Certified Cultural Property

Tax implications of disposition

Presented by: Pamela Liang
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Importance of Cultural Property

- Encourage the acquisition of national treasures within Canada by institutions and public authorities
  - Example: museums, art galleries
- Preserve and exhibit such treasures to the public
- Tax benefits as an incentive to encourage the gifting of cultural property to enrich the collections of such institutions and public authorities

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Background

What is certified cultural property?

- A property of outstanding significance and national importance to Canada, for which a certificate has been issued by the Canadian Cultural Property Export Review Board

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Tax Treatment

Overview

- Disposition of certified cultural property to institutions and public authorities designated by the Minister of Canadian Heritage
  - Individual and corporate donors
  - Sold, donated, or combined donation/sales agreement
  - Tax exemption for capital gains realized
  - Tax credit or deduction to donors, if disposition by way of a gift, up to 100% of their net income

Cultural Property Export and Import Act (CPEIA)

Designated Organization

- Institution that is publicly owned and is operated solely for the benefit of the public, that is established for educational or cultural purposes and that conserves objects and exhibits them or otherwise makes them available to the public
- Only designated organizations may apply for certification on behalf of donors and vendors
- Disposition agreement between donor and the collecting organization

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Cultural Property Export and Import Act (CPEIA)

Criteria for Certification

- Canadian Cultural Property Export Review Board
  - Object or collection may be deemed of outstanding significance if it satisfies any one or more of the following:
    - A close association with Canadian history
    - A close association with national life
    - Aesthetic qualities
    - Value in the study of the arts
    - Value in the study of the sciences
  - Whether its loss to Canada would significantly diminish the national heritage

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Tax Treatment

General Application

- Taxpayer deemed to have received fair market value as proceeds of disposition of the property
- There would be an income inclusion if the certified cultural property were a trading asset such as inventory
- Gift must be evidenced by filing both the receipt from the donee and the certificate provided by the Review Board
- Must be a gift or sale of the object, not a gift or sale of an interest in an object
- Intellectual property may not follow the object, which could affect the value of the object
  - E.g. copyright, right to reproduce, etc.

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Fair Market Value

Determination by the Review Board

- Fair market value of an object is deemed to be the fair market value determined by the Review Board
  - CRA gives deference to the Review Board but may reserve the right to administer the *Income Tax Act* to determine FMV
- "Eligible Amount" of the object reflects any advantage to donor

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Fair Market Value

Determination by the Review Board cont'd

- Application to Review Board must include substantiated monetary appraisals
- Donors or vendors who are not satisfied with a Review Board determination of FMV can request a Review Board redetermination
- If donor or vendor disagrees with redetermined FMV, can appeal the redetermined amount to the Tax Court of Canada

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Capital Gains and Losses

- No capital gain from the sale or gift by a taxpayer of certified cultural property to a designated cultural institution
- Capital gains also exempt for dispositions as a consequence of the death of a taxpayer
  - Transfer must occur within the period ending 36 months after taxpayer's death
- Capital losses may only be deducted within *ITA* limits
  - Losses on the disposition of personal-use property

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Tax Credits for Gifts

Individuals

- Credit can be claimed, as determined by a formula, for the value of the individual's "total gifts"
- Total gifts:
    - total of various charitable gifts made by the taxpayer, including total cultural gifts
- Total cultural gifts:
    - total of all amounts, each of which is the eligible amount of a certified cultural property gift made to a designated institution or public authority by the taxpayer or the taxpayer's estate in the year, or any of the five immediately preceding taxation years, to the extent that the value of the gift is not otherwise included in determining a tax credit claimed for a prior taxation year

Tax Credits for Gifts

Individuals

- Difference between “total gifts” and “total cultural gifts”
  - Definition of “total gifts” limits the credit available to 75% of the taxpayer’s net income
  - Limit does not apply to “total cultural gifts” for which credit can be used to offset tax on 100% of taxpayer’s net income

Tax Credits for Gifts

Individuals

- Formula to determine tax credit
  - Subsection 118.1(3) of the *Income Tax Act*
  - Applying the lowest Part I tax rate (15%) to the lesser of $200 and the individual's total gifts for the year. To that amount is added the highest Part I tax rate (33%) applied to the portion of the individual's total gifts for the year in excess of $200.

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Tax Credits for Gifts

Estates

- Gift by will
  - The gift is deemed to have been made by the estate at the time the property is actually transferred to the donee
  - Valuation of gift for donation tax receipt is the FMV of the gifted property at the time the property is transferred to the donee
  - Gift by a graduated rate estate (“GRE”)
    - Made by a GRE
    - Gift made within 36 months of the testator’s date of death
    - Gift of assets that is property or substituted property owned by the testator at his or her date of death

Tax Credits for Gifts

Estates

- Tax credit for GRE gifts can be claimed by:
  - The donor’s terminal tax year
  - The donor’s tax year immediately preceding the terminal tax year
  - The tax year of the GRE in which the donation was made
  - The estate in any of the 5 following taxation years of the GRE or
  - Prior tax years of the GRE

- Tax credit for estates that are not GRE can be claimed:
  - The tax year in which the gift is made
  - In any of the five following taxation years

Tax Credits for Gifts

Individuals

- Gift by artists
  - If a charitable gift (by will or therwise) is made by an artist and the gifted work is included in the artist's inventory, the artist will be deemed to have received proceeds of disposition equal to the cost amount of the work of art to the artist.
  - Artist will be entitled to a credit based on the fair market value of the gift, determined by the Review Board, but will reflect neither a profit nor a loss on its disposition in calculating income from the artist's business for income tax purposes.

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Exception

Tax-Shelter Gifting Arrangement

- Any property for which a promoter represents than an investor can claim deductions or receive benefits that equal or exceed the amount invested within four years of purchase
- Value of donated property deemed to be no greater than its cost to the donor

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Deduction of Gifts

Corporations

- Entitled to deduct the FMV of the aggregate of gifts of certified cultural property made during the year to designated cultural institutions, or in the five immediately preceding taxation years, unless a deduction has already been claimed for the same amount in a preceding taxation year
  - Deducted amount may not exceed the corporation's income for the year that remains after the deduction of amounts
  - Unused amounts may be carried over to the subsequent five taxation years
  - Deduction reduces taxable income for corporations (in contrast to the tax credit received by individual donors)
- Gifts by partnerships can flow through tax consequences to partners

Appraisals

- If property was a trading asset to the donor, the appraisal cost is deductible in determining the donor's income to the extent that it is reasonable in the circumstances
- Appraisal costs incurred in respect of donations of capital property are not deductible in determining income
- Appraisal costs incurred in connection with, but prior to, the disposition of a property increase the donor's costs of disposition to the extent that such costs are reasonable in the circumstances

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Disposition by Designated Cultural Institutions

- Disposition within ten years of the time the property was first certified by the Review Board and donated to a designated cultural institution
    - If the designated cultural institution subsequently disposes of the cultural property, the institution shall pay a special tax equal to 30% of the FMV of the property at the time of such disposition, unless the disposition is made to another designated cultural institution

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Potential Issues

- Determination of fair market value
- Finding appropriate appraisers
- Other objects of cultural significance
- Must be an "object"
  - Intellectual property associated with object could affect value

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Questions?

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Canadians with International Assets

Presented by: Lorne Saltman
May 17, 2017

Topics to Discuss

1. Introduction: Know Your Client
2. Common law vs. Civil Law Jurisdictions
3. Recognition of Trusts
4. Multiple Taxation in Life or on Death
5. Canadian Outbound Taxation
6. Foreign Property Reporting
7. Offshore Investment Fund Property
8. Foreign Trusts

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Know Your Client

- Review comprehensive statement of net worth
- Identify location and ownership of all property
- Consider current estate plan, if any
- Review family tree, background, residence, domicile, citizenship for client and family members

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Common Law Versus Civil Law

- *Matrimonial Regimes*
  - Separation of property during marriage
  - On death or divorce: equitable division of property in common law jurisdictions
  - Community of property in civil law jurisdictions
- *Testamentary Freedom versus Forced Heirship*
  - General common law freedom limited by spousal and dependent claims
  - Civil law forced heirship provides for mandatory distribution of a portion of the estate to family members

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Recognition of Trusts

- Generally, civil law jurisdictions do not have the trust concept , i.e. the division of ownership between "legal" and "beneficial" is not recognized in law
- Hague Trust Convention provides for recognition in those jurisdictions it is in effect
    - The Hague Conference has currently 82 Members: 81 States and the European Union, including for example, France and Italy
- Income tax implications unclear in some civil law jurisdictions: separate entity/contract/agency ?

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Multiple Taxation in Life or on Death

- Tax can be levied on a living person, a deceased, an estate and/or a beneficiary
- Tax base can be: citizenship, residence, domicile, location of assets
- Some tax treaties provide relief from double taxation in life or on death
- Need for advance planning, including tax liability of intended beneficiaries

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Multiple Taxation in Life or on Death ...cont'd

If Hold Interests in Certain U.S. Entities, There May Be Exposure to Double Taxation

- The CRA considers a Limited Liability Company ("LLC") to be a separate corporation for Canadian tax purposes, even though for U.S. tax purposes, these are treated as "pass-through" entities, like a partnership
- Recently, the CRA announced they would treat Limited Liability Partnerships ("LLPs") and Limited Liability Limited Partnerships ("LLLPs") created in Delaware and Florida also as separate corporations

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Multiple Taxation in Life or on Death ...cont'd

If Hold U.S. Real Estate, The Issues To Consider Include The Following:

- U.S. Estate tax at an escalating rate up to 40% of the gross value of U.S. *situs* property, such as a U.S. vacation home
- U.S. Gift tax on a similar scale
- U.S. income tax on sale of the property
- Canadian income tax on the capital gain either deemed to be realized on death or from actual sale of the property
- Avoiding double taxation

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Multiple Taxation in Life or on Death ...cont'd

Available Arrangements to Hold U.S. Vacation Property

- Individual ownership
- Holding company in Canada
- Holding company in U.S.
- Non-recourse mortgage
- Life Insurance
- Canadian family trust

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Multiple Taxation in Life or on Death …cont'd

Use of Canadian Family Trust

- Structure
  - Spouse with resources contributes purchase price of property to trust as settlor
  - Other spouse is trustee
  - Beneficiaries include other spouse and issue (but not settlor spouse)

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Multiple Taxation in Life or on Death ...cont'd

- Implications
  - Insulation from U.S. Estate tax and Gift tax
  - Avoidance of U.S. probate on death
  - Integration of trust with wills and estate planning
  - On sale, capital gain taxed in the U.S. to trust or individual beneficiaries at long-term capital gains rate, currently 20%
  - On sale, must recognize U.S. capital gain to trust or beneficiary in Canada , subject to maximum tax at 26.77%, with a foreign tax credit for the 20% tax paid to the U.S.

Canadian Outbound Taxation

- Canada taxes Canadian residents earning income abroad
- "Residency-Based"
- A resident of Canada is subject to tax in Canada on his/her/its worldwide income under Part I of the Act
- 2 ways for a Canadian resident to earn income abroad:
  - Directly; or
  - Indirectly

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Canadian Outbound Taxation ...cont'd

Foreign Property Reporting

- A Canadian resident must report ownership of foreign income-producing property where the aggregate cost is more than $100,000
- Where a Canadian resident transfers or loans funds to a non-resident trust, or receives a distribution from such a trust, these transaction have to be reported
- A Canadian resident that has a foreign affiliate must report this as well

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Canadian Outbound Taxation ...cont'd

- The Income Tax Act was recently amended to require large multinational corporate groups to provide country-by-country reports that the CRA will share with other tax authorities: is this a sign of coming disclosure for individuals?

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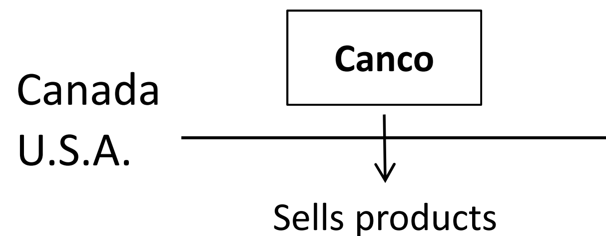
Canadian Outbound Taxation …cont'd

Foreign income can be earned directly by a Canadian resident

- Example:



- Foreign income earned directly must be included in the resident's income and reported in the resident's Canadian tax return
- Such income may also be taxed in the country in which it was earned
- Foreign tax credits provide relief from double taxation

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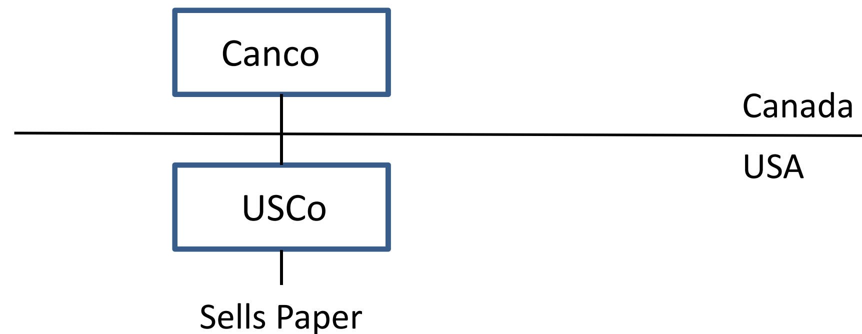
Canadian Outbound Taxation ...cont'd

Foreign Income Earned Indirectly

Example:



- Certain passive foreign income earned indirectly by a Canadian resident must be included in the resident's income on a current/accrual basis
- Active foreign income earned indirectly by a Canadian resident is only included in the resident's income when it is distributed to the resident

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Canadian Outbound Taxation ...cont'd

Foreign Income Earned Indirectly

- Foreign income can be earned indirectly by a Canadian resident through:
  - A foreign corporation:
    1. Foreign Affiliate
    2. Controlled Foreign Affiliate
    3. Holding "offshore investment fund property"
  - A Non-Resident Trust

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Canadian Outbound Taxation ...cont'd

Foreign Income Earned Indirectly - Foreign Affiliate

- A foreign affiliate ("FA") is a foreign corporation that:
  - a Canadian resident alone, or together with other related persons (not necessarily Canadian residents), own 10% of the shares of a class or series of the foreign corporation; and
  - The Canadian resident itself owns at least 1% of those shares.

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Canadian Outbound Taxation …cont'd

Foreign Income Earned Indirectly - FA Consequences

- Canadian residents earning income abroad through FAs are required to track their earnings in surplus accounts
- Exempt surplus account - tracks active business income earned by an FA in a designated treaty country

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Canadian Outbound Taxation ...cont'd

Foreign Income Earned Indirectly - FA Consequences

- Dividends paid out of an FA's *exempt surplus account* are included in the income of the Canadian corporate shareholder when received, but are fully deducted in computing taxable income of the Canadian corporate shareholder
- Therefore active business earnings earned in a designated treaty country are effectively not subject to Canadian tax
- A Canadian resident tracks passive income, non-active business income, and active business income earned in a country that is not a designated treaty country in a taxable surplus account

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Canadian Outbound Taxation ...cont'd

Foreign Income Earned Indirectly - FA Consequences

- Dividends paid out of a FA's *taxable surplus* are included in the Canadian shareholder's income; however, a deduction in computing taxable income is allowed for the underlying foreign taxes paid by the foreign affiliate on its profits and for any foreign withholding taxes on the dividend
- Therefore passive, non-active and active business income earned in a country that is not a designated treaty country are subject to Canadian tax as *FAPI* ("foreign accrual property income")

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Canadian Outbound Taxation ...cont'd

Foreign Income Earned Indirectly - FA Consequences

- If a FA holding company ("Barbco") were to dispose of the shares of another FA carrying on an active business for a capital gain, there would be no inclusion of the gain in *FAPI*. The capital gain would be included in the "hybrid surplus" of Barbco
- If a dividend from Barbco's hybrid surplus is received by a Canadian resident corporation, one-half would be tax-free and one-half would be included in its income, with a form of foreign tax credit being available for any Barbados taxes imposed on Barbco (which in this case would be nominal if any)

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Canadian Outbound Taxation ...cont'd

Foreign Income Earned Indirectly - FA Consequences

- In summary, the regime for taxing income of foreign affiliates is based on characterizing the nature of the foreign income
  - *Exempt surplus* includes income earned from an active business carried on in a *designated treaty country* by a resident of that country
  - *Taxable surplus* consists of *FAPI*, *income from property*, active business income earned in countries that are not *designated treaty countries* and certain other amounts earned by foreign affiliates
  - *Hybrid surplus* arises from capital gains realized on the disposition of foreign affiliates.

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Canadian Outbound Taxation ...cont'd

Foreign Income Earned Indirectly - FA Consequences: Summary

- Dividends received by a Canadian corporate shareholder are considered to be paid first out of the *exempt surplus* and then out of *taxable surplus* and *hybrid surplus*
- Once *exempt*, *taxable surplus* and *hybrid surplus* have been exhausted, further dividends are treated as a recovery of the shareholder's cost, and the adjusted cost base of the shares in the foreign affiliate is reduced accordingly

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Canadian Outbound Taxation …cont'd

Foreign Income Earned Indirectly - Controlled Foreign Affiliate ("CFA")

- Canadian corporate shareholders receiving *exempt surplus* through a CFA are subject to the same Canadian tax treatment thereof as an FA, i.e. no Canadian tax thereon
- CFAs are also subject to the same treatment of *taxable surplus* with one major exception – Canadian shareholders are taxable on an accrual basis on foreign accrual property income (*FAPI*) earned by CFAs, regardless of whether *FAPI* is actually distributed to the shareholder

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Canadian Outbound Taxation …cont'd

Foreign Income Earned Indirectly - Controlled Foreign Affiliate ("CFA")

- Moreover, an additional deduction is allowed in computing income of the Canadian shareholder in respect of dividends paid out of previously taxed *FAPI*, which was included in *taxable surplus*

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Canadian Outbound Taxation ...cont'd

Foreign Income Earned Indirectly - FAPI

- *FAPI* very generally means passive income
- *FAPI* includes
  - "income from property",
  - income from a business, other than an active business, and
  - certain taxable capital gains.

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Canadian Outbound Taxation ...cont'd

Foreign Income Earned Directly - FAPI

- "Income from property" includes interest, rents, royalties, dividends and income from an "investment business"
- An "investment business" is a business (other than a business defined not to be active under the ITA) carried on principally to earn income from property, insuring or reinsuring risks, factoring trade accounts receivable, and profits from the disposition of investment property.

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The Offshore Investment Fund Property Rules

- The OIFP Rules are aimed at penalizing investments by Canadian residents in offshore entities that primarily earn investment or passive income.

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The Offshore Investment Fund Property Rules ...cont'd

- In order for the OIFP rules to apply, the following conditions must be met at any time in a taxation year of the taxpayer:
  - The taxpayer must have an interest in an "offshore investment fund property"
  - It may reasonably be concluded that one of the main reasons for investing in the offshore investment fund property is to significantly reduce the income tax that would have been paid if the income had been earned directly by the taxpayer.

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The Offshore Investment Fund Property Rules ...cont'd

- An "offshore investment fund property" generally is a share of the capital stock of, an interest in, or a debt of, a non-resident entity (other than certain non-resident entities including *controlled foreign affiliates*) that may reasonably be considered to derive its value primarily from portfolio investments of that or any other non-resident entity in certain property.

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The Offshore Investment Fund Property Rules …cont'd

- If the OIFP Rules apply, an amount must be included in computing the taxpayer's income from the investment. This amount is determined generally by multiplying the "designated cost" of the taxpayer's investment by a factor based on the prescribed interest rate.

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The Non-Resident Trust Rules

- The Non-Resident Trust (“NRT”) rules impose liability jointly on a Canadian contributor and the trust if there is either:
  - A connected contributor (i.e. having contributed at a time other than at a *non-resident time*), regardless of the beneficiaries’ residency, or
  - A resident beneficiary (i.e. having a Canadian resident beneficiary and a connected contributor).

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The Non-Resident Trust Rules ...cont'd

- The property of a NRT is divided into a "resident portion" and a "non-resident portion". The "resident portion" consists of property of the trust that has been contributed by residents and certain former residents of Canada (and any property substituted for such property).
- The "non-resident portion" consists of any property that is not part of the "resident portion" of the property of the trust.

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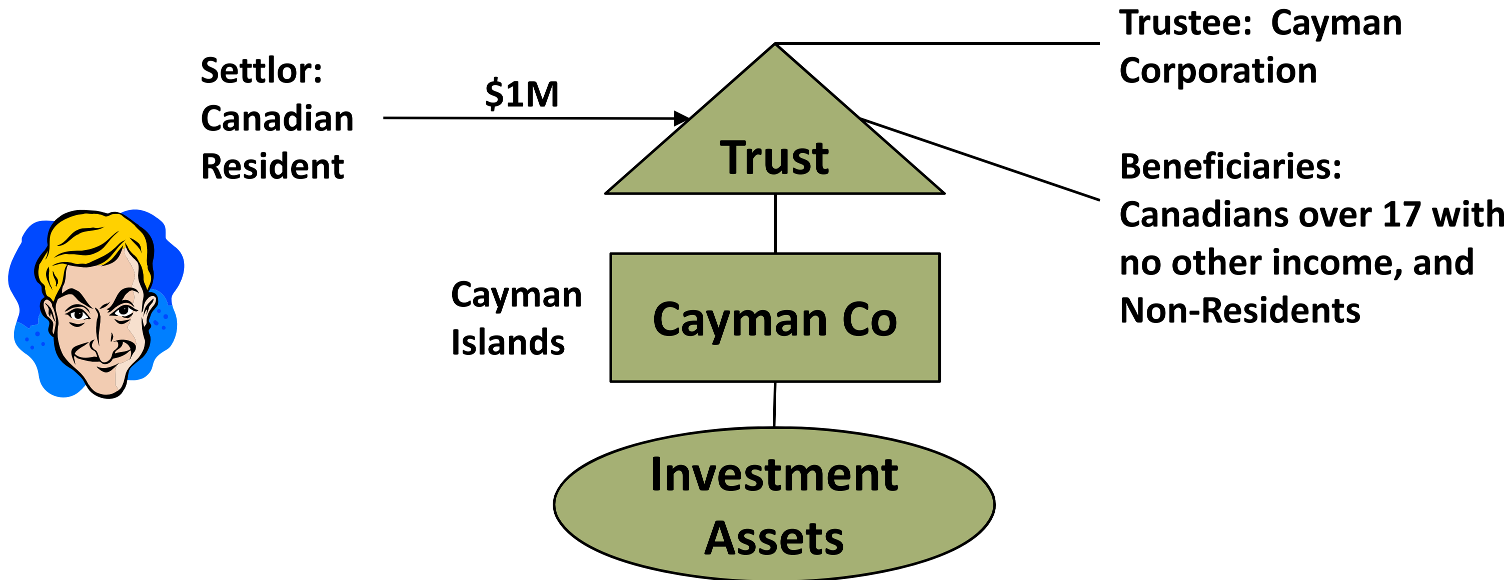
Outbound Offshore Trust



- Deemed to be Canadian Trust (NRT)
- Trust may allocate income every year to Non-Resident Beneficiaries, if such Beneficiary can take advantage of remittance-based taxation
- Withholding tax applies on distributions to Non-Resident Beneficiaries out of the "resident portion"
- 25% tax rate compared to 53%

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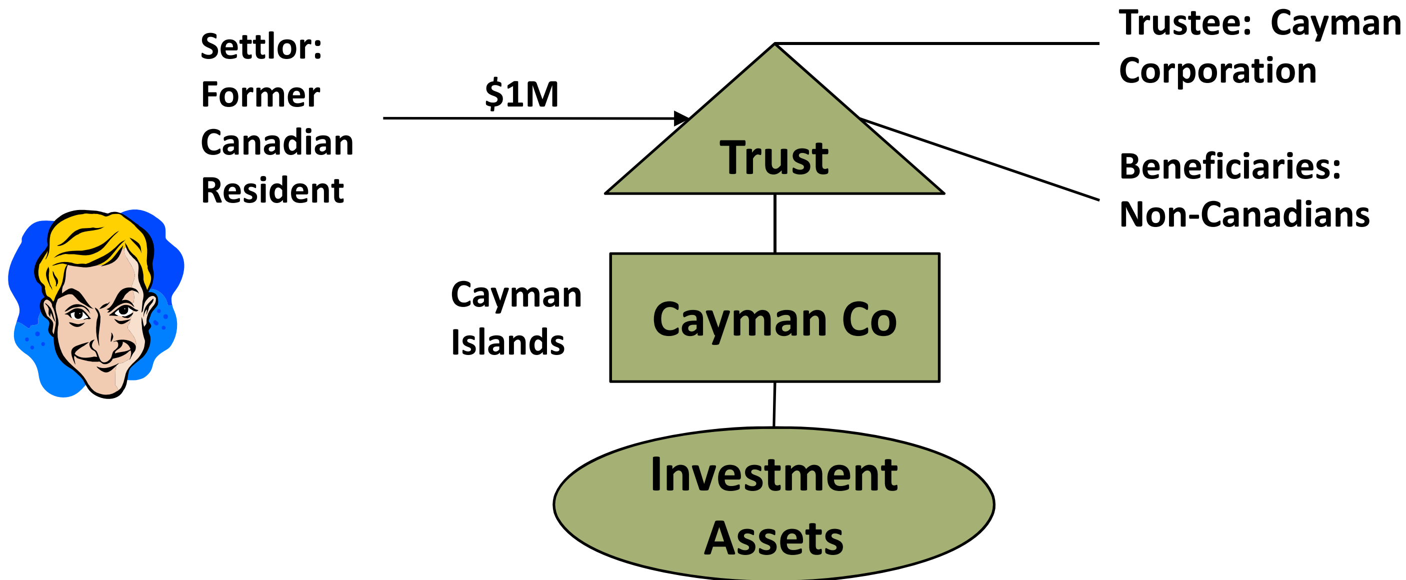
Offshore Trust Subsequent to Leaving Canada



- Trust not subject to Canadian tax as no Canadian contributor
- May eliminate tax in new country
- Trust cannot have Canadian Beneficiaries

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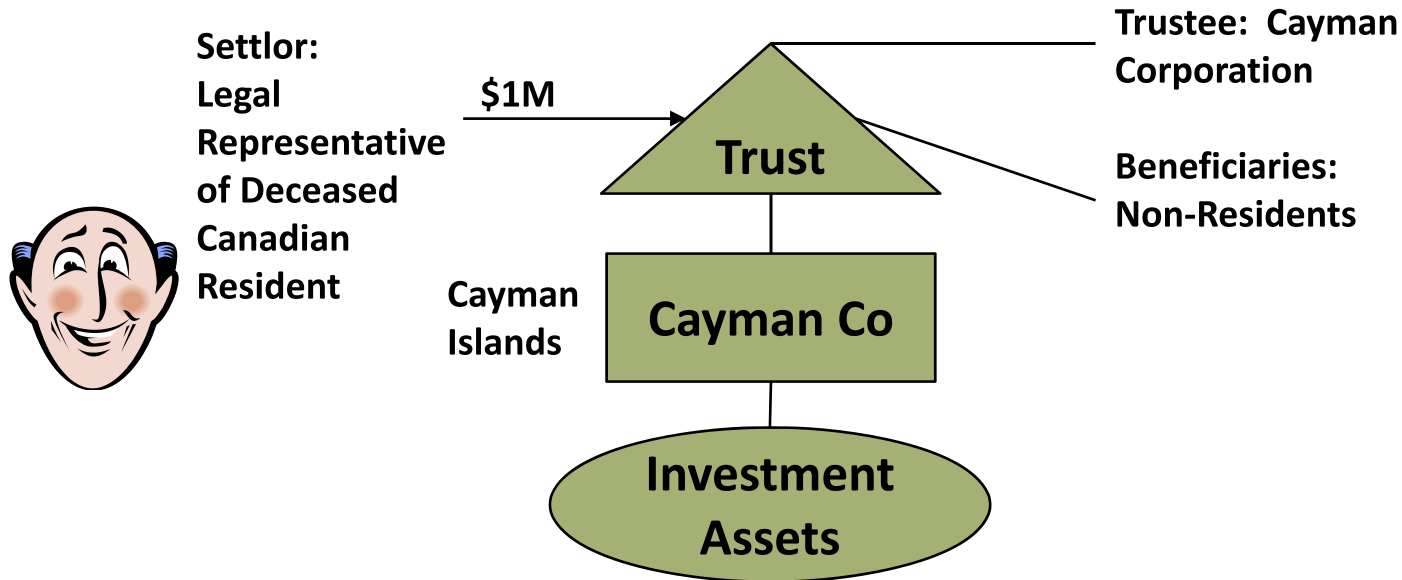
Offshore Trust in Will



- May be able to minimize tax in the country of residence of the Beneficiaries

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Questions?

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