the cottage. In addition pursuant to subsection 40(4), Mr. Smith will be deemed to have owned Mrs. Smith's interest in the property during the years of Mrs. Smith's ownership and will be deemed to have been his principal residence for the years it would have been Mrs. Smith's principal residence had Mrs. Smith designated it in the prescribed manner. Consequently, Mr. Smith will be able to claim the principal residence exemption in respect to the entire gain on the cottage.

It should be noted, again, in passing that as with any transfer to a trust subsection 75(2) could potentially apply and tax advisers should also ensure that 75(2) will not apply to the trust as this would likely result in adverse tax consequences to Mr. Smith.[41]

Claiming the Principal Residence Exemption after the cottage has been transferred to the trust

Much as was the case with Mr. Smith's *alter ego* trust, the ordinary *inter vivos* trust presents some issues which must be considered if the trustees wish to claim the principal residence exemption in respect of the trust's years of ownership. The trustees may wish to claim the principal residence exemption in respect of the cottage in the case of a sale or if the 21 year deemed disposition rule applies.

In order to claim the principal residence exemption for any year the ordinary *inter vivos* trust must meet the same requirements as Mr. Smith's *alter ego* trust. For example, paragraph (c.1) of the definition of principal residence contained in section 54 will preclude the trust from claiming

the exemption for any year during which any beneficiary who was a specified beneficiary for the year claimed the exemption in respect of another property for that year.

In addition, again as before, a property that is designated by the trust as its principal residence for a particular year, is deemed to be a property designated as the principal residence of each specified beneficiary of the trust for the calendar year ending in the particular year. Therefore, claiming the principal residence exemption in respect of the cottage for a given year will preclude such year being available to any of the specified beneficiaries of the trust for that year as well. Therefore, caution is in order when claiming the exemption in respect of a cottage owned by a trust with multiple beneficiaries.

As with respect to Mr. Smith's *alter ego* trust, if there is a complete change of use of the cottage because the trustees rent it out, the deemed disposition can be prevented by means of a 45(2) election. However, pursuant to paragraph (d) of the definition of principal residence in section 54, the principal residence exemption can only be claimed for a maximum of four years after the 45(2) election (assuming there is no subsequent change of use).

Generally, this means that the trust should be able to claim the principal residence exemption in respect of the trust's years of ownership for any year during which a specified beneficiary of the trust or their common law partner, spouse, former spouse or common law partner or their child ordinarily inhabited the cottage.[42]

Transferring the assets of the ordinary inter vivos trust to the beneficiaries

Pursuant to subsection 104(4), Mr. Smith's ordinary *inter vivos* trust will be deemed to have disposed of its capital assets at proceeds equal to their fair market value on the day that is 21 years after the day on which the trust was created. Therefore at some point prior to the deemed disposition it may be desirable to transfer the cottage owned by Mr. Smith's trust to the beneficiaries.

By virtue of subsection 107(2) the cottage can be distributed to beneficiaries of the trust on a tax-deferred basis. As noted earlier, in order to avoid the application of subsection 75(2) Mr. Smith will not be entitled to the return of the cottage. The trust deed could provide that the entitlement to capital is discretionary as determined by the trustees or could provide for a specific distribution, e.g. to Mr. Smith's issue in equal shares *per stirpes*.

It bears mentioning that pursuant to subsection 107(2.01) an election can be made when the trust makes a distribution of capital property to a beneficiary in satisfaction of that beneficiary's capital interest in the trust and that property would, if the trust had so designated under paragraph (c.1) of the definition of principal residence in section 54, be a principal residence of the trust for a taxation year. If this election is made the trust will be deemed to have disposed of the property immediately before the distribution for proceeds equal to fair market value and the trust will be deemed to have reacquired the property for an equal amount. The step up in cost occurs immediately before the distribution. Pursuant to subsection 107(2), the trust will then be deemed to have disposed of the cottage at an amount equal to its cost (now fair market value as a result of the subsection 107(2.01) election) and the taxpayer will be deemed to have acquired the property

for the same amount. This allows the trust to claim the principal residence exemption in respect of the cottage.

Finally, should a beneficiary of the trust who received the cottage in satisfaction of his or her capital interest in the trust, later wish to use the principal residence exemption with respect to that property, subsection 40(7) may be of some use. Subsection 40(7) provides that where property has been acquired by a taxpayer in satisfaction of all or any part of the taxpayer's capital interest in a trust in circumstances to which 107(2) applies the taxpayer is deemed to have owned the property since the trust last acquired it.

Other Options

Now that the use of a trust has been examined, it would be useful to examine other options which might achieve Mr. Smith's goals. As described earlier it may be possible to combine the use of a continuing power of attorney for property with a method to avoid estate administration tax.

A continuing power of attorney for property could employed so that if Mr. Smith is incapable or unwilling to manage the cottage his attorneys could do so in his place. The continuing power of attorney could provide that Mr. Smith's children be his attorneys.

In order to address Mr. Smith's concerns about tax liability, the continuing attorney for property could be combined with a method which ensures that his beneficial interest in the cottage passes to his heirs in a second will that deals with assets not requiring probate. This would mean that the value of the cottage would not be subject to estate administration tax.

One such method would be an arrangement by which the right of survivorship would be held as joint tenants with his children but the beneficial interest would be retained by Mr. Smith.[43] On Mr. Smith's death, the beneficial interest in the cottage would pass to his children under his will for assets not requiring probate.

Another option would be a structure whereby the legal title to the cottage is held by a bare trustee corporation with the beneficial interest being held by Mr. Smith pursuant to a bare trust agreement. As with the joint tenancy option, on Mr. Smith's death, the beneficial interest in the cottage would pass to his children under his will for assets not requiring probate.

As discussed earlier, Mr. Smith could gift the cottage to his children and enter into a long-term lease for nominal rent combined with a continuing power of attorney for property under which his children serve as the attorneys. The gift will be a disposition at fair market value and Mr. Smith will need to decide whether to pay the tax or claim the principal residence exemption. This option would be viable if Mr. Smith was prepared to claim the exemption on this gift.

Weighing the Options

Mr. Smith will need to consider the advantages and disadvantages of the various options. The use of a trust be it an ordinary *inter vivos* trust or an *alter ego* trust presents a complex set of rules which contain uncertainties. On the other hand, the use of a continuing power of attorney

for property coupled with one of the methods to minimize estate administration tax is less complex.

Mr. Smith will need to weigh the complexity of the rules applicable to trusts against the limitations of the continuing power attorney for property as well as the tax benefits and disadvantages of each option including when the tax liability on the accrued gain in the cottage will be triggered.

In our experience simplicity is often very attractive to clients.

Determination of the Principal Residence Exemption in respect of Land in Excess of ½ Hectare

The definition of principal residence in section 54 provides that a principal residence includes the land on which the housing unit sits and the portion of the land that is immediately contiguous to the land subjacent to the housing unit as can be reasonably required as contributing to the use and enjoyment of the housing unit as a residence. However, where the subjacent land and immediately contiguous land exceeds ½ hectare, the excess (the "Excess Land") is deemed not to have contributed to the use and enjoyment of the housing unit as a residence, unless the taxpayer establishes that the Excess Land was necessary to that use and enjoyment.

Over the years there have been numerous cases dealing with the issue of whether the excess land forming part of a property that is subject to a minimum lot size requirement or severance or subdivision restrictions satisfied the use and enjoyment requirement. In particular, one issue was at what time this requirement had to be satisfied. This particular issue has now mostly been resolved by the decision in *Wayne Cassidy v. the Queen*[44] ("Cassidy"), a decision of the Federal Court of Appeal (the "FCA").

The computation of the gain on a principal residence is set out in paragraph 40(2)(b) and is computed using the formula A-(A x B/C) - D. The exempt portion of the gain is calculated using the formula A x B/C. Under the formulas,

- A is the amount of the gain,
- B is one plus the number of taxation years that end after the acquisition date for which the property was the taxpayer's principal residence and during which the taxpayer is resident in Canada,
- C is the number of taxation years ending after the acquisition date during which the taxpayer owned the property, and
- D is an adjustment to deal with the situation where the taxpayer elected to bump the ACB of the residence in 1994 under subsection 110.6(19) and was not relevant to the case.

The FCA held that the paragraph 40(2)(b) requires an annual determination and that, for each taxation year in which the property was owned by the taxpayer claiming the exemption, Variable B requires a determination as to whether the property met the definition of "principal residence". The FCA also concluded that where the issue is whether the Excess Land is part of the principal residence, the formula is to be applied in two stages; first to the portion of gain allocable to the sale of the house and ½ hectare of land and then to the portion of gain is allocable to the Excess Land.

The FCA applied the formula to the facts of the case which were as follows. Mr. Cassidy (with his then common law spouse) purchased a house and 2.43 hectares of land in 1994, became the sole owner in 1998 and lived in the house from its acquisition date to the date it was sold in 2003. When the property was acquired, the local zoning laws prevented the Appellant from buying less than a 2.43 hectare parcel of land. An Official Plan Amendment came into force on May 2, 2003 allowing Mr. Cassidy to apply to have the property rezoned and subdivided. Mr. Cassidy agreed to sell the property on May 23, 2003 and the deal closed on November 27, 2003 after certain conditions for the purchaser's benefit including successful application for rezoning and subdivision were satisfied.

The gain arising on the sale was not reported by the Appellant in his 2003 income tax return as he believed that the entire gain qualified for the principal residence exemption. However, the CRA reassessed him on the basis that the excess land did not qualify for the exemption at the date of the sale.

The FCA applied the formula using the two stage process. The property was the Appellant's principal residence for ten years (1994 to 2003 inclusive). Therefore, Variable B with respect to the house and ½ hectare of land was eleven (11) and determined that the entire gain allocable to the house and ½ hectare of land was exempt. With respect to Variable B as it related to the Excess Land, the Court held that that land was part of the Appellant's principal residence for nine (9) years (1994 to 2002 inclusive), did not decide whether the Excess Land was part of the principal residence for 2003, determined that Variable B was 10 without counting 2003 and, therefore, the gain allocable to the Excess Land was also exempt. The appeal was allowed.

The CRA's administrative position now reflects this decision in this case and states,

> A municipal or provincial law or regulation may require, for example, a minimum lot size for a residential lot in a particular area that would be in excess of one-half hectare, or impose a severance or subdivision restriction with respect to a residential lot in a particular area restricting the lot from being one-half hectare or below. If such a law or regulation existed in any given year during which the taxpayer owned the property, the area that is in excess of one-half hectare would normally be part of the principal residence for that particular year.[45]

The Occupancy Period for Condominiums, the Equitable Interest under the Agreement of Purchase and Sale, and the Principal Residence Exemption

The final issue to be addressed by this paper concerns the claiming of the principal residence exemption in respect of the sale of a condominium unit prior to the transfer of legal title. Unlike traditional real estate, a condominium property usually has an intermediate stage between the transfer of legal title and the initial purchase. This intermediate stage is known as the occupancy period.

Pursuant to section 80 of the *Condominium Act*[46] there is an "interim occupancy period" where the purchaser is entitled to occupy his or her condominium unit prior to receiving a deed in respect of the unit. Under the definition of principal residence contained in section 54, the required elements to obtain the principal residence exemption for an owner who is an individual are: that a particular property that is a housing unit is owned in the year by the taxpayer and that the housing unit was ordinarily inhabited in the year by the taxpayer or certain other person. There are circumstances where the taxpayer will have met the other requirements to satisfy the principal residence exemption, but who will have sold their interest in the property (properly assigned their agreement of purchase and sale) prior to receiving legal title. The Tax Act itself requires "ownership" of the housing unit in order to qualify for the principal residence exemption. The question raised is whether the interest possessed by a taxpayer during the so-called occupancy period amounts to ownership.

There are two components of the interest held by a taxpayer during the occupancy period of a condominium development. The first arises as a result of the agreement of purchase and sale itself. The second arises as a result of the operation of Condominium Act (as well as any rights arising under an "interim occupancy agreement" or supplementary terms contained in the agreement of purchase and sale).

The law of real property provides that an agreement of purchase and sale confers to the purchaser an "equitable interest" in respect of the property. This equitable interest is referred to as a "beneficial interest" because the purchaser can demand specific performance with respect to the property from the court in certain circumstances[47], that is the purchaser can demand the transfer of legal title from the vendor to the purchaser. The agreement of purchase and sale (which confers the equitable interest in the property) is assignable, that is it can be sold to third parties, provided that the agreement of purchase and sale itself permits this.

The rights arising under the Condominium Act (also supplemented by an "interim occupancy agreement" or terms included in the agreement of purchase and sale), on the other hand, provide that a purchaser of a condominium unit is entitled to occupy their unit prior to the transfer of legal title subject to certain restrictions as set out therein.[48]

The use and enjoyment rights arising out of the Condominium Act clearly do not amount to ownership, they represent a transient right to occupy a condominium unit much in the way of a tenant. The equitable interest requires a little more analysis.

Although the CRA accepts that the equitable interest created by an agreement of purchase of sale constitutes ownership in respect of registered property, it does not accept that there is ownership in the case of an unregistered condominium unit. In paragraphs 2.79 and 2.80 of the Principal Residence Folio the CRA states that,

> In the common law jurisdictions, two forms of property ownership are recognized – legal and beneficial. Normally **legal ownership** exists when title is transferred to, recorded in, registered in or otherwise carried in the name of a person. Legal owners are generally entitled to enforce their ownership rights against all other persons.
>
> One person's legal ownership of a property may, however, be subject to another person's beneficial ownership of that property. The term **beneficial ownership** is used to describe the type of ownership of a person who is entitled to the use and benefit of the property whether or not that person has concurrent legal ownership. A person who has beneficial ownership rights but not legal ownership can enforce those rights against the holder of the legal title. For example, beneficial ownership frequently arises when property is held in trust for a person in circumstances where, according to the terms of the trust, that person has authority to instruct the trustee to deal with the property as requested.

In addition that document further states in paragraph 2.89 that,

> A purchaser's interest in property under an enforceable agreement for sale will, subject to ¶2.90, be considered to constitute ownership of the property.

However in paragraph 2.90, it is stated that,

> When acquiring a residential condominium unit, it is not unusual for a taxpayer to make a down payment, to enter into an agreement of purchase and sale, to enter into an occupancy agreement and to take possession prior to the registration of the condominium. The occupancy agreement may provide for payments which reflect the carrying costs of the condominium until the purchase transaction can be completed. Normally in such a situation, the taxpayer does not own (either beneficially or legally) the condominium unit until the condominium is registered under the relevant provincial legislation and the purchase transaction has closed.

And therein lies the contradiction. Ordinarily, the purchaser under an agreement of purchase and sale in respect of a registered condominium unit should possess an equitable right in the unit as against the vendor and yet the CRA does not recognize any ownership interest in respect of an unregistered condominium unit. The reason for this incongruence is apparently that until the deed is granted in respect of the condominium unit, the equitable right is inchoate and does not yet exist. That is the purchaser under the agreement of purchase and sale cannot demand specific performance until the interest is registered. As such it appears that no beneficial interest in the condominium exists until registration.

However, an argument could be advanced that the totality of the rights possessed by a taxpayer during the occupancy period under an agreement of purchase and sale in respect of an

unregistered condominium unit amounts to ownership for the purposes of the definition of principal residence. In paragraph 2.81 of the Principal Residence Folio the CRA states that,

> In determining whether a person has beneficial ownership, one should consider such factors as the right to possession, the right to collect rents, the right to call for the mortgaging of the property, the right to transfer title by sale or by will, the obligation to repair, the obligation to pay property taxes and other relevant rights and obligations. Not all of these incidents of ownership need occur concurrently before it is concluded that the person has beneficial ownership of the property, which is a question of fact in each particular case.

As demonstrated by our earlier analysis most of these incidents of ownership are present during the occupancy period, what is notably absent is the right to title. However, pursuant to subsection 78(1) of the Condominium Act each agreement of purchase and sale,

> of a proposed unit entered into by a declarant before the registration of the declaration and description that creates the unit shall be deemed to contain the following covenants by the declarant:
>
> 2. A covenant to take all reasonable steps to deliver to the purchaser without delay a deed to the unit that is in registerable form.

Pursuant to section 134 of the Condominium Act, an owner of a proposed condominium unit can make an application to the Superior Court of Justice for an order enforcing compliance with any provision of the Condominium Act. Pursuant to subsection 134(3), the Superior Court of Justice may grant damages or such other relief as is fair and equitable in the circumstances. It would seem that by virtue of the Condominium Act the Superior Court of Justice has the authority to order a declarant to deliver a deed in registerable form to a purchaser. It could perhaps be argued that an agreement of purchase and sale in combination with the rights of the purchaser under the Condominium Act grants the purchaser an interest in a condominium unit that approximates the rights of a purchaser under an agreement of purchase and sale for a registered property to demand specific performance. These rights approximating the right to specific performance could be argued to be equivalent to the right to receive legal title (the incident of ownership that appeared to be lacking in our earlier discussion). Consequently, an argument could be advanced that during the occupancy period a purchaser under an agreement of purchase and sale possesses sufficient incidents of ownership for the purchaser to qualify as the owner of the property for the purposes of the definition of principal residence contained in section 54.

This argument has not yet been tested in court and as such its legal efficacy is highly uncertain. Therefore, purchasers of condominium units should ensure they take legal title if they wish to claim the principal residence exemption in respect of their condominium unit because as a matter of law their interest under their agreement of purchase and sale may not constitute ownership until such time as the condominium unit itself is registered.

Conclusion

This paper has provided an overview of some of the issues that should be addressed when conducting planning related to principal and cottage residences. Specifically, this paper provided a case study illustrating the complexities of holding a cottage residence in an *inter vivos* trust and provided an explanation of the recent *Cassidy* case which clarified the claiming of the principal residence exemption with respect to Excess Land. Finally, this paper looked at the possibility of claiming the principal residence exemption during the occupancy period of a condominium unit prior to the transfer of legal title.

It is our hope that our discussion of these topics has provided some insight into the complexities surrounding the taxation of personal residences. Clients often mistakenly assume that planning surrounding something as mundane as a residence should be relatively straightforward. Unfortunately, this is not the case, but with appropriate planning tax advisers can make the best of a complicated situation and provide their clients with solutions that meet both their tax and non-tax objectives.

Endnotes

[1] R.S.C. 1985 (5th Supplement) c.1, as amended (referred to herein as the "Tax Act"). Unless otherwise indicated all statutory references in the paper are to the Tax Act.

[2] Susan Pigg, *Tax auditors target condo sellers in hunt for* 'flippers', Toronto Star, August 29, 2013, online: http://www.thestar.com/business/real_estate/2013/08/29/tax_auditors_target_condo_sellers_in_hunt_for_flippers.html.

[3] *Wayne Cassidy v. The Queen,* 2011 FCA 271.

[4] For a more complete review please see Hugh Woolley, C.A. TEP, "Principal Residences, Selected Issues," 2010 British Columbia Tax Conference, (Vancouver: Canadian Tax Foundation, 2010), 6:1-55.

[5] In the case of Ontario: *Estate Administration Tax Act*, 1998, S.O. 1998, c. 34, Sch.

[6] Definition of "personal-use property" in section 54.

[7] Generally referred to as a "Deed of Settlement" or "Trust Agreement"

[8] For a more extensive, and perhaps more accurate summary of the nature of a trust see Donovan W.M. Waters, *ed.*, *Waters Law of Trusts in Canada*, 3d ed. (Toronto: Thomson Carswell, 2005), at c. 1.

[9] *Ibid*., at c. 3.

[10] In *Family Law Act*, R.S.O. 1990, c F.3., as amended (referred to herein as the "FLA")

[11] "net family property" is defined in subsection 4(1) of the FLA.

[12] Subsection 4(2) of the FLA.

[13] Robert M. Halpern, ed., *Property Rights and Obligations Under Ontario Family Law* (Toronto: Thomson Reuters, 2012), at pp. 5 and 6.

[14] Subsection 2(1) and the definition of "value of consideration" in subsection 1(1) of the Land Transfer Act, R.S.O. 1990, c.L.6., as amended.

[15] Definition of "disposition" in subsection 248(1).

[16] Subsection 69(1).

[17] The term "alter ego trust" is defined in subsection 248(1).

[18] See the interaction of subsections 73(1), (1.01) and (1.02).

[19] For a more comprehensive examination of self-benefit trusts please see: Brent Kerr and John Sorensen, "Use of Special-Purpose Trusts," Report of Proceedings of Fifty-Ninth Tax Conference, 2007 Tax Conference (Toronto: Canadian Tax Foundation, 2008), 35:1-44.

[20] For articles on 75(2) and its application to trusts see: Maria Elena Hoffstein and Michelle Lee, "Revisiting the Attribution Rules," 2012 Ontario Tax Conference, (Toronto: Canadian Tax Foundation, 2012), 9: 1-40, and Maria Elena Hoffstein, "Tax Planning with Trusts - Current Issues," 2007 Ontario Tax Conference, (Toronto: Canadian Tax Foundation, 2007), 13A:1-45.
[21] CRA IT-305R4, October 30 1996.
[22] Subsection 105(1) provides that the value of all benefits to a taxpayer during a taxation year from or under a trust be included in computing the taxpayer's income for the year with certain exceptions.
[23] *Income Tax Technical New No. 11*, September 30, 1997 (now cancelled) and CRA document no 2012-0470951E5, December 4, 2012.
[24] See the section in this paper entitled "*Tax issue one: allowing Mr. Smith's family to use the cottage*" for an explanation of this issue.
[25] Paragraph 2.48 of Income Tax Folio S1-F3-C2: Principal Residence, March 27, 2013(the folio being hereinafter referred to as the "Principal Residence Folio".
[26] Paragraph 2.59 of the Principal Residence Folio.
[27] Subparagraph 104(4)(a)(iii).
[28] Paragraph 104(4)(c).
[29] Paragraphs 104(4)(b) and (c).
[30] Subsection 248(1).
[31] Definition of "*inter vivos* trust" in subsection 248(1).
[32] Paragraphs 2.10 and 2.11 of the Principal Residence Folio.
[33] Subparagraphs (c.1)(i)-(iv) of definition of principal residence in section 54.
[34] Section 2301 of the Income Tax Regulations, C.R.C., c. 945, as amended.
[35] Subparagraph (c.1)(i) – (iv) of the definition of principal residence in section 54.
[36] Paragraphs 2.15 of the Principal Residence Folio.
[37] See paragraph 2.65 of the Principal Residence Folio.
[38] paragraph (f) of the definition of principal residence in section 54.
[39] paragraph (d) of the definition of "principal residence" in section 54. See also paragraph 2.66 of the Principal Residence Folio.
[40] *Waters*, *supra*, note 8 at c. 3.
[41] See Hoffstein and Lee, and Hoffstein, *supra*, note 20.
[42] Paragraph (a.1) of the definition of "principal residence" in section 54.
[43] The possibility of transferring the right of survivorship while retaining the beneficial interest in the property was made available by *Pecore v.Pecore*, [2007] 1 S.C.R. 795.
[44] 2011 FCA 271.
[45] Paragraph 2.35 of the Principal Residence Folio.
[46] 1998, S.O. 1998, c. 19, as amended, (referred to herein as the "Condominium Act").
[47] *Rayner v. Preston (1881), 18 Ch.D. 1, 13 (dissent.)* as cited in Estate of *Myrth May Stewart (Appellant) v. Her Majesty the Queen*, 2003 DTC 329.
[48] Section 80 of the Condominium Act.

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