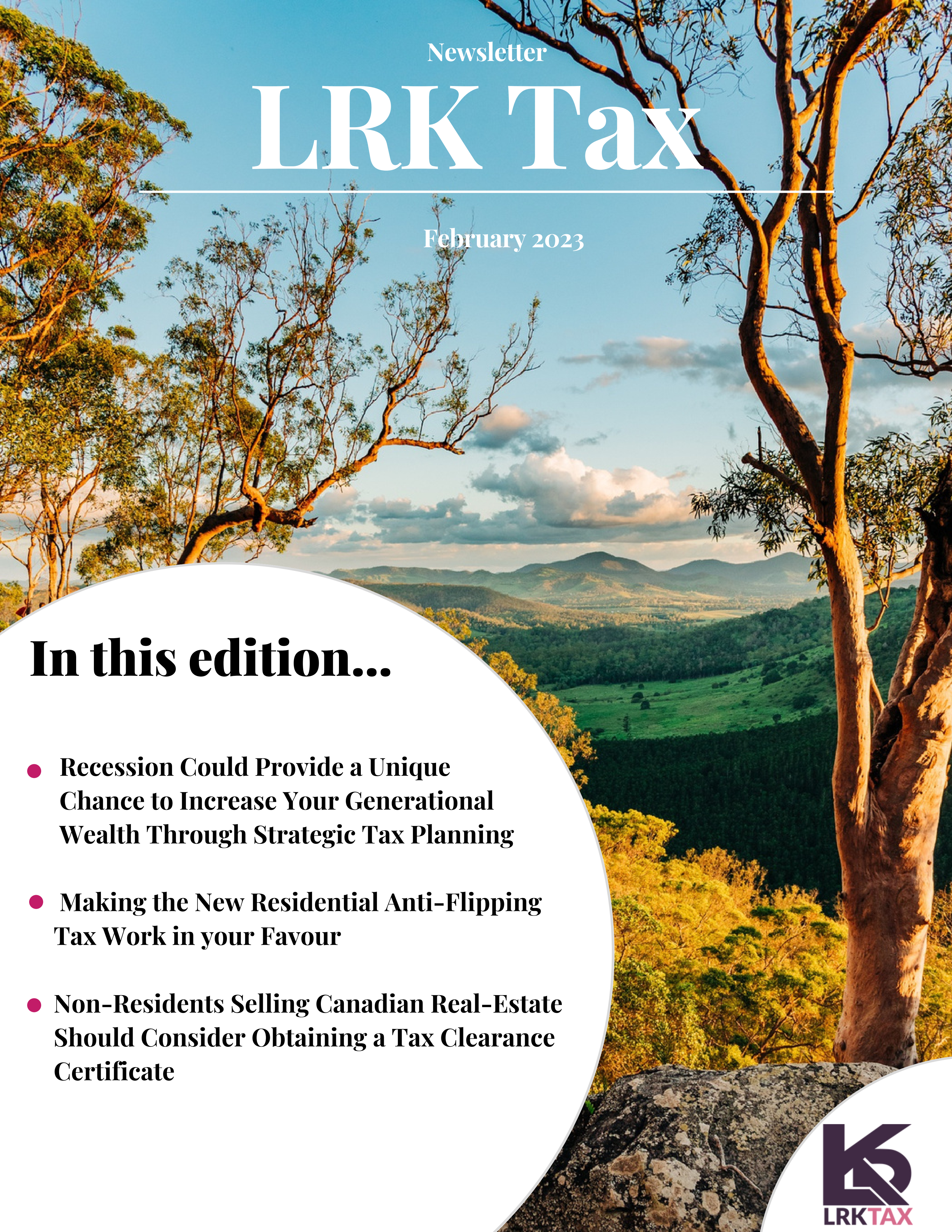

Newsletter

LRK Tax

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In this edition...

- Recession Could Provide a Unique Chance to Increase Your Generational Wealth Through Strategic Tax Planning
- Making the New Residential Anti-Flipping Tax Work in your Favour
- Non-Residents Selling Canadian Real-Estate Should Consider Obtaining a Tax Clearance Certificate

LRKTAX

Recession Could Provide a Unique Chance to Increase Your Generational Wealth Through Strategic Tax Planning

Thanusan Raveendran and Martin Lee, CPA, CA

If you turned on the news, you likely heard most economists predicting the Canadian economy going into recession in 2023. While a recession is not a good thing, it gives some business owners a unique opportunity to significantly increase their generational wealth through careful tax and estate planning.

Estate Freeze During a Business Downturn

During a recession, the value of your business may be down compared to the good years. And this may be for a short period. While the value is down, you can freeze the value of your share in the business and pass on the future growth to your children and grandchildren. This process is called an "Estate Freeze."

Discover the Benefits of Estate Freeze: A Real-Life Success Story of One of Our Clients

Here's an adaptation of a real-life scenario with one of our clients who recently completed an Estate Freeze.

Gabriel owns Mango Endeavors, a business that makes all kinds of deserts using the best mangos in the world. It is 2023, and due to the economy, the valuation of his business is down from $10 million to $6 million. The business has good fundamentals and a track record. Gabriel expects the valuation to pick up to $10 million when the recession is over. Gabriel is getting near retirement, and his two kids, Michelle, and Mariam, will take over the business. He needs to make life-altering decisions like how much life insurance to buy to pay for his taxes upon death so that the business or his kids don't have to foot the bill.

Gabriel was stressed. He got on a call with LRK Tax, and upon discussing his life plan, we introduced him to the "Estate Freeze," which put a smile on his face.

How does the Estate Freeze Increase Generational Wealth?

Without getting into the nuts and bolts, an Estate Freeze is a bunch of tax and legal transactions that will freeze the value of Gabriel's business at a value of $6 million. By doing the Estate Freeze, Gabriel will increase his generational wealth by a little more than $1.5 million.

First, When Gabriel passes away, if the value of the business gets back up to $10 million, he would pay taxes of $2.5 million. This means Gabriel's tax upon death gets reduced to $1.5 million.

Secondly, in Ontario, we have something called the Estate Administration Tax (or what is commonly called the "**Probate Tax**"). The Probate Tax in Ontario is 1.5%. Gabriel would have paid Probate Tax of $150,000. With the Estate Freeze, his Probate Tax gets reduced to $90,000, saving him $60,000.

Peace of Mind and Insurance

Even more, Gabriel knows exactly what his death taxes will be. So, he knows exactly how much insurance to buy to cover the tax, giving him peace of mind knowing that the business can go on without disruption and his customers are kept happy. Gabriel was glad he had a conversation with us.

Get in Touch with Us About a Custom Estate Freeze Designed for You

We would be happy to sit down with you and determine if an estate freeze makes sense for you and help you with all levels of implementation

Making the New Residential Anti-Flipping Tax Work in your Favour

Thanusan Raveendran and Martin Lee, CPA, CA

The **Anti-Flipping Tax** is a deeming rule – set to take effect in 2023 – that taxes profits from flipping residential real estate owned for less than 12 months as business income rather than capital gains. In Canada, capital gains are taxed favourably. Only 50% of the capital gains get included in taxable income and taxed. The tax applies to both individuals and corporations.

Taxpayers who flip residential properties inside a corporation could be eligible for the small business deduction. In Ontario, corporations eligible for small business deductions only pay a tax of 12.2% on the first $500,000 of business profits and 25.08% on capital gains.

These corporations would see the anti-flipping tax as a good thing because it automatically deems gains from short-term flips as business profits, allowing them to qualify for the lower small business tax rate. In the past, these taxpayers may have had some doubts as to whether they qualified for the small business deduction.

Furthermore, taxpayers should be able to claim more expenses because gains from short-term residential property flips are considered business profits. Note if these gains were treated as capital gains, taxpayers would not be able to claim expenses like mortgage interest, condo fees, insurance, and property taxes. They would only be able to claim the selling costs.

Example

It is 2023, and Ben has his eye on a residential property he wants to renovate and flip within 12 months. After reading the above article, he calls his accountant and lawyers to purchase the property inside a corporation, BenCo.

BenCo purchased the property for $400,000, made renovations for $100,000, and sold it for $1 million within 12 months.

Ben is in the top bracket; whereby capital gains get taxed at 26.77%. Ben defers more than $70,000 by doing the flip inside a corporation.

	Corporation	Individual
Proceeds	$ 1,000,000	$ 1,000,000
Cost	-$ 500,000	-$ 500,000
Gain	**$ 500,000**	**$ 500,000**
Tax rate	12.20%	26.77%
Income tax (anti-flipping tax)	$ 61,000	$ 133,825
Taxes deferred	**$ 72,825**	**$ -**

If you plan on flipping residential real estate, it may make sense to do so inside a corporation to take advantage of the lower tax rate. However, if you already own a residential property personally and want to transfer it to a corporation, it may be challenging to accomplish that tax-free. For this reason, it is often easier to purchase the property directly through a corporation.

This is one of the reasons we do not see this anti-flipping tax have a significant impact in cooling the real estate market, as it was intended to. Many taxpayers already use corporations to make real estate investments and may welcome this announcement.

In any case, if you plan on flipping a property in 2023, we suggest you reach out to your tax advisor to review the impact of the anti-flipping tax and the best legal structure to have it work in your favour.

Non-Residents Selling Canadian Real-Estate Should Consider Obtaining a Tax Clearance Certificate

Thanusan Raveendran and Martin Lee, CPA, CA

With measures like the Underused Housing Tax ("**UHT**") and the overall downturn in the Canadian real estate market, some foreigners are hitting the sell button on their Canadian real estate. Suppose you are a non-resident (i.e., a foreigner) of Canada and sell Canadian real estate in most cases. In that case, getting a tax clearance certificate from the Canada Revenue Agency ("**CRA**") is usually a good idea.

What happens if I sell Canadian real estate?

Suppose you are a foreigner and sell Canadian Real-Estate. In that case, you must pay Canadian tax on the capital gain and file a Canadian tax return. The government is worried about collecting taxes from foreigners, so they force the buyer to withhold the tax and remit it to the CRA on your behalf.

The withholding tax is often higher than the actual tax

The problem is that withholding tax is usually 25% of the gross selling price, not capital gain. So, suppose you sell a home for $1 million, and the cost of the home was $1 million. The withholding tax would be 25% of $1 million, not the capital gain, which would be $nil, and no tax.

The withholding tax is just a pre-payment of tax, so when you file your tax return, the $250,000 ($1 million x 25%) reduces your final tax. In the above example, you will receive a refund of $250,000 since there would be no capital gain.

Tax Clearance Certificate on Real Estate

Most people will want cash immediately instead of paying the hefty withholding tax. Applying for a Tax Clearance Certificate with the CRA makes sense in such cases. Tax professionals refer to this as the “**Section 116 Clearance Certificate.**” This is done by filing form T2060 or T2060A with the CRA. If the CRA is satisfied with your application, they will issue a tax clearance certificate. If you present the tax clearance certificate to the buyer, they will be permitted to withhold the 25% tax based on the capital gain instead of the sale price, leaving you with more money upfront.

The buyer needs to remit the tax within 30 days after the end of the month of the sale.

Request for a CRA Comfort Letter When Tax Clearance Certificate Delayed

Due to backlogs, the CRA could take 3 to 6 months to issue a Tax Clearance Certificate. To ease the process, the CRA is often willing to issue a **comfort letter** while they review your application. The comfort letter allows the buyer’s lawyers to hold the withholding tax ($250,000 in our example) in escrow and release it as per the Tax Clearance Certificate when received. This eliminates the need for the buyer to submit the taxes to the CRA within the specified time frame. They will be allowed to hold onto the funds until the Tax Clearance Certificate is issued.

The CRA doesn’t automatically issue the comfort letter. You need to request them to do so.

So, in our example, if you receive the comfort letter, the buyer’s lawyer will hold the $250,000 in escrow. When CRA issues the Tax Clearance Certificate, the lawyers will release the $250,000 since you have no capital gains.

Advice on Completing the Tax Clearance Certificate

The CRA asks for a lot of information when you apply for the clearance certificate, so it is best to involve a tax specialist like us. Also, it is good to ensure that you complied with all the tax filing obligations in the past, like making sure you paid withholding taxes on any rental properties.