

Private Company Services
High Net Worth

Wealth and Tax Matters

for individuals and private companies

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Editorial

Welcome to the first edition of *Wealth and Tax Matters* — a PricewaterhouseCoopers newsletter for individuals and private companies, from our High Net Worth practice.

This publication is written to keep individuals, business owners and tax practitioners up-to-date on ways to preserve wealth, enjoy the fruits of their hard work and avoid unnecessary tax liabilities. *Wealth and Tax Matters* is published three times per year and will feature articles on a variety of issues including new or updated legislation, individual tax planning, estate planning ideas, family business issues and much more.

Provincial and federal budgets were released recently, making this a timely issue. A number of changes should be considered to ensure tax is minimized and returns are maximized. The revised legislation, especially in the area of compensation planning and taxable dividends, affects almost every business and will inspire some thoughtful discussion.

We encourage your feedback, questions and suggestions for articles. Please contact Loris Macor at email: loris.macor@ca.pwc.com, phone: 519 985 8913, Nicole Miles at email: nicole.miles@ca.pwc.com, phone: 416 218 1464 or one of our regional contacts listed on the inside back cover of this newsletter. We understand that your wealth matters and we can help you preserve it.

Enjoy!



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Spreading your bets

Alternative to traditional fixed income investments



Many older individuals rely on a portfolio of fixed-income securities for retirement income. In recent years, relatively low interest rates have cut into their retirement incomes. Still, many are reluctant to dip into principal to supplement the declining yields, so their cash flow suffers. Current fixed income rates are in the range of 2% to 4.85% for three-year investments, the higher rates being offered by less well-known financial institutions. For a top tax bracket Ontario taxpayer, this equates to after-tax returns of 1.07% to 2.6%, not even matching inflation.

An available alternative increases after-tax yields (in the right circumstances) on what remains effectively a fixed income investment, just like a term deposit or GIC. Many individuals who could benefit do not take advantage of this opportunity to enhance their after-tax cash flow without assuming additional risk.

The alternative involves two life-insurance based products and is often called a “back-to-back” annuity plan, although insurance providers use proprietary terms to describe essentially the same product.

This strategy should be considered for taxpayers in high tax brackets, age 65 and older, who are non-smokers in reasonable health. The plan actually works better the older one is when starting the plan, up to a limit of about 85 years of age. The person’s portfolio should have a significant fixed income component, with current fixed income yields that are less than satisfactory. The individual should be comfortable devoting some portion of his or her fixed income portfolio capital to this strategy, without having access to the “capital” of that component. (However, the capital will be fully liquid and available to their estate.)

Here is a situation in which the strategy would work wonderfully. Mrs. Elder (who is a healthy non-smoker) is 72 and has a fixed income portfolio of \$3,000,000, which is currently yielding 3.8% before tax. She is willing to commit \$1,000,000 of that portfolio to a back to back annuity strategy. She realizes that although she will not have access to that \$1,000,000 of capital during her lifetime, during her life she will receive an enhanced after-tax yield. Mrs. Elder also understands that her heirs will have access to the full \$3,000,000 as an inheritance from her estate, and is comfortable having access to only the \$2,000,000 she retains in GICs for capital during her lifetime.

The strategy is relatively simple. Mrs. Elder used \$1,000,000 of her GICs to purchase a life annuity from a financially stable insurance company. By selecting a life annuity with no guarantee period, the monthly payout from the insurance company is maximized, and is fixed for the rest of her life.

From her heirs' perspective, this might appear to be a risky strategy, because as a 72-year old she does not necessarily have a long life expectancy. However, a second component of the strategy addresses that concern. From a financially stable insurance company, Mrs. Elder purchases a life insurance policy on her life, with a \$1,000,000 death benefit, and arranges for monthly premium payments. When she dies, her life annuity payments terminate, but her estate (or beneficiaries directly) receive the \$1,000,000 life insurance benefit. This assures the \$1,000,000 inheritance is preserved, (as well as the \$2,000,000 still in GICs, of course).

During Mrs. Elder's life she receives a monthly payment from the life annuity, which is used to pay the life insurance premium, with the residual being available to her for use as she sees fit. From a tax perspective, only a small portion of the monthly life annuity is taxable,

the bulk being treated as a return of capital for tax purposes. This contrasts with the interest on a GIC, which is fully taxable.

For Mrs. Elder, the after-tax yield available after paying the life insurance premiums equates to her earning 7.6% before tax on the \$1,000,000 capital devoted to the strategy. The after-tax funds available to support her lifestyle are considerably increased. This yield is also locked-in for the rest of her life.

Assuming her previous \$1,000,000 term deposit had been paying 3.8%, with Ontario tax rates, she would have retained \$20,364 each year after-tax in respect of the interest. With this back-to-back strategy in respect of \$1,000,000, she would retain \$40,714 after-tax (and after payment of life insurance premiums) each year to live on. In other words, the strategy would essentially double her after-tax cash flow, with no appreciable increase in her risk, and she would have locked that in for life.

Because males have shorter life expectancy, the strategy works even better for them, and the older one is at inception of the strategy, the higher the yields, again because of shorter life expectancy.

Life insurance tends to get a bad rap in public opinion. However, when used properly and in appropriate circumstances it is a powerful financial tool. This is a perfect example. In the right situation, to enhance their after-tax yields, rather than suffer life-style constraints from low interest rates, investors should consider back-to-back strategies for a portion of their fixed income portfolios.

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Are you maximizing your donation credits?

Traps to avoid when making donations in wills



The *Income Tax Act* (“the Act”) deems a “gift by will” made by an individual in his or her will to have been made by the individual immediately before death. This allows the donation to be claimed in the individual’s tax return for the year of death or the preceding year. This article highlights two areas in which the estate planner should exercise particular caution.

Matching the donation tax benefit with the tax

Even when a donation qualifies as a gift by will, the donation may be of little benefit if the deceased owned shares of a private company that require special planning after death to avoid double tax. Tax can arise:

- first, when the Act deems the individual to have disposed of his or her shares immediately before death for proceeds equal to their fair market value; and
- again when the company disposes of its appreciated assets and is wound up.

The double taxation issue is of particular concern for individuals who hold significant assets (e.g., marketable securities, real estate, shares of an operating company) through a holding company.

With planning, the executors can often complete transactions to avoid double tax. However, the most common plan involves winding-up the private company within one year of death and making a tax election under the Act to carry back the resulting capital loss to the final tax return. If the executors implement this wind-up plan:

- no capital gain will be reported on the shares in the final tax return;

- tax will be payable by both the company and the estate which cannot be reduced for the donations made; and
- the donations will not be used to offset tax unless sufficient amounts of income from other sources are reported in the final tax return of the deceased, or in that of the previous year.

If a significant donation qualifies as a gift by will, the bump provisions in subsection 88(1) of the Act may be the preferable way to avoid double tax on the shares. The bump plan will not eliminate the capital gain in the deceased's final tax return on the shares, allowing donations to reduce the tax owing. If the technical requirements of the bump plan are met, it can eliminate some or all of the accrued gains on the assets held by the company, so that double tax will be avoided on a future disposition of the corporation's assets.

When structuring donations in a will of an individual who owns private company shares, it is important to consider what plan will be implemented after death to avoid double tax. If the technical requirements of the bump plan cannot be met, a wind-up plan may be the only alternative. In that case, it may be possible to draft the will so that the donations can be used to reduce tax owing by the estate on the wind-up of the company. Based on the Canada Revenue Agency's current interpretation of a "gift by will," to shift the donations to the trust tax return of the estate, the will must give executors significant discretion over the donation amount.

Donations made by spousal trusts

Many individual wants to provide for his or her spouse before making significant donations to charities. It is not uncommon for an individual's will to transfer assets to a spousal trust and to make donations to charities from the trust after the spouse dies. In structuring donations in a spousal trust, several traps must be avoided.

If the terms of the spousal trust do not give the executors discretion to encroach on capital for the surviving spouse, the donations made in the deceased's will should qualify as gifts by will. In this case, the net present value of the future donations would be claimed in the deceased's final tax return. If a rollover applies to the appreciated assets being transferred to the spousal trust, income in the deceased's final tax return and the prior year tax return may be insufficient to allow the full amount of the donations to offset income and reduce tax. In this case, the executors may make a tax election on a portion of the assets to realize sufficient income in the final tax return to use the donations. This would increase the tax cost of the elected property.

In most situations, the executors have the power to encroach on capital of the spousal trust for the benefit of the surviving spouse. If the trustees of the spousal trust have the power to encroach on capital, such that the capital of the trust could be less than the donations, the donation would be contingent on this discretion and no donation tax credit would be available in the deceased's

final tax return. The question then arises whether the spousal trust can claim a donation tax credit under section 118.1(3) of the Act when it transfers amounts to charities.

The CRA once took the view that the spousal trust would not be considered to be the donor in law if an individual's will provided for the donation to be made from the spousal trust after the death of the surviving spouse. This extremely harsh position provided no relief for the donation. The CRA subsequently reversed its position. Now, a spousal trust can claim a tax credit if the trustees of the spousal trust have the power under the terms of the trust to make donations to charities after the death of the beneficiary spouse.

However, based on comments made by the CRA in technical interpretation letters, no donation tax benefit will be available if the charity is receiving the amount as a capital beneficiary of the spousal trust. Therefore, based on CRA's interpretation of the donation rules, whether the donation tax benefit will be available in the spousal trust to reduce tax owing as a result of the deemed disposition arising on the death of the beneficiary spouse depends on how the individual's will is drafted.

Even if the will is drafted so that the spousal trust obtains tax credits for its donations, a serious timing issue can arise, because the donation tax credit cannot

be claimed until the gift is made and no donation carry back provisions apply. The CRA is of the position that the property must actually be transferred to the charity in the taxation year of the spouse's death to reduce income resulting from the deemed disposition of its capital property. If the spouse dies near the end of the taxation year, transferring the property to the charity before year-end may be difficult. Furthermore, the trustees may not be willing to give substantial amounts to charities until they get a clearance certificate from the CRA.

The Department of Finance is aware of the technical issues in making donations through wills and trusts and the difficulty of matching the donation tax benefit with the tax liability. However, unless changes are made to the legislation, extreme care is required in structuring those donations.

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Are your hands tied?

Non-competition agreements and other restrictive covenants



Non-competition and covenant clauses are often included in purchase and sale transactions. Recent court cases have concluded that amounts received by a vendor on the sale of shares of a corporation, for an agreement not to compete by the vendor with the business carried on by the corporation, were generally not taxable. Recently proposed tax rules that would override these court decisions, may lead to undesirable results for the vendor.

Under the *Income Tax Act*, a restrictive covenant is “...an agreement entered into, an undertaking made, or a waiver of an advantage or right by the taxpayer...whether legally enforceable or not, that affects, or is included to affect in anyway whatever, the acquisition or provision of property or services...” Under the proposed tax rules, a restrictive covenant payment will be taxable as ordinary income in the year in which the amount is received or first becomes receivable.

The proposed rules will apply when amounts are received or receivable by the taxpayer, unless received by the taxpayer before 2005 under a grant of a restrictive covenant made in writing on or before October 7, 2003. The restrictive covenant could apply to a taxpayer or to another taxpayer that does not deal at arm’s length with the taxpayer receiving the payment. The intent is to tax the person who is bound by the restrictive covenant, and not the person who actually receives the payment, if those two are not at arm’s length.

In addition, if a purchase and sale agreement includes a restrictive covenant clause, but no specific value is assigned to this condition, other proposed changes, will deem the payer and recipient to have made a separate payment for the restrictive covenant, which will be included in the income of the recipient, and, for the first time, taxed as ordinary income.

These changes may lead to unintended tax results for the parties and create significant issues when negotiating purchase and sale agreements that include non-competition clauses. The following summarizes some of the limited exceptions to the ordinary income treatment, but these are not broad enough to cover many common transactions:

- **General goodwill exception** – The amount that typically would be used in computing the taxpayer’s “cumulative eligible capital” in respect of a business is treated as “goodwill.” For this treatment to apply, the taxpayer providing the covenant and the purchaser must file a joint election.
- **Eligible interest exception** – Capital gains treatment will be maintained when a covenant is included as part of a sale of an eligible interest. This includes a capital property that is:
 - a partnership interest in a partnership that carries on a business;
 - a share of the capital stock of a corporation that carries on a business; or
 - a share of the capital stock of a corporation of which 90% or more of the fair market value of which is attributable to eligible interests in one other corporation.

In addition, the covenant must be a non-competition provision and must be given to an arm’s length party, no tax rollover provisions will apply and a joint election by the vendor and purchaser must be made in a prescribed form.

- **Carve-out exception** – The proposed rules that would assign a value to a restrictive covenant if none is agreed to by the vendor and purchaser will not treat the proceeds as having been received in respect of a restrictive covenant if:

- an arm’s length employee agrees not to compete as part of a sale by the employer;
- a vendor is selling goodwill, a shareholder agrees not to compete, and an election is filed; or
- property is sold (including shares of a target corporation) and certain parties agree not to compete.

If these exceptions apply, to avoid having any of the proceeds amount taxed as ordinary income either the goodwill exception or eligible interest exception conditions (summarized above) must also be satisfied.

Future Considerations

In a purchase and sale situation, caution must be exercised when entering into an agreement, undertaking, or waiver of an advantage or right. An amount received or receivable in respect of the condition could be taxed as ordinary income. The exceptions in the proposed legislation give some tax relief to the taxpayer who agrees to a restrictive covenant, but are limited in scope. Only careful planning will ensure that the taxpayer will meet the exceptions and that adverse tax consequences are avoided.

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Sprinkling income to family members

Tax planning using multiple classes of shares



Most private corporations have been structured with a single class of common shares held by one or more owners of the corporation. However, organizing a company with several separate common share classes, each of which is issued to a particular shareholder, allows dividends to be distributed in a more tax-efficient manner, taking into account; residency status, marginal tax rates and cash needs.

For example, non-residents do not benefit from the tax-free distribution of funds from the Capital Dividend Account (CDA) or the enhanced dividend tax credit on eligible dividends. Accordingly, separate classes of shares will allow for the “streaming” of the capital and eligible dividends to those shareholders who are residents of Canada, and can therefore benefit.

In some jurisdictions, two or more classes of shares with identical attributes can be created. In jurisdictions where corporate law does not allow for this type of share structure it may be possible to structure the corporation’s share capital with several classes of shares that have similar attributes that are essentially the same with a slight variation (e.g., increased dividend entitlements).

Two examples highlighting the flexibility of distributions from multiples classes of shares follow on the next page.

A way to help future planning

Taking advantage of multiple classes of shares is a powerful tax-planning technique. When private companies (including professional corporations) are incorporated, creating multiple classes of common shares should be considered as a way to help future planning.

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Example 1

Consider Opco, a Canadian-controlled private corporation (CCPC) that is owned by two siblings one of whom is a non-resident. Among its tax attributes Opco has:

- \$1 million of Capital Dividend Account (CDA).
- \$1 million of General Rate Income Pool (GRIP)
- \$4 million in cash to distribute to shareholders.

If Opco has only one class of common shares, the dividends and the related tax attributes will be split evenly between the resident and non-resident shareholders. Half of the CDA and GRIP will be “wasted” on the non-resident shareholder.

If Opco had two separate classes of common shares (class A for the non-resident and class B for the resident), Opco could declare a \$2 million taxable, ineligible dividend on the class A shares. On receiving ineligible dividends, the non-resident would incur no additional tax costs. Opco could then declare a \$1 million capital dividend and a \$1 million eligible dividend on the class B shares.

Separating the shareholdings of the resident and non-resident shareholders into two classes, would generate a \$500,000 increase in both the capital dividend and the eligible dividend paid to the Canadian resident shareholder.

Example 2

Consider the case of Dr. McAvity, a dental professional with an incorporated practice Dentco and her spouse, Philip, who does not work or have any other income. Dentco can issue a class of participating shares to Philip. (Care should be taken so that the share capital meets the various requirements of the relevant professional governing body for professional corporations.)

Dr. McAvity can pay herself a salary from Dentco, up to the highest marginal tax bracket. Any additional income of Dentco will be taxed corporately in Dentco at the small business rate. After-tax amounts can be distributed to Philip as a dividend on his shares.

Because Philip has no other income, dividends paid to him will be taxed in his hands, giving the family an additional set of graduated tax rates. Furthermore, if the couple has a child over the age of seventeen, an additional class of shares can be issued to the child.

Dividends can be paid on the new shares to take advantage of the child’s marginal rates. These dividend payments are especially beneficial, because an individual with no other source of income can earn up to approximately \$30,000 of ineligible dividends without incurring an income tax liability.

Is relief on the way?

Stock option plans



Employee incentive plans, such as stock option plans, which offer employees a stake in the growth of a business, are a popular and efficient way to attract and retain employees. At the beginning of the decade, these plans were frequently used to retain employees in the context of a surging stock market. For some of the employees, it was an opportunity to make a substantial amount of money, and, for others, the beginning of a tax nightmare.

The problem

For a participating employee, the time at which the stock option is exercised is a key moment for income tax purposes. At this time, the amount of the taxable benefit is crystallized. That amount will have to be included as employment income in the calculation of total income. (In some circumstances, the inclusion might be deferred and/or a deduction in the calculation of the employee's taxable income might be available)

The taxable benefit will be the amount of the fair market value of the shares, at the time the employee's options are exercised, minus the total amount paid to acquire the shares. Once the options are exercised, the employee is treated the same as any other investor with similar property: any subsequent realized increase or decrease in the value of the employee's shares, when compared to the exercise price, will be considered as a capital gain or a capital loss. This tax treatment seems reasonable and fair, at first glance, but can create serious tax problems for some employees.

Suppose an employee exercises a stock option and realizes a taxable benefit of \$100,000 in a taxation year. In the same taxation year, the stock value drops dramatically, resulting in a \$80,000 capital loss upon disposition. A capital loss can be used only to offset a capital gain, not other income, so, the employee will be prevented from offsetting any part of the taxable benefit that flowed from the same shares, because the benefit is income, not capital.

In this situation, the employee will be taxed on a benefit of \$100,000, even if the net benefit realized upon disposition is only \$20,000. In extreme circumstances, the employee may not be able to pay the tax. Moreover, most employees are unlikely to have substantial future capital gains against which to apply the \$80,000 capital loss carry-forward.

Until now, the Department of Finance (“Finance”) has maintained that this outcome was correct on technical grounds, arguing that the employees who decide to keep shares received upon the exercise of stock options should be presumed to have accepted the risk involved. Moreover, Finance has considered its position to be fair to all investors, and therefore did not intend to amend the Income Tax Act (ITA) to correct what most people considered as being unfair treatment.

The JDS Uniphase employees’ experience

The issue is not academic. For example, some employees of JDS Uniphase (JDS) faced this exact problem. During the same year, the employees realized significant taxable benefits upon the exercise of their stock options but had to sell their shares at a value up to 80% lower than the fair market value at acquisition. Some had to pay tax bills

exceeding \$100,000—a huge liability for those with middle-range annual incomes. To make matters worse, JDS closed its plant soon after.

Neither the Canada Revenue Agency nor the Tax Court was able to offer any solution to these unfortunate employees, declaring themselves bound by the clear requirements of the ITA. Each referred the problem to Finance which, for the sake of equity among investors, maintained its stand.

The JDS employees’ last hope was political intervention. They finally got it in the form of a remission order that cancelled the tax liabilities flowing from the exercise of their stock options. Even those who had paid the tax got a reimbursement. Remission orders are rare and are usually granted only to individuals facing serious financial problems, made worse by extenuating factors.

Recent development

In October, 2007, Finance was again asked whether it intended to amend the ITA to extend the tax concession granted to JDS employees to all employees facing similar situations. Interestingly, Finance indicated that it will reconsider the question in its periodical review of policy issues. Whether or not this issue will be among Finance’s priorities is not clear. The JDS employees’ problem was eventually settled in a fair way. Now, in its periodical review, Finance will have to decide whether or not to move from equity among investors to fairness to employees.

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A case of give and take

How the Fifth Protocol affects cross-border estate planning



In September 2007, after nearly 10 years of negotiation, Canada and the United States jointly released the Fifth Protocol to the Canada-U.S. Income Tax Convention. The Protocol includes important changes that may affect cross-border estate planning in the areas of charitable deductions, taxes imposed by reason of death on registered retirement savings plans (RRSP) and U.S. stock options.

Charitable Donations

New language in the Convention (more often referred to as “the Treaty”) will restrict the cross-border donation planning opportunities for Canadian residents who are not U.S. citizens. Currently, the U.S. provides an estate tax deduction if a Canadian resident donates U.S. property on death to a U.S. or Canadian charity. This allows Canadians to minimize or eliminate their U.S. estate tax exposure by donating their U.S. property to a Canadian charity. The donation also provides a credit for Canadian tax purposes.

Under the Protocol, this tax relief will no longer be available with respect to donations made by will to Canadian charities. As a result, a Canadian decedent (deceased) who donates U.S. assets on death can avoid U.S. estate tax only if the U.S. property is donated to a U.S. charity. This restriction does not apply if the Canadian resident is a U.S. citizen.

Taxes imposed at death on Canadian RRSPs and RRIFs

The Protocol provides foreign tax credit relief when Canadian and U.S. taxes are imposed at death on RRSPs and registered retirement income funds (RRIFs). The right to claim a foreign tax credit to avoid double taxation in this situation no longer requires a ruling request to the Competent Authority.

Canadian residents: Canadian residents who die owning U.S. securities in an RRSP or RRIF may be subject to both U.S. estate tax and Canadian income tax. The Protocol allows Canadian-resident decedents to claim a foreign tax credit on their Canadian terminal income tax returns for U.S. estate taxes paid on the fair market value of U.S. investments in their RRSPs or RRIFs. The foreign tax credit is limited to the amount of Canadian federal income tax paid on the RRSP or RRIF on death. To claim the foreign tax credit, Canadian income tax must be triggered at the decedent's death. As a result, no foreign tax credit relief is available if the RRSP or RRIF is transferred to a surviving spouse as a rollover.

U.S. citizens/residents: A decedent who is a U.S. citizen or a U.S. resident may be subject to both U.S. estate tax and Canadian income tax if he or she dies owning an RRSP or RRIF. The Protocol allows U.S. decedents to claim a foreign tax credit on their U.S. estate tax returns for Canadian federal income tax paid as a result of the deemed disposition of the RRSP or RRIF.

Taxes imposed at death on U.S. stock options

It is not uncommon for Canadian-resident employees to be granted options to acquire shares of a U.S. public company. Upon death, the Canadian resident may be subject to U.S. estate tax on the value of the U.S. options if the value of the U.S. stock exceeds the exercise price. In addition, the decedent may be subject to Canadian income tax as a result of the deemed disposition of the option on death.

The Protocol confirms that amendments to the Treaty will provide relief from double taxation when a Canadian resident owns U.S. stock options at death. Canadian federal tax arising on the deemed disposition of the options at death will be reduced by the amount of U.S. estate tax paid on the U.S. options. This revision removes the risk of double taxation.

While the Protocol has resolved the double tax issues on death relating to RRSPs, RRIFs and options in the cross-border context, it has taken away a useful planning strategy for Canadians wishing to minimize their U.S. estate tax exposure by donating U.S. property to a Canadian charity. U.S. estate tax planning steps put in place in the past likely will have to be revisited in light of the proposed changes in the Protocol.

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Are your children U.S. residents or citizens?

Bequest and U.S. estate tax and planning considerations



Many Canadian parents have children that are citizens of the U.S. or live there. Estate planning that does not take these children into consideration may be costly.

Consider Bob, a Canadian resident, and the father of Amy and Candace. Amy lives in the U.S. but is not a U.S. citizen. Candace lives in Canada but became a U.S. citizen a few years ago. Bob's estate has a value of \$10 million and he would like to divide his estate equally between his two children.

Outright Bequests to U.S. Children

An outright bequest to Candace and Amy could result in increased tax when they pass away because U.S. citizens and residents are subject to estate tax on their worldwide assets.

Because Candace is a U.S. citizen, the \$5 million of assets she receives from Bob may be subject to U.S. estate tax on her death. At the current top rate of 45%, the tax could reach as high as \$2.25 million, even ignoring any appreciation in the value of these assets. This 45% rate will apply when Candace's taxable estate is greater than US\$2 million (US\$3.5 million in 2009).

Amy faces the same tax exposure on her death if she is domiciled in the U.S. when she dies. Amy is considered to have acquired U.S. domicile if she lives in the U.S. and has the intent to reside in the U.S. permanently. Therefore, with no planning, Bob's \$10 million bequest could eventually result in \$4.5 million in U.S. estate taxes.

Bequests to Testamentary Trusts for U.S. Children

One way to deal with the U.S. estate tax exposure is to leave the assets in trusts for Candace and Amy, but this creates its own challenges.

Testamentary Trusts and U.S. Estate Tax

U.S. estate tax on assets in testamentary trusts may still be payable when the two sisters die. Trusts in which Candace and Amy have a “general power of appointment” over the assets will be subject to U.S. estate tax when they die. A general power of appointment exists if Candace and Amy have the ability to distribute trust assets to themselves, their estates, their creditors or the creditors of their estates. This will likely be the case if Candace and Amy are beneficiaries and trustees of their respective trusts.

U.S. estate tax on the assets in the trusts may be avoided if the Candace and Amy are not trustees of their trusts. However, this may not be practical if their father wants them to have some degree of control over the trust assets. Candace and Amy can still be trustees (and U.S. estate tax avoided), if they cannot participate in decisions to distribute capital to themselves or that power is subject to the “ascertainable standard”. Subjecting Candace and Amy as trustees to the “ascertainable standard” means that they can participate in decisions to distribute trust capital to themselves only if the distributions are for their health, education, maintenance or support. Although the will can include this provision in the terms of the testamentary trusts, it may be difficult to apply the standard when administering the trusts.

Trust Residency — The Foreign Trust Rules and the 21-Year Rule

The trust’s residency may have U.S. and Canadian income tax consequences.

Under U.S. income tax rules, U.S. beneficiaries of trusts that are resident in Canada are likely subject to the U.S. foreign trust rules. Although these rules are beyond the scope of this article, significant taxes on distributions to U.S. persons may arise and should be considered if a trust is to be a resident of Canada and is allowed to

accumulate income and capital gains. In this case, the will should provide for a mechanism to make the trust resident in the U.S. — particularly if the beneficiaries are U.S. residents. If a change of residency for the trust is being contemplated, the Canadian non-resident trust rules will have to be considered at that time.

The implications of Canada’s “21-year rule” should also be considered. This rule provides that every 21 years a Canadian-resident trust is deemed to dispose of its property at fair market value. As a result, any accrued gains in the trust will be taxed. To avoid this disposition, trust property is typically distributed to the capital beneficiaries before the 21st anniversary. A distribution to Amy and Candace poses two challenges:

- any assets received by them will be included in their U.S. taxable estate; and
- the trusts will still be taxed on the accrued gain on the distributed assets if Candace and Amy are not living in Canada.

To address these concerns, if the trusts are expected to exist for 21 years after Bob dies, consideration should be given to allowing the trusts to be made resident in U.S. when Bob dies or when a beneficiary emigrates from Canada. The Canadian income tax that can be triggered when a trust changes its residence should be considered when a beneficiary emigrates, as well as the Canadian non-resident trust rules.

In summary, U.S. children present challenges when it comes to leaving them assets. Citizenship and residency of children can change, so wills and family situations should be reviewed regularly. The tax consequences of not doing so could be costly.

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Better late than never

Section 85, an adjustment clause

Now and then, a dubious administrative policy is abandoned. Usually, when the technical basis of an administrative policy the tax authorities follow is questionable, but the amounts involved are not particularly significant, a review is delayed and indeed may never happen.

One refreshing exception relates to Section 85 of the *Income Tax Act* (ITA), which provides a rollover mechanism that allows a taxpayer to elect to make a tax-deferred transfer of “eligible property” to a taxable Canadian corporation. A prescribed form must be filed, specifying an elected amount, usually between tax cost and fair market value. For tax purposes, this amount becomes the deemed proceeds of disposition of the eligible property. Section 85 also imposes penalties when deadlines are not respected or amendments to the forms are requested.

When the transfer involves non arm’s length taxpayers, price adjustment clauses are routinely included in the legal documents. Typically, these clauses stipulate that, if the tax authorities determine that the fair market value of a given property is higher or lower than the price indicated on the agreement, the consideration will be adjusted, taking into account the final valuation determined by the authorities. By agreeing to these adjustments, taxpayers attempt to avoid the harsh consequences, such as taxable benefits and double taxation, that can arise from a defeat in a dispute with the Canada Revenue Agency (CRA) about fair market value and the consideration received on the tax deferred transfer.

If, after discussions with the CRA, in the context of a transaction that is subject to section 85, the parties agree to proceed to a price adjustment, the CRA’s longstanding practice, as a prerequisite to the recognition of the price adjustment clause, is to require amended forms to be filed, disclosing the adjusted price and providing for the payment of the statutory penalties. That creates costs in respect of paperwork and penalties. When the price adjustment clause has no effect on the elected amount (for example, because the elected amount is based on tax cost and not on fair market value), this requirement to file amended elections, seemed to many not to be justified, whether on technical or policy grounds.

Fortunately, the CRA has announced a reversal of its longstanding position and it will no longer require the filing of an amended section 85 election as a prerequisite for the recognition of the price adjustment clause. Therefore, in appropriate circumstances, taxpayers will no longer be required to incur the additional costs and the administrative burden of the amended forms and related penalties.

This new approach is certainly a welcome change to an unpopular policy. More importantly, it is an encouraging indication that, from time to time, administrative policies on a secondary issue may be reviewed and corrected. Better late than never.

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