

Wealth and tax *matters*

for individuals and private companies

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Issue 1



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See “How to get *Wealth and tax matters*,” on page 41.

Editorial

Welcome to another edition of *Wealth and tax matters*—the first one reflecting the new PwC branding, which we hope you will like. Articles cover issues facing the family business, cross-border tax matters and various tax traps.

Our first set of articles deals with planning for the family business—both the tax and non-tax. We look at shareholders' agreements and how to deal with the death of a shareholder, the non-tax issues involved in family succession and tax structuring to consider when planning for the sale of the business.

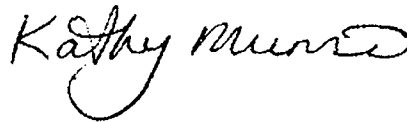
More and more we see the long reach of Uncle Sam in Canada. The second set of articles deals in part with this issue. We provide an update on the U.S. estate tax regime and that country's new FATCA rules, which stretch across the border and affect U.S. citizens residing in Canada. Recognizing the increasing number of children attending schools outside of Canada, we also offer an article on the tax implications.

Our final set of articles deals with potential traps for the unwary. We examine the proper administration of family trusts, as well as the rules dealing with a change in use of real estate and those governing payments to non-residents of Canada.

Thank you for reading our publication. Please let us know if we can be of assistance to you in dealing with your wealth and tax matters.



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Death of a shareholder

Shareholders' agreements (Part 2)

If you have a shareholders' agreement in place, it likely contains provisions that will apply in the event of a shareholder's death. While specific terms can vary, provisions that will result in the buy-out of a deceased shareholder's shares are common. These important provisions can give the deceased shareholder's family a market for the shares and permit the surviving shareholders to carry on business without the deceased shareholder's family. But regardless of the business rationale, the specific terms should be analyzed by a tax professional.

If not structured properly, unintended tax consequences can arise.

When an individual dies owning shares of a private corporation, tax planning may be necessary to avoid double taxation.

This second of a series of articles dedicated to tax considerations of shareholders' agreements for private corporations will focus on the tax implications for buy-sell rights triggered at death.

Tax implications of a shareholder's death

In general, Canada's *Income Tax Act* deems an individual to have, immediately before death, disposed of all of his or her capital property (including shares of a private corporation) at fair market value (FMV). The deceased individual will realize a capital gain on the deemed disposition to the extent the FMV of the capital property exceeds the tax cost. Income taxes payable by the estate will be based on the net capital gains reported in the deceased's final income tax return.

If, however, the capital property is transferred to the deceased's spouse or a qualifying spousal trust as a consequence of death (i.e., under the terms of a will or under intestacy laws), the tax on the accrued capital gain can be deferred until the spouse either disposes of the property or dies. Ensuring that this spousal rollover of capital property is available may be an essential element in a tax-efficient buy-out of the deceased's private corporation shares.

In addition, when an individual dies owning shares of a private corporation, tax planning may be necessary to avoid any incidence of double taxation. (For

more on double taxation, see "Double Tax on Private Company Shares" in the spring 2009 edition of *Wealth and tax matters*.)

Given the serious tax implications that flow from the death of a shareholder and that tax planning may be necessary to alleviate any negative tax results, care should be taken to ensure that terms of a shareholders' agreement do not limit or frustrate an appropriate tax plan.

Who will purchase the shares?

If a buy-out will occur after a death, the shareholders' agreement should identify who will purchase the shares from the deceased's estate (or from surviving family members)—the remaining shareholder(s) or the corporation. The better choice will depend on both the intended business result and the tax implications.

If the remaining shareholder(s) purchase the shares, the effective tax result for the deceased and family is a capital gain equal to the difference between the purchase price and the tax cost of the shares. If the deceased has not used all of his or her \$750,000 lifetime capital gains exemption, it can offset all or part of the capital gains, assuming that the shares qualify for the exemption. The remaining shareholders will acquire additional shares of the corporation at a tax cost equal to the amount paid for the shares.

Puts and Calls

Puts – A put is an option in a contract that gives the holder the right to sell, and requires another entity to purchase, the underlying property at a certain price.

Calls – A call is an option in a contract that gives the buyer the right to buy, and requires another entity to sell, the underlying property at a certain price.

Alternatively, if the corporation purchases the shares, the effective tax result for the deceased and family is a dividend equal to the difference between the purchase price and the tax paid-up capital of the shares, which might or might not equal the tax cost of the shares. While dividends are generally taxed at a higher rate than capital gains, if the corporation has a positive balance in its capital dividend account (CDA), with proper planning, the effective tax rate on the dividends can be reduced or, in some situations, eliminated. If a corporation owns life insurance on the deceased's life, the death benefit it receives (less the adjusted cost basis of the policy) will be added to the corporation's CDA and can be used as part of a tax-efficient buy-out.

Funding the purchase

No matter who is identified to purchase the shares, funding the purchase can be a challenge. Options include purchasing life insurance policies on the lives of the shareholders, using personal savings, borrowing funds, paying the estate on an instalment basis (this, however, can result in negative tax implications if the corporation is the purchaser) and selling assets. If the purchaser is the remaining shareholders and corporate assets are to be extracted to fund the purchase price, additional tax will arise unless the corporation has a sufficient balance in its CDA.

Several alternatives may exist, and no single approach fits all situations, so it is important that shareholders anticipate more than one funding option and the tax consequences that would arise on the death of a shareholder.

Tainting a spousal rollover

In a common buy-out plan, the corporation purchases insurance on the lives of each of the shareholders and uses the proceeds to buy back the deceased shareholder's shares after death. If the amount of life insurance (and resulting CDA balance) is sufficient to cover the purchase price (or, at least, the deemed dividend that will result on the share purchase) and the deceased shareholder transfers the shares to his or her spouse as a consequence of death, the taxes that otherwise arise as a result of death and share purchase can be eliminated. The result is that the deceased's spouse receives the purchase price proceeds tax free.

If, however, the shares are not transferred to the spouse, or if the transfer is "tainted" under the tax rules, eliminating tax on the buy-out may not be possible. This tainting of any purported transfer of shares to the spouse occurs if a shareholders' agreement requires the deceased's estate to sell the shares. This is because the mandatory nature of the agreement will prevent the estate from vesting the shares in the spouse's hands.

Instead of imposing a mandatory sale in the shareholders' agreement, the agreement should include both a put and a call option (see box) permitting the estate (or spouse) and the corporation to put or call the shares. These provisions:

- will not taint the transfer of shares to the spouse; and
- allows the deceased's estate and spouse to take maximum advantage of tax planning.

Who is entitled to receive the CDA?

If using the corporation's CDA is an essential element of a tax-efficient buy-out of a deceased's shares (such as is discussed above), the shareholders' agreement should set out explicitly how the CDA will be used, and who has the benefit of the amount. In a recent Ontario Supreme Court decision, **Ribeiro Estate v. Braun Nursery Ltd.** (2009), the court determined that, even though the shareholders' agreement was explicit that life insurance proceeds were to be used by the corporation in purchasing the deceased's shares, the corporation was not required to use the corresponding CDA for the benefit of the deceased. As a result, even if the most tax-efficient plan (from the deceased's perspective) is for the corporation to use the CDA to fund the buy-out, the corporation cannot be compelled to do so unless the shareholders' agreement requires it.

Next steps?

A well-drafted shareholders' agreement should ensure that all shareholders:

- can extract their investment in the corporation (at agreed times);
- minimize their tax liability at death; and
- are clear on who is entitled to certain tax balances, such as the CDA.

We recommend that you consult with your tax adviser to determine if these elements have been properly integrated into your shareholders' agreement.

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Part 3: Events other than death

Shareholders' agreements often deal with events other than death. In the next edition of *Wealth and tax matters*, Part 3 of this series will examine the tax implications of buy-sell provisions triggered by events such as contract breaches, marriage breakdown and financial difficulty.



The science of succession within the business family (Part 1)



One of the many findings in the recent *PwC Global Family Business Survey 2010/11 – Kin in the Game* confirmed that family businesses are a critical force in our economy—perhaps one of the reasons Canada was not hit as hard as other countries in the recent recession. The survey attests that:

- over 70% of the respondents believe that being a family business helped them get through the crisis;
- 66% said they experienced modest to significant growth during that time;
- an astonishing 31% increased their capital expenditure to invest;
- only 18% reported their operating profits had decreased; and
- 67% have access to surplus cash flow.

The verdict, consistent with numerous global studies, is that family businesses are here to stay. But that makes some interesting figures even more important:

- at least one in four of these companies will experience a major transition of leadership in the next four years; yet
- not even half the companies surveyed have identified anyone to fill the positions.

If these companies are managed by the founding owner, chances are that most hope for the leadership to be taken on by someone in their family. Unfortunately, the statistics of unsuccessful transitions support the adage “shirtsleeves to shirtsleeves in three generations”—a sad reality for many.

On the other hand, we are finding ever more successful ways of handling transition. Adopting some key strategies in the first generational transition will pave the way for smoother transitions when the time comes.

What makes family business, and business families, unique and transitions so hard?

The advantages of being a part of, or working for, a business family (and their family business) are many. While the size of the business and the stage of leadership (generation 1, 2, 3 or more) will vary, several benefits can differentiate a family business. Typical advantages include:

- commitment to long-term growth and legacy;
- decision-making (financial, strategic, personnel) with long-term vision in mind, not short-term results;
- ability to reflect strong values in business decisions and relationships;
- loyalty to the past;
- reflecting the diversity of the family members;
- commitment to more than shareholder value;
- opportunities for career development; and
- community presence and philanthropic endeavours that reflect the values of the family.

Families, the bedrock of our emotional development, and business, a rational, financial vehicle for livelihood, meet and marry within the family business, creating unique dynamics.

But along with the advantages of working with a family business come many challenges, some not prevalent in public companies. Among the endless list of potential issues facing a business family are:

- conflicting values and personalities;
- the desire to change directions or invest in new opportunities;
- divergent work styles;
- different skill sets;
- integrating new family members in the company;
- compensation plans for family members; and
- generating policies on the inclusion in leadership for those outside the family.

Families, the bedrock of our emotional development, and business, a rational, financial vehicle for livelihood, meet and marry within the family business, creating unique dynamics. For the business family, the great skill is to learn to accept and manage the continuous stream of contradictions that they will face and, more importantly, to find an upside. Nowhere is that more evident than in the transition of leadership.

The science of leadership transitions

The science of leadership transitions deals with the rational business case of succession. The ample research and tools now available can help any organization create a clear, strategic succession plan. The details will vary, depending on the competencies required, the depth and breadth of leadership, and the culture of the organization. However, the fundamental steps remain the same:

- **Start early:** A non-negotiable fact is that the leadership will change one day. Even for the founder with a sense of invincibility, someday another person will fill his or her shoes. Successful leaders often have two or three options for someone to step into the position all through their careers, not just when they feel it is time to slow down. By being diligent in identifying the fundamental skill set that is necessary for running and growing the company at different stages, it becomes easy to spot potential candidates in the family. This not only helps with contingency planning, it helps the departing leader shift towards more of a stewardship style of leadership, and away from his or her unique, idiosyncratic style.

Starting early also enables the founder to work with advisers on long-term plans for the technical aspects of the transition as it pertains to ownership agreements, valuations, taxation and risk management. (See the three succession planning articles in *Wealth and tax matters*, Winter 2009).

- **Communicate often and effectively:** Communicating with key advisers and key stakeholders to garner insights and

opinions about what competencies and skills are needed helps develop a collaborative and contributing team that will work hard to get the right person for the job. One key person to include may be the other CEO—the Chief Emotional Officer of the family, typically the founder’s spouse.

- **Identify candidates and formalize a plan:** The sooner potential candidates can be identified, the earlier a clear development strategy can be implemented to give the candidate the best shot at success. Having a clear roadmap of competencies and skills will help potential candidates plan their education, careers and experiences, as well as providing benchmarks along the way. This reduces the conflict between equality and merit that can often exist in a family business. Ideally, this phase should be handled by an external consultant, to reduce counterproductive relationship-based interference by the founding generation and perceived biases in the organization.
- **Plan for overlap of leadership:** Often called “family partnership,” this is the stage in the transition in which the incoming leader and the outgoing founder can work together, often for a few years. It is a time for mentoring, sharing of ideas, merging the old with the new and, most critically, making decisions together. This dovetailing phase ensures that the outgoing founder’s vision and objectives are met—typically creating much more peace of mind about turning his or her attention to life beyond the business. This time gives the successor a chance to integrate new long-term ideas, by respecting and building on what is in place. Through sharing wisdom and building trust, the founder and the next generation leader are building a bond that strengthens the family and the business.

- **Set an exit date and stick to it:** Once it is clear a succession is going to take place, it is imperative to plan the timing of entry, overlap and departure. This sets the stage for multiple successes:

- the incumbent can fully prepare for the handover;
- the organization can manage expectations and adjust to styles of leadership; and
- the founder can pass the torch with confidence and pride.

Many founders find constructive and helpful roles that allow them to stay active in their business, yet with enough distance to allow the new leaders to lead independently. Some founders can never truly let go. If the business is going to survive multiple generations, the passing of the leadership has to be managed professionally, and clear boundaries between the roles of founder and successor must be identified.

The transition can be planned, documented and rolled out accordingly. Following best practice can ensure a significantly improved outcome.

But what happens when some of the uncomfortable contradictions creep into the scenario?

The art of transition acknowledges these contradictions and tensions, and their emotional impact. It is this, the art of transition—rather than the science—that the next article in the series will discuss. We’ll consider how to use proven best practice to navigate through situations with two opposing ideas, yet with no right or wrong answer, and how to deal with the challenges that arise from the very nature of the organization—the family, in business, together.

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Before it's too late... the right business structure

Private business owners can get many potential tax planning, wealth enhancement and value protection benefits from having a holding company (Holdco) in their corporate structures. To maximize these benefits, the holding company and ownership of shares in operating companies (Opco) must be placed strategically within the corporate structure.

In our experience, the traditional “in-line” holding company, in which Holdco owns shares of Opco, is often not the optimal choice of structure for businesses when there is or will be a future possibility to sell Opco shares as a Qualifying Small Business Corporation (QSBC). An individual in Canada can shelter during his or her lifetime \$750,000 of capital gains arising on the disposition of QSBC shares.

Put another way, when we see corporate structures in which a holding company owns the common shares of a potential QSBC, we often find substantial opportunities for better structuring, with more benefit to the business owner. In this context it is vital to remember that only individuals have a \$750,000 personal capital gains exemption (CGE); companies get no such exemption when they realize capital gains on the sale of QSBC shares.

One of the primary tax benefits of incorporation is the significant tax deferral provided by the low corporate tax rates, from 11% to 19%, applied to active business income earned by a private company. This compares to a top personal tax rate of say 45% (they range from 39% to 50%). For a company earning \$500,000 of net income per year that is subject to a 15.5% rate, the tax deferral available annually is a staggering \$147,500.

To take maximum advantage of this deferral, funds have to be retained at the corporate level. Retaining these funds in Opco creates a real risk of putting the company offside the stringent QSBC test.

Accumulated excess funds are not typically considered to be a business asset for purposes of the QSBC test, and therefore will disqualify the Opco as a QSBC. The implication is that the shares would not qualify for the personal \$750,000 CGE on sale (or death). Avoiding this outcome is one of the primary reasons for having a holding company, so that Opco can be purified by means of ongoing dividends to Holdco.

On the other hand, if Holdco owns the shares of Opco and receives the dividend, even though the QSBC purification of Opco might be accomplished, the effort would be ineffective for CGE purposes. This is because Holdco is not eligible for CGE because only individuals are eligible for CGE. So, the existence of Holdco as the parent of Opco in the typical “in-line”



People say “timing is everything in life” and that is so true when it comes to creating the proper business structure.

structure usually prevents the business owner from ever claiming a personal CGE in respect of the accrued gains in Opco shares.

Better options for placement of Holdco in the corporate structure allow ongoing purification dividends to occur tax free between corporations, and/or permit creditor-proofing dividends to occur—all while maintaining ownership of the Opco shares in a way that lets individuals use their CGE if a buyer is found for the Opco shares while it qualifies as a QSBC. These options require insertion into the structure of a discretionary family trust that directly owns common shares of Opco, and perhaps Holdco.

Timing

Not only is it important to have the proper structure in place to maximize tax, estate planning and wealth preservation benefits, this structure should be created at the proper stage in the life cycle of the business. Too many business people have learned this unfortunate truth at the wrong time: when there is “contemplation” of a sale of Opco shares to an unrelated party.

To put some exceedingly complex rules into layman’s language, the *Income Tax Act* imposes stringent, almost impossible, rules on what can be done in terms of tax-deferred reorganization in “contemplation of sale” to an unrelated party. On the other hand, these stringent rules are not activated by internal reorganization activities carried out by related parties when an arm’s length sale is not being contemplated. In fact, when no reorganization is being done in contemplation of sale, it is generally rather easy to accomplish whatever tax-deferred restructuring is desired, as long as it involves related parties, such as in a typical family owned business.

In practice, this means that you have to have your structure right, well in advance of any potential sale activity. In particular, the restructuring activities

cannot be considered to be part of the same “series of transactions” as the ultimate sale. If the structure is wrong, and a possible sale opportunity presents itself, usually it’s too late to do any tax-efficient restructuring to facilitate the sale, because those stringent “in contemplation” rules come into play. In other words, just when you need to have a great structure—at the time of sale—typically it is impossible to create that structure tax effectively.

Here is an all-too-common experience that many tax professionals have encountered: A tax professional has just come into contact with Dave and Marie, a married couple who have spent their working careers creating Opco, a thriving private corporation carrying on a manufacturing business. They followed previous advice to create Holdco to own all the common shares of Opco. Each of them owns half of the shares. This structure was created to allow for ongoing purification of Opco for purposes of the QSBC test, and also as prudent business practice to facilitate removal of excess assets out of Opco in light of its liability exposure from operating its manufacturing business.

Opco has been successful over many years, and they used the structure as it was intended. Now Holdco has \$7 million of marketable securities, in addition to Opco shares with a market value of about \$5 million.

Dave and Marie are excited when they come to see us as their new tax adviser, because they have just received an unsolicited offer from a large public company competitor to buy just their manufacturing business at a fabulous price of \$10 million. The public company has even offered to complete the purchase as a purchase of shares (rather than assets), knowing that the after-tax result to Dave and Marie would be substantially enhanced by the \$750,000 CGE that each of them could claim. Dave and Marie fully intend to accept this offer, use each of their personal CGEs to partially shelter from tax, and then move on to a new phase of their lives, free from the responsibility of running the manufacturing operation.

Business people need to have the required business structure in place, flexible enough to handle a variety of exit strategies, well in advance of any actual exit.

Imagine their disappointment when we tell them that they don't have any shares to sell that qualify for CGE, because they personally don't own the Opco shares—Holdco does. The only shares they own personally are Holdco shares, which don't qualify because Holdco has too much value in marketable securities.

They propose an answer. Knowing about the tax-free treatment of intercorporate dividends (because of the dividends paid by Opco to Holdco over the years), Dave and Marie suggest that this problem can be fixed easily, simply by creating a new company, Stripco, and with some reorganization transactions the \$7 million of marketable securities in Holdco could be stripped out as tax-free intercorporate dividends to Stripco. This would leave Holdco with just the Opco shares, and they could then sell the Holdco shares to the buyer and enjoy their personal CGE claims.

We have to give them more disappointing news: the \$7 million cannot be stripped as inter-corporate dividends, because the "in contemplation" rules would deem most or all of the \$7 million to be a capital gain realized at the corporate level. In fact, the "stripping reorganization" they are contemplating could potentially trigger corporate capital gains approaching \$14 million, even though only \$7 million was being stripped.

This sad story has a simple moral. Business people need to have the required business structure in place, flexible enough to handle a variety of exit strategies, well in advance of any actual exit. The structure itself is vitally

important, and so is the timing of its creation. Creating the proper structure tax effectively at the time of exit generally is next to impossible.

Fortunately, if one avoids the "in-line Holdco" structure, with proper planning at the proper time and judicious use of a discretionary family trust, a good result is well within reach. You can get all of the benefits of having a holding company, in terms of QSBC purification, along with asset protection. As well, substantial opportunities will be created for multiplication of the CGE with family members and/or tax-deferred rollovers of the family business shares to the next generation. This structure can also provide substantial protection from the potentially disastrous tax consequences of an untimely death, and offers unparalleled flexibility in income splitting and estate and in succession planning.

If you have a corporate structure in which your holding company owns the shares of your operating company, you really owe it to yourself to re-examine the alternatives. It could be a rewarding exercise. People say "timing is everything in life" and that is so true when it comes to creating the proper business structure.

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Uncle Sam's long arm

Estate tax law and your U.S. vacation home

At the end of 2010, President Obama approved temporary legislation that made changes to the U.S. estate, gift and generation-skipping transfer (GST) tax regimes. These changes are effective only until the end of 2012, unless new legislation is passed. While they affect mainly U.S. citizens and residents in the United States, Canadian residents also are subject to U.S. estate tax at death on the fair market value of assets situated in the United States, such as a U.S. vacation home.

The Canada-United States Tax Treaty provides some relief for Canadian residents in the form of a credit and the amount of this credit is tied to the U.S. estate tax exemption.

This article explores some of the changes to the U.S. estate tax regime and the impact on U.S. real estate property owned by a Canadian.¹ All amounts are in U.S. dollars.

What's new?

Before the new legislation, U.S. estate and GST taxes were repealed for 2010. The new legislation passed on December 17, 2010, reinstated both the U.S. estate tax and GST tax with a top tax rate of 35% and a \$5 million lifetime exemption (indexed for inflation after 2011) retroactively for 2010. The new legislation also increases the gift tax lifetime exemption to \$5 million. Any use of the \$5 million exemption towards a gift will reduce the exemption available for estate tax.

With the increase in the exemption to \$5 million, Canadian residents now will have a U.S. estate tax liability only if their worldwide assets are valued at more than \$5 million.

How is U.S. estate tax calculated for Canadians?

As a Canadian who is not a U.S. citizen, you will be exposed to U.S. estate tax based on the fair market value of U.S. property owned at death. For 2011 through 2012, estate tax rates start at 18% and reach 35% for properties worth more than \$500,000.

You can reduce your estate tax liability by claiming a credit equal to the greater of:

- (a) \$13,000;² and
- (b) $\$1,730,800^3 \times \text{the value of your U.S. assets} \div \text{your worldwide assets}$

Under (b), therefore; if your U.S. home accounts for 15% of the value of your worldwide estate, you will be entitled to a credit of \$259,620 ($\$1,730,800 \times 15\%$).

An additional credit is available if the U.S. property passes to your Canadian spouse.

Example: The \$1,000,000+ property
Consider Ron and Monica who are married and both residents of Canada (neither is a U.S. citizen). Monica owns a Florida home worth \$1.5 million. Her worldwide estate is worth \$10 million. Monica's estate tax liability is \$246,180 as shown in the table below.

If the property passes to Ron, the Treaty provides further tax relief, through the marital credit. As the table shows, this credit is sufficient to eliminate Monica's U.S. estate tax.

		Year of death 2011
U.S. estate tax before unified credit		\$505,800
Without marital credit	Unified credit	\$259,620
	Final U.S. estate tax	\$246,180
With marital credit	Marital credit	\$246,180
	Final U.S. estate tax	Nil

What's in your worldwide estate? Your worldwide estate includes all property owned at death—regardless of where it is located—such as your principal residence, and even:

- life insurance proceeds, if you own the policy or if the proceeds are payable to your estate;
- certain property transferred within three years of death;
- registered plans (e.g., registered pension plans, registered retirement savings plans and registered retirement income funds);
- certain trust interests; and
- stock options.

1. This article addresses the tax issues for Canadian residents who are not U.S. persons for U.S. income and estate tax purposes.

For U.S. income tax purposes, a U.S. person is an individual who is a U.S. citizen or U.S.-resident alien. For U.S. estate, gift and GST tax purposes, a U.S. person is a U.S. citizen or an individual who is domiciled in the United States.

2. \$13,000 is the U.S. estate tax on \$60,000 of assets

3. \$1,730,800 is the U.S. estate tax on \$5 million of assets.

Canadian tax considerations

On death, you will pay Canadian income tax on the accrued capital gain on your U.S. vacation home and will also be subject to U.S. estate tax on the value of that home. U.S. estate tax is often greater than Canadian tax; however Canada generally will provide a foreign tax credit for U.S. estate tax paid on the U.S. home. Since Canadian capital gains rates are significantly lower than the top U.S. estate tax rate and Canadian tax applies only to the gain in the property rather than its fair market value, the estate likely will pay tax at the U.S. estate tax rate. However, the provinces generally do not allow a foreign tax credit for U.S. estate tax paid. As a result, the deceased may be subject to some double taxation at the provincial level.

Uncertainty in future estate tax rates and credit amounts

Unless new legislation is enacted, in 2013 the United States is scheduled to return to its former higher rates, top tax rate of 55% and lower lifetime exemption of \$1 million. While nothing is certain, it seems prudent to plan on the assumption that the U.S. estate tax will be around in some form beyond 2013.

	Year of death	
	2011-2012	2013 and after
Unified credit amount	\$1,730,800	\$345,800
Highest estate tax rate	35%	55%

To help reduce your estate tax exposure, various ownership options are available, including:

- owning a U.S. vacation property;
- personal ownership;
- personal ownership in joint tenancy;
- a Canadian trust;
- non-recourse mortgage;
- other options, such as through a Canadian corporation or partnership and donation of the property to a U.S.-registered charity.

For more about these options, see “Owning a U.S. vacation property” on page 14 of the autumn 2008 edition of *Wealth and tax matters*.

We encourage you to call your PwC adviser to discuss your options before entering into a purchase agreement.

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Telltale times

U.S. taxpayers and their offshore assets

For U.S. taxpayers “the risk of being caught holding assets offshore has increased significantly...FATCA provides IRS with better transparency and additional tools that we need to crack down on Americans hiding assets overseas,” according to Internal Revenue Service (IRS) Commissioner Doug Shulman.¹

1. Commissioner Shulman was addressing an assembly of lawyers, corporate tax executives and accountants at the 23rd Annual Institute on Current Issues in International Taxation, Washington DC, December 10, 2010.



**\$100
billion**

Amount the
U.S. loses in
tax revenue
annually to
offshore tax
abuses.

If you are a U.S. citizen living in Canada (or elsewhere outside the United States), the new FATCA (*Foreign Account Tax Compliance Act of 2009*) rules could affect you. If you hold any type of financial assets offshore that have not yet been declared to the IRS, you can be almost certain that non-U.S. institutions, including Canadian banks, will be starting a declaration process.

Are you are affected?

In a nutshell, FATCA effectively applies to U.S. persons who hold financial assets outside the United States.

The U.S. tax regime is unusual in that it imposes tax on both U.S. citizens and U.S. residents² (U.S. persons) on *worldwide* income, wherever they live. Therefore, U.S. citizens or green card holders who live in Canada must report and pay tax to the IRS on their Canadian and worldwide incomes. Even though they may owe no tax to the IRS (for example, in view of treaty relief from double taxation), they may still have a U.S. filing obligation.

FATCA facts: Why the focus on offshore assets?

President Obama signed the final version of FATCA into law on March 18, 2010, as part of the *Hiring Incentives to Restore Employment (HIRE) Act*. The HIRE legislation, introduced partly in response to mounting pressure against Swiss bank secrecy, dovetails with the well publicized efforts of the United States to obtain information on UBS bank accounts of U.S. persons. The U.S. government

believes that tax evasion through concealment of identities was becoming widespread and must no longer be tolerated, especially in light of the current budgetary constraints. A major priority for Commissioner Shulman is “cracking down on offshore tax abuse.”

The IRS estimates that two million Americans have foreign accounts, many of which are undeclared. According to a 2008 U.S. Senate Committee Report, the U.S. loses about US\$100 billion of tax revenue annually to offshore tax abuses.

The U.S. Congress’ Joint Committee on Taxation estimated that FATCA could prevent the evasion of US\$8.7 billion over the next 10 years.

The U.S. income tax system, like Canada’s, is based on voluntary compliance; U.S. taxpayers must report their incomes to the IRS and calculate the tax due. When the income comes from U.S. third parties, such as corporate employers or bank deposits, the payers typically report it to the IRS. However, foreign income of U.S. persons is not so straightforward for the IRS to check.

Against this backdrop and a desire for increased transparency, FATCA is intended to initiate a worldwide exchange of information on wealthy U.S. individuals.

What is FATCA?

Under FATCA, from the beginning of 2013, non-U.S. companies that fit within a broadly defined category of “financial institutions” will be required to identify

2. U.S. residents include green card holders and individuals who are “substantially” present in the United States (i.e., for at least 31 days in the current year and 183 equivalent days during the current year and prior two years).

and report on accounts held for U.S. persons and possibly withhold on certain payments³ made to U.S. persons who invest through or in non-U.S. entities. In addition, other non-U.S. companies will be required to disclose the identities of any “substantial” U.S. owners. To be clear, these rules will apply to Canadian institutions, including for example, Canadian banks and insurance companies.

The FATCA rules generally will require:

- non-U.S. financial institutions, such as banks, insurance companies and asset managers, to report to the IRS the bank and financial accounts (including, for this purpose, certain debt or equity interests in the financial institution) of U.S. persons; and
- other non-U.S. entities, such as corporations, trusts and partnerships, to report to a withholding agent the U.S. person’s ownership of or beneficial interest in these entities. For this purpose, “U.S. persons” include non-U.S. companies that have U.S. owners that own 10% or more of the company, excluding publicly-traded companies. The 10% threshold is reduced to 0% for investment companies.

Therefore, FATCA effectively forces disclosure by non-U.S. banks and other

foreign entities to the IRS or U.S. withholding agents.

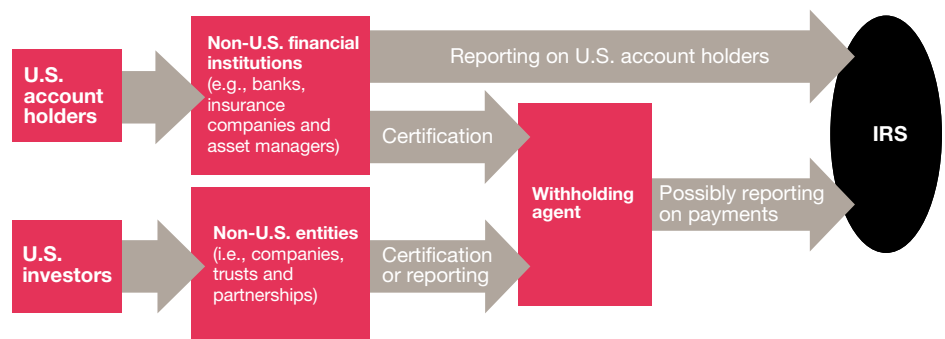
If the non-U.S. financial institution does not comply, certain U.S.-source dividend, interest, rental, premium, annuity and royalty income paid to the foreign financial institution will be subject to a 30% withholding tax. This is a big jump from a more typical treaty rate of 0% or 15% on interest or dividends.

Even more severe is the application of this 30% tax to gross proceeds from the disposition of securities that can produce U.S.-source dividends or interest. The 30% rate will apply to accounts held by U.S. persons—and here is the sting in the tail—potentially by foreign persons as well. If a Canadian financial institution were to decline to comply with FATCA, its own Canadian customers might have 30% withholding tax on their U.S.-source investment income.

The global withholding and reporting under the new FATCA rules is a sweeping change that IRS Commissioner Shulman called “the most important development in international information reporting in a generation...to combat tax evasion.”

Non-U.S. financial institutions that do comply will have to act quickly to develop or modify several reporting systems.

Information flow (example)



³ Typical payments include U.S.-source interest, dividends and rents, plus gross proceeds from the sale of property that can produce U.S.-source interest or dividends.

The ID process

Phasing-in rules apply to pre-existing accounts held by individuals. For these, foreign financial institutions have five years to establish certain identification and documentation requirements. In many cases the identification procedures may result in a request for passport information. Individuals that refuse to provide the information will have their accounts marked “recalcitrant” (i.e., as non-compliant) and withholding will be required.

New accounts that individuals open after 2012 will face immediate identification and documentation requirements, including:

- a review of documentation to verify that the account is for a U.S. owner; or
- if the account is for a non-U.S. person, the production of a non-U.S. passport or other documents to establish that an individual account is not held for a U.S. person.

Again, failure to provide the requisite documentation will result in the account’s being classified as “recalcitrant” and withholdings will be required. Verification procedures for other entities will be more complex.

Most financial institutions likely will enter into an agreement with the IRS and each year will be required to report details of the U.S. account holder such as:

- name
- address
- U.S. tax identification number (TIN)
- account number
- account balance
- gross receipts
- payments and withdrawals



Alternatively, the non-U.S. financial institution may elect to become subject to the same reporting requirements as a U.S. payer, with the result that it would file U.S. information returns that report both foreign and U.S. sources of income.

A new era of demanding reporting and disclosure

FATCA has significantly boosted the reporting obligations of non-U.S. financial institutions, including Canadian financial institutions, as well as those of other entities and trusts with “substantial” U.S. owners or beneficiaries. Greater transparency opens privacy issues for individuals, which some commentators argue have yet to be adequately thought through.

In addition to FATCA, a further voluntary disclosure programme was announced by the IRS on February 7, 2011. This gives U.S. taxpayers with undisclosed offshore accounts until August 31, 2011, to decide whether to disclose their holdings to the U.S. government without being criminally prosecuted.

The message is clear: identify yourself or suffer the consequences. Uncle Sam is watching.

If you have any questions regarding your U.S. status or how the new rules relating to your past or due filings, please consult your tax adviser for specialist advice.

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Educating Rita (children attending foreign schools)

Post-secondary education outside Canada

Is your child—we'll assume it is a daughter—enrolling in a foreign university, college or other post-secondary educational institution outside Canada? Whether she is going as far away as Australia or commuting across the border to the United States, this article addresses questions about Canadian income tax benefits and filing requirements that are likely to arise.



Canada has tax treaties with several countries, including Australia, the United States and the United Kingdom.

Does your daughter's status as a Canadian resident change when she leaves Canada to attend school?

Your daughter's residency for income tax purposes will determine her obligation to file a Canadian income tax and benefit return for a particular year. Before she leaves Canada to attend school, she should consider whether her move will be temporary or if she is severing her residential ties with Canada permanently.

In most cases, a student attending a foreign education program will be considered a resident of Canada and must file a Canadian income tax return. However, Canadian income tax obligations should be reviewed every year, because if she is considered to be ceasing Canadian residency your daughter will be subject to Canada's

departure tax regime. This can have significant tax implications, particularly if she holds shares in the family's private business.

How do tax treaties affect residency status?

Even if your daughter is considered a resident of the foreign country under its domestic tax laws, she still may be considered a Canadian resident under a tax treaty. Tax treaties contain tie-breaker rules designed to ensure a

taxpayer is a resident of only one country and does not pay tax twice on the same income. Canada has tax treaties with several countries, including Australia, the United States and the United Kingdom.

Let's assume your daughter will continue to be considered a resident of Canada and therefore must file a Canadian income tax return reporting her worldwide income for the taxation year.

Is your daughter's scholarship, fellowship, bursary, or prize for achievement in a field of endeavour included as taxable income?

The amount of a scholarship, fellowship, bursary or prize for achievement in a field of endeavour is taxable, but is reduced by the scholarship exemption amount. In most cases, that exemption is unlimited if the amount received is in connection with the student's enrolment in an educational program for which she may claim an education tax credit for the year. (See the discussion on education tax credits, below.)

For example, if your daughter received a \$2,000 scholarship towards tuition fees for a post-secondary education program that qualifies for the education credit, she would receive a \$2,000 scholarship exemption, so no amount would be included in income for the year. On the other hand, if the amount received is not in connection with enrolment at a qualifying educational institution and your daughter is not able to claim the education tax credit, the exemption is only \$500.

Are moving costs deductible?

In most cases, moving expenses are not deductible. Eligible moving expenses paid may be deductible only if your daughter moved more than 40 kilometres closer to the foreign university, college or other post-secondary education institution in which she will be in full-time attendance. However, those expenses may be deducted only if:

- they were not paid by the student's employer;
- they are less than the amount that is required to be included in the student's income for the year as a scholarship, fellowship, bursary, or prize for achievement in a field of endeavour, less the scholarship exemption amount; and
- the student has included as income any reimbursement or allowances received for the expenses.

For example, if your daughter received a \$2,000 scholarship towards tuition fees for a post-secondary education program that qualifies for the education credit, she would receive a \$2,000 scholarship exemption and no amount would be included in income for the year. Consequently, any moving expenses incurred would not be eligible for deduction, because there is no excess scholarship amount against which to offset the expenses.

Do all foreign schools qualify for Canadian tax benefits?

For your daughter to be eligible to claim tuition, education and textbook income tax credit amounts, her foreign school must qualify as a "university outside Canada." That requires it to:

- have authority to confer academic degrees of at least the bachelor's level or equivalent, according to the education standards of the country in which it is located;
- have an academic entrance requirement of at least secondary school; and
- be organized for teaching, study and research in the higher branches of learning.

Institutions that the Canada Revenue Agency accepts as qualifying are in Schedule VIII of the Regulations of the *Income Tax Act*.

Once you have determined that the school your daughter has selected qualifies as a "university outside Canada," to claim the tuition, education and textbook credits she will have to forward one of the following forms to her school to have them complete and certify the eligible fees:

- TL11A – Tuition, Education, and Textbook Amounts Certificate – University Outside Canada; or
- TL11C – Tuition, Education, and Textbook Amounts Certificate – Commuter to the United States.

Your daughter should keep the form in her records, in case she is audited, but she need not include it in her tax return.

Is your daughter eligible for the tuition, education and textbook tax credits?

Tuition credit

A non-refundable tuition fee tax credit is available only if:

- the course leads to a degree of at least a bachelor's level;
- the course is at least three consecutive weeks (reduced from 13 in the 2011 federal budget);
- while enrolled, the student is considered to be in full-time attendance; and
- the tuition fees are eligible fees and have been paid.

As long as the fees are eligible, there is no limit.

Eligible fees	Non-eligible fees
<ul style="list-style-type: none"> • Admission fees • Charges for use of library or laboratory facilities • Exemption fees • Examination fees • Application fees (but only if the student subsequently enrolls) • Charges for a degree 	<ul style="list-style-type: none"> • Student activities (social or athletic) • Medical care or health services • Transportation and parking • Board and lodging • Administrative penalties incurred when a student withdraws from a program or university

Courses taken over the Internet normally do not qualify for the tuition fees tax credit. To be considered in full-time attendance, the student must be physically present at the institution or be present via scheduled interactive virtual classroom sessions. Courses for which students study largely at their own pace and assignments are submitted electronically using a correspondence

method, do not qualify for the tuition credit. However, those courses may be eligible for the education and textbook tax credit.

Education and textbook credits

Your daughter may be able to claim the education amount of \$400 for each eligible month if she is or was a full-time student enrolled in a qualifying education program, the course lasted at least three consecutive weeks (reduced from 13 in the 2011 federal budget) and leads to a bachelor degree or higher. If she was a part-time student enrolled in a specified education program, she may be able to claim the education amount of \$120 for each eligible month.

The education credit does not require full-time attendance but rather that the student be considered to be taking a full-time course load.

If your daughter qualifies for the education credit as a full-time student, she may also claim a \$65 textbook amount for each eligible month. For a part-time student, the textbook amount is \$20 for each eligible month.

Will your daughter be living in Canada but commuting to a U.S. educational institution?

If your daughter lives in Canada all year and commutes regularly to the United States to take courses, such as a student enrolled in a teacher college program, different rules may apply. For the tuition credit, Form TL11C must be completed and the fees paid must consist of eligible tuition fees (see the table above) of more than \$100. The student need not be in full-time attendance.

In the commuter situation, neither the tuition credit nor the education and textbook credit requires the course to last three consecutive weeks (reduced from 13 in the 2011 federal budget) or lead to a degree. Otherwise, however, the requirements of the education and textbook credit are the same as those for non-commuters, using Form TL11A.

What if your daughter cannot use all of her tuition, education, and textbook credits?

Your daughter is required to claim her tuition, education and textbook credits on her personal tax return first even if they were paid by someone else, such as you or a grandparent. If she cannot claim all of the amounts she may be able to transfer the unused amounts to her spouse or common-law partner, her parents or grandparents. The maximum she can transfer in any given year is \$5,000 less the amount she used.

If your daughter holds shares in your private company, either directly or indirectly through a family trust, you may want to consider paying additional dividends to her, if that will allow her to take full advantage of her tuition and education credits.

The best time to consider the tax implications and opportunities is before your child heads off to school. We suggest contacting your tax adviser to address these issues early and identify opportunities for tax-efficient funding of his or her post-secondary education.

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You have created a family trust—now what?

In the autumn 2009 edition of *Wealth and tax matters* (page 7), we discussed three plans for using a trust to split income with family members who have little or no income.

This article examines the proper administration of family trusts.

If you create a trust, to avoid some common pitfalls you should be aware of your administrative obligations—particularly in light of the recent scrutiny trusts have been getting from the Canada Revenue Agency (CRA) in response to some aggressive tax planning arrangements involving trusts.

This article focuses on your duties as trustee, including maintaining its books and records, and completion of tax compliance and reporting for the trust.

Focus of CRA auditors

CRA auditors are examining trusts to ensure they meet all technical requirements. They may ask to see what property was used to settle the trust. Unless property was settled on a trust, the trust will not exist in law. CRA auditors are also asking for evidence that the proper steps were taken before the year end of a trust, to make income allocable to the beneficiaries for tax purposes and for proof that the trust's income was used for the benefit of those beneficiaries.

The CRA is looking at deemed dispositions of trust property. These occur when the trust is deemed to dispose of its assets for fair market value proceeds on its 21st anniversary and every 21 years after that. If a trust has distributed appreciated property to the beneficiaries,

the CRA is checking to ensure the trust is entitled to the tax-deferred rollout—which is generally denied if the attribution rule (subsection 75(2)) has applied to the trust or if the property is distributed to a non-resident beneficiary. A *Wealth and tax matters* article in the autumn 2008 edition (page 05) discussed in detail the subsection 75(2) rule and its implications.

In addition, the CRA is looking at the residency of trusts that are offshore or in a low-rate tax province such as Alberta. Where central management and control is located will determine the residency of a trust based on recent court decisions.

Maintenance and retention of books and records

If you are a trustee, one of your duties is to maintain trust accounting records for your family trust. You also have to:

- complete the annual T3 Trust Income Tax and Information Return;
- communicate information to beneficiaries; and
- respond to the CRA's requests and questions.

Generally, documents and records that the trust should maintain include, but are not limited to:

- statements for all bank and investment accounts;
- details of:
 - income earned, including tax slips;
 - expenses paid, including invoices and receipts;
 - all capital transactions (i.e., acquisition and disposition of property);
 - all taxes paid, including statement of accounts and notice of assessments;
 - distributions to beneficiaries;
 - any contributions or loans to the trust;
- trust tax returns, including T3 summaries and supplementaries;
- loan and promissory note documents; and
- trustee resolutions.

Although a trust is not required to have financial statements, preparing them annually is good practice, because it helps track assets, liabilities, trust capital and net income.

A trust is required to retain all books and records (electronic or paper) until the trust is wound up.

Tax compliance and reporting

Your family trust is considered to be an *inter vivos* trust, so its taxation year end is December 31. Generally, every trust is required to complete and file a T3 Return and pay the tax owing no later than 90 days after its tax year end (March 31; March 30 in a leap year). Although technically an *inter vivos* trust is subject to the same quarterly tax instalments as individuals, if the trust paid tax in the previous year, the CRA's long-standing administrative practice is to not charge interest even if the instalments have not been paid.

Amounts deducted by a trust: Income paid or payable to a beneficiary

Inter vivos trusts are taxed on income at the same top marginal tax rates that apply to individuals (subject to possible provincial surtax savings in some provinces). To avoid paying tax at those rates and to split income with low-income family members, the income must be properly allocated to the beneficiaries before the end of the year. The discussion below assumes that the income attribution rules do not apply, so that any income allocated from the trust will be taxable in the beneficiary's hands and not taxable to another person (e.g., a parent or other person who transferred or lent funds to the trust). The autumn 2009 edition discusses the attribution rules (page 1) and planning using a trust to avoid the attribution rules (page 7).

For a non-discretionary trust, if the trust agreement requires all income to be paid to beneficiaries in a pre-determined allocation, those amounts are considered payable in every year by virtue of the trust agreement. Instead of the trust being taxed on the annual income earned, each beneficiary will be taxable on his or her share.

For a discretionary trust, an amount will be considered payable to a beneficiary in the year if:

- the amount was paid to the beneficiary in the year; or
- the beneficiary was entitled to enforce payment of the amount before the end of the year.

When amounts are considered paid

For amounts to be considered paid to a beneficiary in the year:

- the trust must actually distribute funds; and
- the beneficiary must receive the amounts in that year.

Each beneficiary should have his or her own bank account for receiving amounts paid. The amounts must then be used only for the benefit of the beneficiary. Subsequent loans or transfer of the amounts to a parent trustee for his or her personal benefit may result in the disallowance of the deductions.

If payment is satisfied by issuing a cheque, the cheque must not be post-dated or subject to any conditions, such as an arrangement to be cashed only after a specific time. Furthermore, amounts

likely will not be considered paid if payments to a beneficiary are made by bookkeeping or offsetting entries, rather than the actual movement of funds.

When a beneficiary is entitled to enforce payment

For a discretionary trust, if the income has not been paid to the beneficiary in the year, it will be considered payable if a beneficiary is able to “enforce” payment of the amount in the year. This will be the case if the trustees exercised their discretion to declare the income as payable before the end of the trust’s taxation year (i.e., by December 31) and the beneficiaries are entitled to enforce payment of the amount before the end of the year. This should be evidenced by a signed resolution of the trustees.

In some circumstances, the income of a discretionary trust cannot be determined until after year end. If amounts are uncertain because of a contingent event, the CRA’s view is that the beneficiary would not be able to enforce payment, and that therefore the amount cannot be considered payable. In this situation, the trustees should exercise discretion and make an irrevocable decision to pay certain allocations to each beneficiary (e.g., 60% of all net income to beneficiary A and 40% to beneficiary B) to establish that amounts are payable before year end, as well as to satisfy the other conditions, outlined above, for being payable before year end.

An adult beneficiary must be informed of the amount payable before the end of the year. For minor beneficiaries, the trustees may advise the legal representative of the child. It would also be prudent for the beneficiaries (or the legal representative) to be informed of the amount payable in writing and to receive a signed acknowledgement from the beneficiaries (or the legal representative).

Finally, the CRA has a long-standing position that a promissory note is necessary to fulfill the enforceable requirement. Nevertheless, the CRA has conceded that enforceable debt is created by exercise of an irrevocable trustee decision to pay an amount and even without issuance of a promissory note. Because of this, tax practitioners often have not recommended issuing a promissory note, relying instead on other forms of documentation, such as trustee resolutions, to be sufficient evidence that amounts are payable.

Still, issuing a promissory note payable on demand (which may be non-interest bearing) to satisfy CRA's current requirements is worth considering. If the actual amount payable is known before the end of the year, the promissory note should also be delivered to the beneficiary (or in the case of a minor beneficiary, to his or her parent or guardian) before the end of the year.

The onus is on the trustee to prepare and maintain sufficient documentation, including trust resolutions, meeting minutes, beneficiary tracking logs and signed notices of acknowledgement, to demonstrate that the requirements have been satisfied and that amounts are in fact payable by the trust before year end.

You may prefer to make payments to a third-party person that provided or will provide goods or services for the benefit of the child, rather than to make payments directly to the child. Under these circumstances, amounts should be considered paid to a beneficiary in the year if:

- the trustees exercised their discretion, pursuant to the terms of the indenture, to make the amount payable to the child in the year before the payment was made, as evidenced by a trustee resolution;
- the trustees have initiated the steps to make the payment, notified the child or the parent (or guardian) in the case of a minor child, of the exercise of their discretion and the child or parent directed the trustees to pay the appropriate person before the payment was made, or if the payment was made at the request of the child or parent, the child or parent was advised of the exercise of discretion and payment of the amount either before or after the payment was made; and
- it is reasonable to consider that the payment was made in respect of an expenditure for the child's benefit, which could include, for example:
 - camp expenses;
 - private school fees;
 - the child's portion of the cost of a vacation;
 - tuition fees and other expenditures for post-secondary education;
 - sports equipment; and
 - lessons (music, dance, skating, etc.)

As discussed above, the income that a beneficiary would be entitled to in any given year generally cannot be ascertained accurately until after the year end. This could pose a practical problem, because direct payments to third-party persons for expenditures may have to be made throughout the year. To avoid this concern, the parent or guardian might be well advised to:

- make the payment to the third-party person;
- then direct the trustees for reimbursement; and
- then be reimbursed after year end when a known amount is payable to the beneficiary and the amount being reimbursed is in satisfaction of that amount payable.

The reimbursement method should satisfy the CRA's technical requirements if you maintain appropriate and sufficient documentation.

Family trusts under the new audit regime

In audits of family trusts, the CRA is now questioning not only the trustees but the beneficiaries themselves. Even in this new audit regime, your family trust can still be a beneficial arrangement and can help you achieve your goals, including income splitting and creditor proofing, as well as succession and estate planning. But it is essential that you fully understand your duties as trustee and what aspects of your family trust are vulnerable to CRA scrutiny, especially in light of constantly changing family circumstances and tax laws.

This article highlighted a few aspects of a trust that are often mishandled or overlooked, with potentially serious tax implications that could defeat the trust's very purpose. With so many tax issues to think about in connection with the trust, it is always wise to get professional advice from your tax adviser, especially if the CRA selects it for a review or audit.

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Changing the use of real estate

Some implications

The way property is used can change in ways that range from subtle to dramatic. Consider, for example, John, who owns a condominium unit and occupies it as his principal residence. After a few years, he moves and begins renting out the unit. Across the street, CanCorp owns and occupies an office building and is considering vacating the space and redeveloping the building into condominiums for sale.

This article looks at the income tax “change in use” rules and some of the implications for John and CanCorp.



Gains from the sale of real estate can be taxed very differently—or not at all—depending on how the property is used or the purpose for which it was acquired. A taxpayer can hold real estate either:

- on account of income (e.g., as “inventory” of a business developing and selling property, or simply property acquired with the prospect of resale at a profit); or
- on account of capital (essentially, any property that is not held on income account).¹

As the terminology suggests, gains realized on property held on income account are fully taxable. On the other hand, gains on property held on capital account are only 50% taxable (as capital gains) or (for a taxpayer’s principal residence) potentially tax free.

More generally, real estate can also be distinguished based on whether or not it is held for income-producing purposes, either directly (e.g., a rental property or property held for resale at a profit) or indirectly (e.g., an office, warehouse or factory used in a business). This distinction is important because when the use of property changes from income-producing to non-income-producing (e.g., personal use), or vice versa, a sale and reacquisition of the property at fair market value is deemed to occur for tax purposes. If the change in use affects part of a property, only that part is deemed to be sold and reacquired.

Similarly, if the property has been used for both income-producing and non-income producing purposes and the relationship between these uses changes, a corresponding portion of the property is deemed to be sold and reacquired.

So, if the property has an accrued gain at the time of a change in use, depending on the character of the property, the owner could have an income or a capital gain, creating a cash tax liability, while lacking the cash to pay the tax. Fortunately, as discussed below, elections are available in certain cases that can prevent this result.

“Change in use” vs. “change in character”

It is also possible for the “character” of a property to change from income to capital or vice versa. In contrast to the “change in use” rules, though, a change in character without a corresponding change in use from income producing to non-income producing (or vice versa) has no immediate income tax consequences.

1. The proper characterization of a particular real estate property as income or capital is not always clear, and has been one of the most frequently litigated tax matters. A long list of some of the factors to be considered is provided in the Canada Revenue Agency’s Interpretation Bulletin IT-218R.

Instead, the fair market value of the property at the time of a change in character is used to determine the gain or loss that is fully taxable as income rather than a capital gain or loss upon the eventual sale of the property.

For example, assume CanCorp's office building was acquired for \$15 million in Year 1, CanCorp decides in Year 5 to vacate the property and redevelop it for sale as a condominium project. In Year 7, the condominium suites are sold for proceeds (net of additional development costs) of \$30 million.

CanCorp's change in use of the property in Year 5 does not trigger immediate tax, because the change is simply between different income-producing purposes. However, the change would be considered a change in character from capital to income. If the fair market value of the property in Year 5 was \$25 million and CanCorp previously deducted \$2 million of capital cost allowance (CCA), CanCorp will have the income tax results shown in the table below.

Change in use examples²

From principal residence to income producing property

When John decides to move out of his condominium unit and he begins renting out the property, he is considered to have changed the use of his property from non-income producing to income

producing. Therefore, he is deemed to have disposed of the property at its fair market value and reacquired it for a cost equal to the same amount. John can use his principal residence exemption (to the extent otherwise available) to reduce or eliminate any gain arising from this deemed disposition.

However, John has an alternative—he can elect in his tax return for the year to be treated as if he had not made the change in use of the property. The election will remain in force until John:

- rescinds the election;
- sells the property; or
- changes its use back to non-income producing (e.g., moves back in).

During this period he cannot claim CCA on the property.

A benefit to making this election is that the property can continue to be designated as his principal residence for up to an additional four years during which he does not otherwise occupy the property. Accordingly, the election can be particularly helpful when dealing with short-term rental periods that might arise in the case of a temporary work relocation, for example.

From income producing property to principal residence

Similarly, if an owner of a rental property decides to stop renting the property and occupy it as a principal residence, he or

			Additions to taxable income	Additions to capital gain
	\$25,000,000	fair market value (FMV)		
Year 5 (change in character)	– \$15,000,000	cost		
	= \$10,000,000	notional capital gain (used upon sale in Year 7)		None
	\$2,000,000	notional recapture of CCA		
	\$10,000,000	capital gain realized on ultimate sale (calculated as the notional capital gain from Year 5)	None	\$10,000,000
Year 7 (sale)	\$30,000,000	actual net proceeds	\$5,000,000	
	– \$25,000,000	FMV at Year 5 change in character		None
	= \$5,000,000	income from sale of inventory		
	\$2,000,000	recaptured CCA	\$2,000,000	

2. These examples assume that the taxpayer is a Canadian resident. For a non-resident of Canada the income tax implications can be different.

she is deemed to have disposed of the property, and immediately reacquired it, at its fair market value, making any accrued gain on the property taxable.

An election to avoid recognition of the change in use is also available to the taxpayer in this situation, except if CCA has been claimed on the property by the taxpayer for any previous year. As in the previous example, when making this election, the taxpayer can choose to designate the property as his or her principal residence for up to four years before moving into the property.

Partial changes in use

A taxpayer might change the use of only a portion of a property (for example, converting the lower level of a house into a rental unit). That portion is deemed to have been disposed of for proceeds equal to a proportionate share of the property's fair market value and reacquired immediately at a cost equal to the same amount. As with John's situation, any gain on the deemed disposition can be reduced or eliminated by the principal residence exemption, to the extent otherwise available. Unlike John's situation, though, the taxpayer cannot make an election to avoid the change in use, because this election applies only to the change in use of an entire property.

The taxpayer must report the income generated from the rental portion of the property and may claim a reasonable portion (calculated based on the area involved) of the expenses relating to the whole property, such as electricity and telephone, as well as CCA on the rental portion of the property.

The CRA's administrative position however is to not apply the deemed disposition rule (and instead allow the entire property to retain its character as a principal residence) if:

- the income producing use is ancillary to the main use of the property as a residence;

- no structural changes are made; and
- no CCA is claimed on the income producing portion.

These conditions might be met when carrying on a child care business in the home, renting out one or more rooms in the home, or having an office or other work space in the home for business or employment.

Unless all three conditions are met, if the use of the income producing portion of the property is later changed again (e.g., it is no longer rented and is once more used as part of the residence), a second deemed disposition and reacquisition at its fair market value occurs at that time.

Other changes in use

The tax rules and concepts applicable to the change in use or change in character of real estate can be complicated, and potential tax costs or savings can be significant. Depending on the character of the property, the change could result in fully taxable income, a 50% taxable capital gain or a combination of both. Consider consulting with your professional adviser whenever you are changing the use of a property. In particular, situations such as the following should be reviewed:

- a change in the use of vacant land;
- indirect real estate acquisitions through the purchase of real estate holding entities such as partnerships or corporations (especially if the intended business use of the property will change); or
- a tax-deferred transfer of property into a partnership or corporation.

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It's my responsibility? Tax considerations when contracting or employing non-Canadian residents

Canadian businesses frequently reach across national borders to engage the services of individuals and corporations with special expertise. These efforts often result in Canadian tax consequences that may not be recognized until after a Canada Revenue Agency (CRA) review has begun.

Of particular note are the tax obligations, last updated in 2010 that Canada's *Income Tax Act* (the Act) imposes on the non-resident performing the services and the entity contracting for those services. It is important to understand how they affect businesses and individuals—particularly given that failure to comply can result in punitive penalties and/or liabilities to be paid by the payer or employer.

Contracting non-residents – Regulation 105

Under Regulation 105, withholding tax applies to payments made to non-residents who provide their services in Canada (e.g., self-employed individuals, corporations, participants in joint ventures and members of partnerships).

The Act and Regulations require that a person or business paying a fee, commission or other amount in respect of services rendered in Canada to a non-resident person withhold and remit 15% of the gross payment on account of the non-resident's potential Canadian tax liability. An additional 9% withholding is imposed if the service is rendered in Quebec. Common examples include foreign professionals providing services in Canada or a foreign supplier sending staff to install equipment in Canada.

Invoices should clearly segregate fees for services rendered in Canada and those rendered outside of Canada. Tax treaties



on their own do not eliminate the responsibility to withhold under Regulation 105.

The payer (the individual or company contracting the services of a non-resident) is required to remit the withholdings on the 15th of the month following the month payment was made to the non-resident. The payer must report the payment and withholding on the T4A-NR and provide a copy to the non-resident by the end of February in the year after the amount was paid.

Failure by the payer to withhold and remit tax has two consequences:

- the payer will be liable for the withholding tax that should have been withheld; and
- the payer may be assessed a punitive penalty: 10% of the balance that should have been remitted or, in the case of gross negligence or repeat offences, 20% plus interest.

There is no time limit for the CRA to reassess if the required withholding has not been made as stipulated by Regulation 105. The onus is on the payer to ensure that the necessary withholdings and remittance are made, and the liability rests with the payer.

From the non-resident's perspective, the withholding is only an instalment of their tax liability, as opposed to a fulfillment of their Canadian tax obligation. Non-residents are required to file a Canadian income tax return (Schedule 91) to ascertain if they have a liability or a refund due. The minimum penalty for the non-resident if the return is more than 100 days late is \$2,500.

It is important for payers to calculate the correct withholding tax accurately. A recent court decision of **Stora Enso Beteiligungen GmbH v. R.**, clarifies computation by providing a formula equivalent to:

$$\text{Required withholding payment} = \frac{\text{Applicable withholding rate}}{100\% - \text{applicable withholding rate}} \times \text{payment}$$

For example, a \$1,000 payment to a non-resident for services rendered in Canada would require withholdings of \$176.47, calculated as $\$1,000 \times 15\% / (100\% - 15\%)$.

Before the 2010 legislative changes, non-resident taxpayers may not have been able to recover overpayments of tax.

The problem was that their ability to file income tax returns and claim refunds of overpayments under Regulation 105 was subject to time limits, while the CRA's ability to reassess the payer for failure to withhold was not. Recent legislative changes now permit a refund of an overpayment of tax if the non-resident taxpayer files a tax return within two years of the CRA assessment.

The Regulation 105 withholding can be reduced or eliminated in several ways. The non-resident must submit a waiver application at least 30 days prior to either the commencement of the services in Canada or the initial payment for the related services, and either:

- the expected net income related to the services rendered in Canada must result in a tax liability that is less than 15% of the withholding that would otherwise be demanded on payments; or
- no tax liability in Canada must result from the non-resident's exemption from tax as provided for by a tax treaty with Canada.

The waiver application should be delivered to the Tax Services Office that serves the area where the services are to take place.

Exceptions from withholding tax apply to:

- reimbursement of expenses incurred; and
- secondment of non-resident employees, for which payroll withholdings are charged under Regulation 102 (see below) instead.

In respect of expense reimbursements, the Tax Court of Canada decision in **Weyerhaeuser Co. v. R.** held that the reimbursement of contractors' expenses is not in the nature of income, so no withholding tax should be imposed. Nevertheless, the expenses incurred and reimbursed must be reported on the T4A-NR, separately from the gross income.

Employing non-residents – Regulation 102

Regulation 102 sets out withholding tax requirements resulting from remuneration paid for employment services provided in Canada by non-resident employees.

Unless a waiver to reduce or eliminate withholding tax at source has been obtained, all employers (resident or non-resident) must withhold Canadian tax from payments made to non-resident employees for services rendered in Canada. The withholdings will include income tax, Canada Pension Plan (CPP) contributions and Employment Insurance (EI) premiums. In addition, the withholding, remitting and reporting requirements for the employer are the same as those to be made for a Canadian-resident employee. The employer is responsible for the liability, interest and penalties associated with the failure to withhold, remit and report.

Regulation 102 waiver applications must be submitted by the employee and approved by the CRA 30 days before commencement of service in Canada. This requirement can pose problems when employers require services in Canada of a non-resident employee immediately. Retroactive waivers are not issued, even if there is no tax liability, so the Regulation 102 withholdings and remittance are still required.

Recent administrative changes provide relief for short-term assignments when the employee is from a country that has a tax treaty with Canada and when certain conditions (outlined below) are met. Under the revised waiver procedure process, the employer and non-resident employee jointly complete and file the R102-J Regulation 102 Treaty Based Waiver Application – Joint Employer/Employee. To take advantage of the procedure afforded by the new waiver, the employee must be from a treaty country and expect only limited earnings. In particular:

- if the employee is a resident of the United States, the Canada-U.S. tax treaty allows the employee to apply for a waiver if the total remuneration is expected to be less than \$10,000; or

- if the employee is a resident of another treaty country, the remuneration expected must be less than \$5,000.

Upon approval of the waiver, the CRA provides a letter to the non-resident employee and the employer indicating that the authorization is for the period beginning the latter of:

- the start date of services provided in Canada by the employee; or
- 60 days before a complete application (except for the Individual Tax Number [ITN] requirement) has been received by the CRA.

The employer must report all remuneration and withholdings on the non-resident employee's T4 Form and provide a copy to the non-resident employee. Because the withholdings do not replace the obligation of the non-resident employee to file a Canadian tax return, the non-resident employee must calculate and file a return to ascertain if the withholding was sufficient to cover his or her tax obligation. If no return is filed, the CRA may deny any future waiver requests.

Conclusion

Many businesses and individuals engage the services of non-residents without considering the withholding tax requirements. If the CRA spots these errors during an audit, the penalties and liabilities can be punitive. To avoid these problems, businesses and individuals that are contracting non-resident services and/or employing non-residents must consult with their advisers to ensure that they comply with the regulations. If you have not been compliant in the past, your advisers can help you take advantage of programs that may be available to reduce penalties and interest.

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