Afridi &Angell

inBrief

Canada edition

Planning for Canada's Departure Tax

James Bowden | 15 May 2023

We have written previously about the importance of planning for the tax consequences of emigrating from Canada; see our previous inBrief here. In this inBrief, we will describe a number of more advanced planning options for Canadian residents who are considering giving up their Canadian residency. Bear in mind that not all of the approaches discussed in this inBrief will be right for any particular person, as each person's individual circumstances will differ.

Upon becoming a non-resident, Canada imposes a departure tax in the form of deemed disposition of certain capital assets, causing any unrealized capital gains to be realized in the year of departure. It is common for high net-worth individuals in Canada to hold their public and private investments through holding companies (**Holdcos**), so one major source of capital gains upon emigration is the shares they own in their Holdcos. We will also touch upon foreign trust planning, Canadian real estate holdings, and charitable donations.

With respect to Holdco shares, much emigration planning focuses on how to minimize the departure tax by reducing the fair market value of those shares prior to exit. Some potential options to achieve this may include.

> *Strategic Dividends:* Causing Holdco to pay out dividends to the maximum extent it can out of tax-preferential accounts maintained by it, which may include Holdco's capital dividend account (CDA), eligible refundable dividend tax on hand (ERDTOH) and non-eligible refundable dividend tax on hand (NERDTOH). Dividends can be paid out of Holdco's CDA tax-free, and dividends that are paid out of its ERDTOH and NERDTOH result in tax refunds to the company, making them somewhat more tax-efficient. In advance of doing this, it may be advisable for Holdco to sell some of its investments, thereby realizing capital gains and creating additional CDA that can be dividend out tax free.

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Areas of expertise include succession planning, the use of trusts locally and internationally, tax planning, asset protection, tax-driven changes in residency, and estate structuring. The Toronto office also continues to provide corporate and commercial support in many instances.

The payment of dividends in this manner will reduce the fair market value of Holdco's shares, thereby reducing the amount of the deemed capital gain on such shares upon emigration.

The other reason you should be sure to dividend out all CDA in any Holdco prior to emigration is because such dividends lose their tax-free status when paid to a non-resident shareholder. Once you are a non-resident, Holdco will be required to apply a withholding tax to any dividends paid to you, and you will be taxed on such dividends personally under the laws of your new country of residence. If Holdco will continue to operate after you emigrate and will continue to have Canadian resident shareholders, it would be prudent to create separate classes of shares that allow for dividends out of CDA to be paid to Canadian shareholders (who can receive them tax-free), and other dividends to be paid to you (as you may very well be in a position to receive them much more tax-efficiently than a Canadian shareholder[1]).

Life Insurance: Cause Holdco to acquire life insurance on your life, acquiring a policy that is maximum funded at the outset but with attributes that result in the policy having a low fair market value. This expenditure in exchange for an asset that is initially low-value (the life insurance policy) reduces the value of the Holdco shares. There are several other potential benefits to this approach that stem from the value of the insurance policy itself, because its value will increase after you have emigrated and can be leveraged as a valuable asset of Holdco going forward (i.e., front-end or back-end leveraging strategies to extract value from the policy during your life), in addition to the security of the death benefit.

If Holdco does leverage the life insurance policy by borrowing against it, Holdco will be able to use those funds for income-generating investments and will be permitted to deduct the interest on the loan. This can be an attractive arrangement.

You may wish to consider whether it makes sense to introduce a foreign ownership structure that is more forward-looking and supports your wealth and estate plans more broadly. For example, if you intend to establish a family trust structure in an offshore jurisdiction as part of your post-emigration planning, it may be prudent to transfer the shares of Holdco to the foreign trust at approximately the same time that you emigrate from Canada. You would do this after having taken any available steps to reduce the value of Holdco's shares, as described above. If Holdco's value is derived primarily from Canadian real estate holdings, this approach could be beneficial if you foresee a sale of Holdco in the future. In that case Holdco shares will be "taxable Canadian property" and will be taxed in Canada, and you can reduce the impact of that tax by reducing the value of Holdco's shares through dividends after you are a non-resident (at the lower beneficial treaty rate).

There are special considerations with respect to Canadian real estate holdings. Canadian real estate is "taxable Canadian property" and is not subject to the deemed disposition upon emigration.[2] How you can best structure your holding of Canadian real estate as a non-resident will depend on whether it is property for your personal use, or if it is a rental property. If it is for personal use, you will need to consider whether your ownership of it puts you at risk of being deemed to be Canadian resident for tax purposes even after your emigration.[3] If it is a rental property, you will likely wish to transfer ownership of it to a Canadian

[1] The withholding tax that Holdco would be required to apply to dividends paid to you as a non-resident would be a default rate of 25% if you reside in a non-treaty country, or could be 5%, 10% or 15% if you reside in a treaty country. You may need to hold your shares through a company established in your new country of residency to access these reduced rates.

[2] You may elect to trigger a deemed disposition of taxable Canadian property if you prefer, in order to trigger gains or losses which you are able to offset against other losses or gains on exit, respectively.

[3] Very briefly, owning a residential property which is available for your personal use in Canada will cause you to be deemed tax resident in Canada, unless there are tie-breaker rules in the applicable treaty with your new country of residence. Ensuring that you will indeed be non-resident for tax purposes is a critical aspect of non-residency planning.

holding company, otherwise the tenant will be required to withhold an amount in respect of tax from every rent payment they make to you as a non-resident owner.

Finally, an option that is not to be overlooked is simply making a charitable donation of assets that have significant accrued capital gains before you emigrate, which will have the effect of reducing both the value of your holdings as well as reducing your departure tax exposure. It will also generate a charitable tax credit which you may use to further reduce your tax burden on exit. If your charitable intentions are relatively large and you wish to maintain some ongoing involvement and control over the how the endowment is managed, you may wish to establish a charitable foundation instead of simply donating funds or assets to an existing charity. A charitable foundation that is registered as such with the Canada Revenue Agency will qualify as a registered charity and can issue charitable tax receipts, and can carry out activities and funding in line with its charitable purpose in Canada and overseas. The charitable options should, of course, only be considered where the primary objective is furthering the chosen charitable purpose with any tax incentives being secondary.

The strategies discussed in this inBrief are intended to illustrate that there may be effective pre-emigration planning that you can consider, aimed at reducing the impact of Canada's departure tax. All such strategies are complex in their planning and application and professional advice is required to evaluate and execute them. If you are interested in exploring planning of this nature, please contact us and we will be delighted to assist. ■