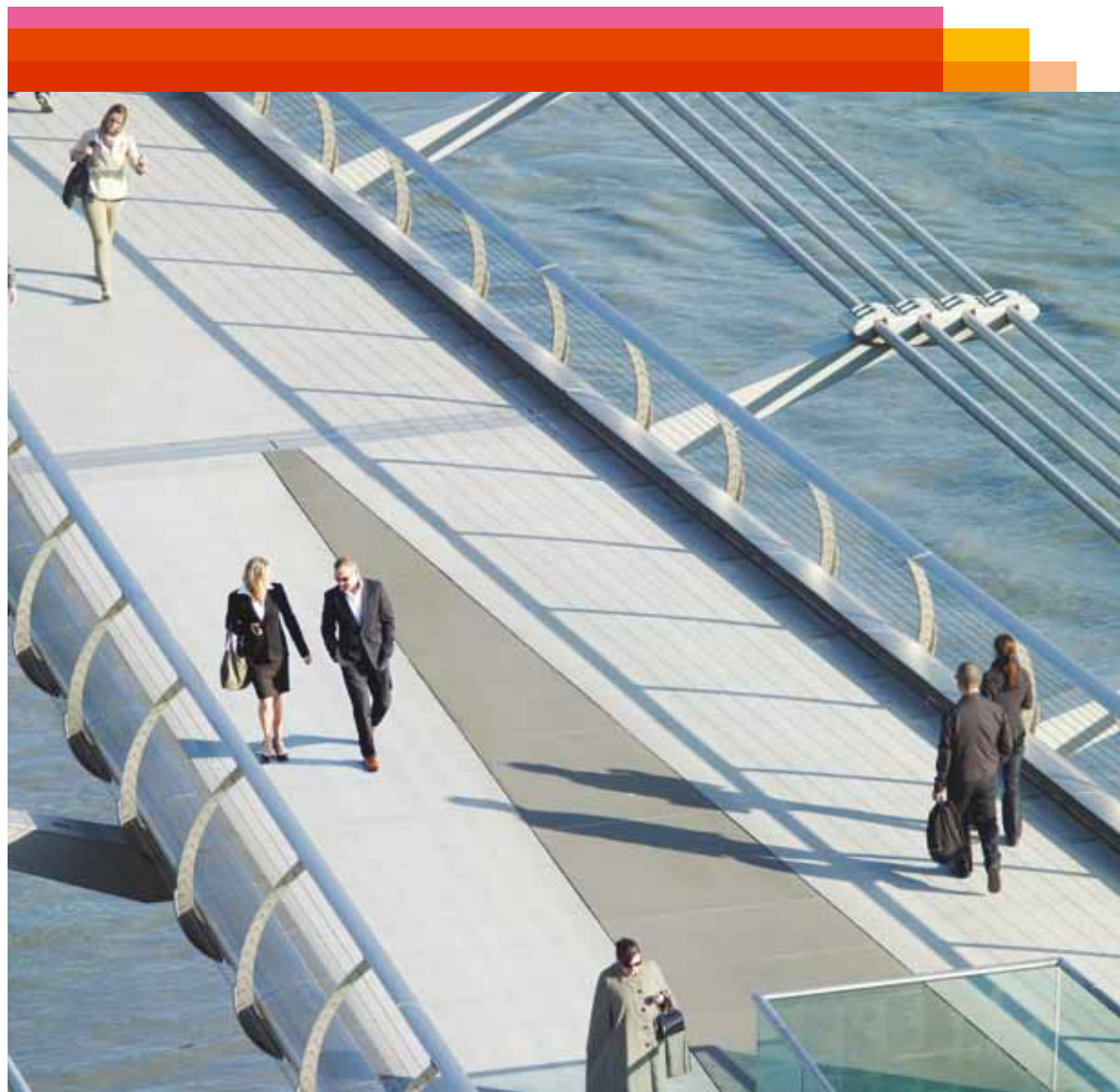


Wealth and tax *matters*

for individuals and private companies

2011
Issue 2



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Editorial

Welcome to our current edition of *Wealth and tax matters*. This edition covers a wide range of topics that we hope you will find interesting and useful. Colleagues listed at the end of this publication are happy to answer any questions that you may have after reviewing the articles.

With Thanksgiving now passed and the holiday season around the corner, many of us turn our thoughts to family matters. The first pair of articles addresses some of these. We start off with the basics of will planning and then move on to issues arising in business succession.

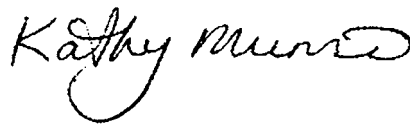
Our second set of articles focuses on new initiatives and changes in the area of tax. Specifically we outline the new initiatives proposed by the Canada Revenue Agency with respect to high net worth individuals as well as changes to the “kiddie tax” regime. We also discuss tax traps of which those with an existing shareholders’ agreement—or those negotiating one—should be wary.

Our final two articles deal with cross-border matters such as owning a U.S. rental property and considerations for those individuals departing 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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Where there's no will there's no way

Creating a last will and testament can be daunting, and does cost a few dollars. However, a current, well-constructed will is a good investment, because it is the only way to ensure that your wishes are realized.



Your will should reflect:

- who should receive your assets—and when;
- who will be the executor of your estate; and
- how your children (or other dependents) will be cared for, and by whom.

So, do you have a will? And if you do, has it been updated to reflect your current situation and wishes? This article addresses some common questions and provides general information on creating or updating your will.

I am married. Won't my assets just pass to my spouse automatically?

Yes—sort of. But lack of a will could lead to family disputes regarding the division of your property (estate), which could lead to bad feelings and costly estate litigation.

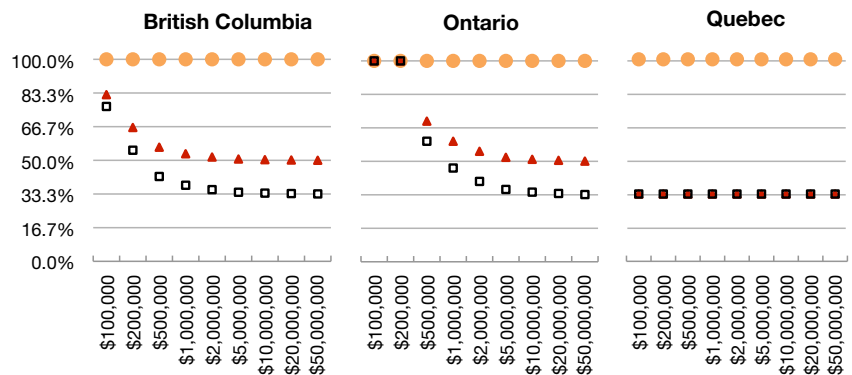
Having a will makes these disputes less likely and prevents provincial and territorial laws from determining how your estate is distributed. If you die intestate—that is, without a will—a court will appoint an administrator for you (except in Quebec, where the beneficiaries appoint an executor) and your estate will be distributed under those laws of the province or territories, possibly resulting in your spouse's receiving less than you intended. Apart from your spouse and children, others (individuals and charities) will get nothing.

Who gets how much if you die without a will and have a spouse (Ontario, British Columbia and Quebec)

	British Columbia and Ontario		Quebec	
	Spouse	Child/children	Spouse*	Child/children
No children	All of your property		All of your property	N/A
One child	The first \$200,000 (Ontario) or \$65,000 (British Columbia)	+ half of the remainder	One-third of your property	The other two-thirds of your property
More than one child	+ one-third of the remainder	Equal shares of the rest of the remainder		

* Quebec's rule applies only to married spouses.

Percentage of estate that goes to the surviving spouse when there is no will



- No children
- ▲ One child
- More than one child

How many executors?

You can have a sole executor or more than one.

If you appoint a sole executor, you should also appoint an alternative executor, in case the executor becomes incapable, cannot act or predeceases you.

On the other hand, having too many executors can make the administration of the estate difficult.

Consider a professional executor, such as a trust company, if your estate is complex, your family lives in another country or your will provides that assets are to be held in trust for your beneficiaries. Don't be surprised if a professional executor wants your will to include a clause specifying the method and/or amount of compensation.

Who should be my executor?

Your executor takes control of and administers your estate. The role can be administratively strenuous, because the executor has to pay the expenses of the estate, file tax returns, submit the will for probate (if necessary) and distribute the estate according to your wishes set out in your will.

Your executor could be your spouse, a family member, a close family friend or business associate. It is a good idea to choose an executor who is younger than you and in good health. Alternatively, you can select a corporate executor, such as a trust company.

Should I appoint a foreign executor?

You can appoint a foreign executor, but that could increase administration costs because foreign executors might be required to:

- issue a bond of security; or
- travel frequently to your former place of residence.

If your executor lives outside of Canada it may also cause your estate to be considered a foreign estate for Canadian tax purposes. This could inadvertently subject your estate to taxation in a foreign jurisdiction and trigger non-resident withholding taxes in Canada.

How often should I review or amend my will?

It is important to review your will regularly, because your family and financial situations evolve. Check your will and make any requisite amendments in the event of any significant change in your family circumstances, such as a:

- marriage;
- divorce;
- birth or death of a family member; and
- permanent move outside of Canada.

Is my will still valid if I get married or divorced?

If you get married, apart from Quebec, your will is revoked automatically¹ and provincial or territorial laws of intestacy will apply unless:

- the will contains a declaration that it is made in contemplation of marriage; or
- you make a new will.

Divorce or separation does not revoke a will, so your former spouse or partner could receive distributions from your estate, and you should see your lawyer immediately to amend your will to reflect your wishes and new situation.

1. It appears that Alberta and British Columbia are in the process of revising their applicable statutes, with the possible result that, once the statutes are in force, marriage will not automatically revoke a will.

Where should I store my will?

Store your will in a secure location (possibly a safety deposit box at a bank)—but make sure your executor knows where it is and has access after your death. The lawyer who drafts your will often can store the signed original in a vault at the law office.

You might want to give your executor an unsigned copy or even your signed will. However, this creates the risk that your executor could destroy or lose the will.

Can I make charitable donations in my will?

Yes, you have the option of making charitable donations in your will. If you choose to do so, be sure that the will:

- identifies the charity properly; and
- provides for what is to happen if the charity does not exist on the date of death, i.e., whether the gift should be made to a similar charity or should lapse.

A properly structured charitable gift under a will can offer significant income tax advantages. The gift can result in a charitable tax credit that may be used to reduce the capital gains tax arising on death. However, several technical issues can result in a mismatch of the donation tax credit with the tax liability. Seek tax advice if you are thinking of a large donation, to ensure your estate obtains the full tax benefit.

Can I make specific gifts under my will?

You can make specific gifts, but they require special care. Many family disputes arise as a result of the division of personal property or personal effects. Some personal property may have great sentimental value to particular potential recipients, all of whom may expect to receive the property. If you feel strongly that certain personal property should pass to a specific person you should make sure your will is clear on that point.

Specific property must be described properly so that it can be identified. Otherwise, the intended beneficiary of the particular item will not receive it.

Do I need more than one will?

Normally you don't need more than one will, but sometimes (and depending on where you live) having two or more special-purpose wills can be a sensible approach. Generally, the three types of wills are:

- a public (or primary) will;
- a private (or secondary) will; and
- a foreign will.

When a person lives in a jurisdiction that requires probate (every province except Quebec, as well as the territories) but has some property that can be transferred upon death without probate, having a private will to deal with probate-free property reduces the size of the probated estate and means that probate fees are calculated as a percentage of a smaller amount (except in Alberta and the territories, which do not use a percentage calculation.) Probate-free property includes joint bank accounts, most personal effects and shares of private corporations.

More on charitable donations in wills

For more information on making a gift to a charity in your will, see *Wealth and tax matters* spring 2008, page 3: "Are you maximizing your donation credits? Traps to avoid when making donations in wills."

The PwC publication *Charitable giving guide for donors* also discusses this issue.

Avoiding arguments

If you anticipate that a family argument may arise as a result of the distribution of personal property, you may want to make your wishes known while you are alive. Alternatively, you can leave it up to your executor and provide him or her with the discretion to sell the property and distribute the proceeds.

Other property, such as publicly traded shares, investment portfolios and bank accounts (apart from joint accounts) requires a probated will and therefore is subject to probate fees.

A third will, often referred to as a foreign will, may be used when a person has assets located in a foreign jurisdiction with lower or no probate fees.

Do all of my assets pass under my will?

Property such as life insurance, certain retirement plans, including RRSPs, and Tax-Free Savings Accounts will not pass under your will if you have named a designated beneficiary. It is important to review the designations in order to ensure that the beneficiaries are named and up to date, especially if you have recently married, remarried or divorced.

Can I avoid the hassles of a will by registering my assets jointly with my spouse or children?

Transfers of assets to be held jointly by you and your spouse or you and your children can be fraught with complications and should not be taken lightly.

For example, transfers of capital property to anyone other than your spouse can lead to immediate capital gains tax. In addition, assets held jointly between parent and adult child may not automatically pass to the adult child upon the parent's death, because it may be assumed that the child holds the assets in trust for the parent's estate. Accordingly, if it is the intention that the assets are to pass to the child, by right of survivorship, that must be documented properly.

What is probate and what does it cost?

Probate is an administrative practice under which a court validates a will and confirms the executor. Estate administration taxes, often referred to as probate fees, are provincial and territorial taxes that are payable if an application is made to the court for a certificate of appointment of estate trustee, an essential step in passing property to beneficiaries.

Alberta and the territories have fees that are capped at \$400 or less. Elsewhere, for estates worth more than \$50,000, probate fees are calculated as a fixed amount plus a percentage (ranging from 0.4% in Prince Edward Island to 1.553% in Nova Scotia) of the value above a threshold. For the formulas, refer to *Tax facts and figures* (page 9).

	Size of Estate					
	\$500,000	\$1,000,000	\$2,000,000	\$5,000,000	\$10,000,000	\$20,000,000
Nova Scotia	\$7,132	\$14,897	\$30,427	\$77,017	\$154,667	\$309,967
Ontario	\$7,000	\$14,500	\$29,500	\$74,500	\$149,500	\$299,500
British Columbia	\$6,650	\$13,650	\$27,650	\$69,650	\$139,650	\$279,650
Manitoba	\$3,500	\$7,000	\$14,000	\$35,000	\$70,000	\$140,000
Saskatchewan	\$3,500	\$7,000	\$14,000	\$35,000	\$70,000	\$140,000
Newfoundland and Labrador	\$2,585	\$5,085	\$10,085	\$25,085	\$50,085	\$100,085
New Brunswick	\$2,500	\$5,000	\$10,000	\$25,000	\$50,000	\$100,000
Prince Edward Island	\$2,000	\$4,000	\$8,000	\$20,000	\$40,000	\$80,000

Tax treatment of RRSPs on death

On death you are deemed to have disposed of your RRSP. The proceeds form part of your income in your terminal return. You can defer the inclusion of your RRSP income if any designated beneficiary of the RRSP is either the surviving spouse or one of certain dependants. Your surviving spouse will be subject to tax on the RRSP

proceeds received unless he or she transfers the RRSP proceeds received to his or her own RRSP.

If the designated beneficiary of the RRSP is a dependent child or grandchild, a deferral is available until that person turns 18—longer if the beneficiary is a disabled dependent child.

What are the Canadian income tax consequences of my death?

Although no estate taxes or succession duties are levied in Canada, income tax or capital gains taxes may arise.

For Canadian income tax purposes, you will be deemed to have disposed of all of your capital property at fair market value immediately before death. Consequently, your estate could face a tax liability if your assets have an accrued gain.

Generally, this liability can be deferred until the death of your spouse, if your assets pass to your spouse or a spousal trust created under your will.

A spousal trust can have several tax advantages, including deferral of capital gains tax on death of the first spouse. To obtain the deferral, the trust must meet some technical requirements—generally that the spouse receives all of the income earned by the trust and no other person may receive or otherwise obtain the use of any capital of the trust while the spouse is alive.

The trust is treated as a separate taxpayer, so that the income earned is taxed at graduated tax rates, allowing income splitting. When the spouse dies the assets pass to named beneficiaries—in most cases the children.

My children live in the United States. Will they pay U.S. tax on their inheritance?

The United States will not tax bequests from your estate, but does have an estate tax, so your children may pay estate tax on the value of those assets when they die. For significant bequests you may want to consider passing the assets to your children in trust. U.S. tax advice is essential if you have U.S. family members, because estate tax exposure there can be significant. (For more information, see “Are your children U.S. Residents or citizens?” spring 2008, page 14. For rates, see *Tax facts and figures*, page 44).

I worry about my children having access to too much money when they are young. What can I do?

If you do not have a will, your children will receive their entire inheritance when they turn 18. If this worries you, then in your will you could set up a trust for each child. The trust could provide for staggered distributions. For example, the trustees of the trust may have the discretion to make income and capital payments to your child until your child attains the age of 25 years. Your child might receive one third of the trust property upon attaining the age 25, 30 and 35. This will allow your child time to adjust to handling large sums of money. (For more background, see “Trust basics” (parts 1 and 2) in the autumn 2008 edition.)

From the questions and answers in this article, it should be apparent that having a current will avoids a host of potential concerns. Having a current will is a prudent step that is well worth the trouble.

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The art of succession

Managing conflict

Transition can be planned, documented and rolled out accordingly. Following best practice can ensure a significantly improved outcome. But what happens when uncomfortable emotions creep in?

“The final test of greatness is a leader’s commitment to his succession. The best plan of all is one that is hardly noticed.”

John Ward

The capacity, skill, and the art of navigating emotionally charged situations, often with two opposing ideas and no right or wrong answer, is what will keep the family and the business together. This can be improved only through trial, error and practice. It may be some time before the final product can be considered a work of art.

Families come in all shapes—each unique unto itself. The very nature of family is to learn to live, work, grow and love together, and survive an array of challenges. Unfortunately, the desire to preserve harmony among family members can lead to conflict avoidance, which can be counterproductive.

Members of families in business have a special emotional attachment to each other and the enterprise, and shared values that make the business unique. It is in the context of these emotional ties that families must communicate, lead, follow, be motivated, handle success or failure and face the daily tests of growing a business.

Often, the sensitive issue of succession planning is what prompts conflict. Inherent in the complicated inner workings of any family is that issues will arise: sibling rivalry, marital discord, children’s need to differentiate themselves from their parents, identity conflict and ownership dispersion. Emotional issues can override rational business behaviour or economic

rationale. Left unattended, these issues can escalate, spawning ill will that festers for generations—an unintended legacy of succession.

A family’s capacity to address and resolve conflict will depend on their values and culture. Many families interpret the conflict as a threat to harmony, loyalty and equity—values that are perceived as essential to keeping the family together. When family members feel conflict is imminent they may find reasons to avoid addressing the problems. Consistent with hard-wired “fight or flight” responses, they might feel that open discussion of an issue will cause irrevocable damage to a relationship. Fear of rejection, retaliation, embarrassment, humiliation or isolation could encourage them to move further away from the real issue. Wanting to avoid the pain that can ensue is a normal reaction, and facing it can feel abnormal.

Conflict is a difference between two or more people characterized by tension, emotion and disagreement, and a polarization that can break human bonds. When our basic needs (shelter, security, belonging, attachment, identity) are threatened, we either fight to protect these needs, or flee from the relationship that puts them at risk, thereby snapping a bond that had been a source of security.

Succession decisions can trigger deep emotional reactions and threaten human needs. *Why was she chosen and not me? What makes him a better option than I am? What if I can't perform as well as Dad? What if I fail? Can't they see he is the wrong person for the job? How come she knows about it and I don't? If I put my daughter in the job, will my wife ever forgive me for not picking my son? Is the right thing for the business the wrong thing for the family?*

What steps can be taken?

Few people, let alone families, can get through life avoiding conflict.

The very reason we avoid conflict, to maintain harmony and keep our family bonds, can actually be better served and enhanced by addressing the conflict. By putting our concerns on the table, we show that we are willing to face our fears up front rather than risk breaking our relationship bonds. We are willing to fight for the values that have defined the family and the business. Addressing conflict requires courage, respect, honesty and often personal humility. These are values that get strengthened through use, and are fundamental to re-enforcing our bonds with people.

The mindset with which people approach discord can radically shift the outcome toward the positive. It is helpful if conflict can be approached as neither good nor bad, but rather as an expression of differences. The following processes and skills will greatly support resolution of conflict within a succession process:

- **Ensure there is a family-created values-based mission statement and code of conduct:** When a family builds the business mission together, cooperation is encouraged. Incorporate ground rules that make family members accountable to agreed values, and will be the safe platform from which they gain the confidence to address the conflict. As transitions occur, revisit these documents so they remain current.

- **Begin early:** Even if a succession plan is in its infancy, begin integrating those that will be affected. Avoiding surprises and sharing possible plans will be seen as collaborative. This includes speaking with people that are not directly involved in the business (advisers, all family members, board members). As soon as the concept of transitioning a business through generations becomes an option for succession, begin dialogue with the incoming generation—even if they are young children. In fact, this conversation should never really end, as succession should be considered an ongoing process.

- **Understand the personality differences within the family, and within the business.**

Consider the main players in a growing family business:

- nuclear family members working in the business;
- non-family employees;
- extended family; and
- family members not working in the business.

Conflict can arise from interactions between or within any of these groups. Understanding the different styles and behaviours of family members can significantly reduce the sources of conflict.

- **Ensure the conversations are dialogues.** Having a dialogue means a mutually respectful two-way conversation, with both parties actively listening and actively discussing. Dialogue typically takes time and energy that many are unwilling to invest. Talking is especially important in cases of intergenerational conflict and misunderstanding.
- **Separate the person from the problem.** Issues cannot be resolved productively if there is disrespect between the parties. Blaming others solves nothing and abdicates responsibility. This problem frequently develops when jealousy arises in the naming of a successor. It is imperative



to understand the perspectives of all the relevant parties (the named successor as well as those not selected) so that their viewpoints can be taken into account. This means that family members must listen openly and actively to each other, reserving judgment and withholding blame.

- **Ask difficult questions.** Simply put, successions that are fraught with difficulty are almost always so because someone lacked the confidence to ask a difficult question or hear a difficult answer, often because of a fear of emotion. Ironically, the act of courage required for these conversations is itself the key to building the trust that engenders strong commitment to maintaining healthy families and businesses. People, particularly family members, need to know that there is a safe, secure, opportunity for airing their concerns and fears. Getting the process started might call for a professional facilitator, as well as a good conflict resolution policy and code of conduct.
- **Question assumptions and clarify expectations.** Inherent in the many conversations, procedures and tasks involved in managing a good succession is the opportunity for misunderstanding. It is easy to assume that those involved (family, advisers or professional management) are clear, current and in agreement. It is crucial to be as clear as possible; err on the side

of over-communicating rather than under-communicating each step of a plan. Don't assume that everybody understands the process. Many transitions hit roadblocks on account of unclear or divergent expectations, which are often only discovered too late in the process.

- **Look for mutually agreeable options and proposals.** When looking at family or organizational dissonance and dissatisfaction, it is important the parties brainstorm a variety of possible resolutions to high-impact decisions. Shifting away from entrenched, unilateral decisions and focusing on a variety of options will create a sense of collaborative decision-making. Sharing objectives makes it easier for people to make reciprocal concessions, and be less defensive. This approach affirms that the unique needs and interests of those involved are important and worth addressing.

Nothing about this process is easy, but the effort is worthwhile—even if it leaves a few bruises—because the alternatives can be far worse, seriously damaging the business and scarring the tissue of the family.

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Are you a target?
CRA's High Net Worth Project



The Canada Revenue Agency (CRA) probably has you in their sights, or soon will, if:

- you have a direct or indirect interest in a related family-owned group of entities; and
- you and/or your family have high net worth.

The CRA's High Net Worth (HNW) Project, also referred to as the "Related Party Initiative," is currently focused on related family-owned groups, having approximately 30 or more entities, with a net asset value in excess of \$50 million. Past audits may have focused on single entities, but now, once you've been identified for an audit, the CRA wants to understand all the companies,

partnerships, joint ventures, foundations, trusts—everything in which you or your high net worth family might have an interest.

The CRA's HNW Project is in response to high-risk compliance issues they have identified related to wealthy families and their use of corporations and other entities. Tax authorities in other countries, particularly members of the Organisation for Economic Co-operation and Development (OECD), target aggressive tax planning too. In fact, they work together, sharing best practices, knowledge, information and results.

Canada has entered into many tax information exchange agreements (TIEAs) with countries to make information sharing easier.

Recently, Canada has entered into many tax information exchange agreements (TIEAs) with countries (including historical tax havens such as Bermuda, Cayman Islands, Jersey and the Isle of Man) to make information sharing easier. It is currently negotiating agreements with 14 other countries, including Lichtenstein, British Virgin Islands and the Cook Islands. The CRA also has many other ways to gather information, and in addition to several internal databases, the CRA has access to provincial databases, including various registries.

If you have compliance concerns, now is the time to use the CRA's voluntary disclosure program to back file any missing information, pay taxes/interest due, but avoid the prospect of costly penalties. Professional advice is strongly recommended in this respect.

Risk factors

A few questions will help you assess your risk of being targeted by the CRA:

- Do you or a related person have a significant direct or indirect interest in a corporation that is a member of a family group of entities—perhaps held through a trust or a partnership?
- Do you hold an interest or asset in a foreign entity that is not a corporate foreign affiliate that facilitates tracking of your earnings from that investment?
- Do you or any family member hold a direct or indirect interest in any entity, investment or bank account located in a tax haven or a country that maintains bank secrecy protection?
- Do you or any family member or an entity within a corporate group provide offshore services or transfer property through domestic or foreign trusts or partnerships for amounts less than fair market value?
- Is the amount of income you or your family report personally consistent with your lifestyles?

- Are assets that are normally considered for personal enjoyment, such as your residence, recreation property (condos, boats, vehicles etc.) registered in the name of a corporation, trust or some other entity, rather than in your own name?
- Are there any intercompany transactions among corporate group members, such as management fees, services, transfers of goods or assets?
- Have you, family members or corporate groups filed elections that identify the tax-free transfer of property?
- Has a clearance certificate been requested with respect to any disposition of taxable Canadian property by any foreign entity in which you or your family member have a direct or indirect interest?
- What information has been reported (by you, a family member, a member of the family corporate group, family trust or a partnership) pursuant to foreign reporting requirements in the *Income Tax Act* that could identify areas of risk?
- Are there any family, corporate or trust funds leaving the country?
- What interactions that you or your family, or offshore entities in which you or your family members are involved, had with foreign tax authorities could result in an exchange of information with the CRA pursuant to treaty provisions or TIEAs entered into by Canada?

What if the CRA contacts you?

If you are contacted by the CRA, consult your tax adviser immediately. If you are targeted under the HNW project, you can expect to receive an “Audit Query Sheet,” (Form T997), as well as a 20-page questionnaire about private companies, partnerships, trusts, joint ventures or other organizations in which you or a family member have an interest, as well as any dealing or interest outside Canada. The questionnaire is designed to give the CRA a full picture of a family’s wealth structure. In line with this objective, your family members (spouse, children, grandchildren, etc.) can also be expected to be included in the audit review.

It is too soon to say how far this HNW Project might extend. Nevertheless, the time is ripe to have a sophisticated review of your overall structure to ensure there aren’t any potential major tax issues—and if there are, to address them before an audit is triggered.

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The time is ripe to have a sophisticated review of your overall structure to ensure there aren’t any potential major tax issues.



The expanded kiddie tax

Still some scope for planning

Recent draft legislation has expanded the “kiddie tax” provisions that restrict income-splitting between adults and related minors. This article explains the changes and outlines the tax planning that can still be carried out.

Birth of the kiddie tax

The kiddie tax was introduced in the federal government's 1999 Budget Plan and took effect on January 1, 2000. The goal was to eliminate the splitting of certain types of income with minor children.

Income-splitting shifts income that normally would be taxed at one person's high marginal income tax rate to a person with a lower rate. Consider the typical situation of a parent in the top bracket splitting income with at least one minor child who otherwise has little or no income, and therefore is in a low bracket. The parent's income could be any combination of salary, bonuses, dividends and other income.

Split income included taxable dividends or shareholder benefits received either directly or indirectly (e.g., through a trust) from a private corporation. Any split income received by specified individuals is taxed at the highest marginal tax rate.

Specified individuals are individuals who had not reached age 17 years before the start of the current calendar year, were resident in Canada when payment was received and are the children of Canadian-resident parents.

Side-stepping the kiddie tax with capital gains

The omission of capital gains from the initial definition of split income opened up a way to preserve some income-splitting opportunities.

Corporate funds could be stripped out for the benefit of minor children, who would be taxed at their lower marginal tax rates rather than paying an annual dividend to the trust in the example below (sidebar), a parent would purchase participating shares of the business from the family trust for cash, or a note payable. When the family trust sold shares, the trust would realize a capital gain, which it would allocate to a minor beneficiary by the trust, and the beneficiary would be taxed at his or her relatively low marginal tax rate.

This did not create any tax problems for the parent, who would have shares of the family business with a full adjusted cost base (ACB) and would then be able to take advantage of planning to extract the value of the shares from the family business as tax-free cash.

How pre-kiddie tax planning worked

Before the kiddie tax, a typical plan might have started with a freeze of the shares of the family business and issuance of new participating shares to a family trust. The income beneficiaries of the trust would include the family's minor children. The family business would pay annual dividends to the family trust, which in turn would allocate that income to the minor children. (For more about estate freezes, see the three articles on succession planning in the winter 2009 edition, starting at page 20.)

This would reduce the family's overall tax bill, because the allocated income would be taxed at the minor child's lower marginal tax rate. But under the kiddie tax any minor children would be specified individuals, and dividends allocated to them would be split income, so the 29% federal rate would kick in, along with its provincial or territorial counterpart. That would wipe out any benefit to the family.

The kiddie tax grows up

Under the new rules introduced in the June 6, 2011 federal budget proposals, if shares of a private corporation are purchased by someone related to a minor vendor, the kiddie tax applies. Capital gains are deemed to be dividends if they were derived from the sale of the shares of a private corporation that is part of a transaction (or series of transactions) that includes acquisition of those shares by a person who does not deal at arm's length with the individual.

Once the capital gain is treated as a dividend it becomes split income and is subject to the kiddie tax. As well, the definition of split income includes income earned directly or indirectly (e.g., through a trust), ensuring that capital gains earned by family trusts and allocated to minor beneficiaries are split income too. So that's that.

Don't write off family trusts

The grown up kiddie tax doesn't eliminate the potentially substantial tax benefits of using a family trust to hold the shares of the family business. For example:

1. **Splitting capital gains:** On a sale of the business to an arm's length third party, the kiddie tax doesn't apply to capital gains earned by minor beneficiaries. This provides the opportunity to use the lifetime capital gain exemption to shelter up to \$750,000 of qualifying capital gains per individual. The maximum saving per individual ranges from more than \$146,000 in Alberta to almost \$188,000 in Nova Scotia.
2. **Directing dividends to adult children:** Children cease to be specified individuals in the year they turn 18. From that point on they can receive dividends from the family trust without being hit by the kiddie tax. Almost all are in lower tax brackets than their parents, so this offers substantial income splitting opportunities.

In light of the expanded kiddie tax, previous planning should be reviewed to ensure that it does not run afoul of the new rules. Family trusts and any other opportunities should be considered—perhaps even some not pursued in the past.

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Breaking up is hard to do Shareholders' agreements (Part 3)

Most shareholders' agreements contain provisions that will apply on the death of a shareholder. The relevant tax considerations were discussed in the previous edition of *Wealth and tax matters* ("Death of a shareholder," 2011 issue 1, page 1).

Few shareholders' agreements, however, give thoughtful consideration to other situations in which a buy-out may be prudent. In fact, shareholders, when asked, typically agree that they want to sever business ties when a shareholder:

- breaches the shareholders' agreement (which might include business funding requirements);
- becomes insolvent;
- ceases to be able to contribute to the business as the result of a disability; or
- faces marriage breakdown and a court could award the ex-spouse some or all of the shareholder's interest in the corporation.

If any of these things happen (referred to as "Events" in this article), triggering a buy-out of the shareholder, unintended tax consequences can arise unless the shareholders' agreement is structured properly. This third in a series of articles dedicated to tax considerations of shareholders' agreements for private corporations focuses on additional tax implications for buy-out provisions triggered by an Event.

Buy-out rights granted to other shareholders

In Part 1 of this series ("*Taxed by association*," winter 2011, page 17), we discussed the tax implications of including in a shareholders' agreement provisions that grant other shareholders (or persons that are not shareholders) rights to buy shares. These include the application of the associated-company rules and the loss of the corporation's status as a Canadian controlled private corporation.



If the buy-out rights are triggered on an Event, these tax implications must be considered. Fortunately, specific exclusions in the *Income Tax Act* prevent these implications from coming into play if the buy-out rights are triggered on bankruptcy or permanent disability. However, those terms are used in a narrow way, and may not apply when you think they might. In a nutshell, here's how they work:

- **Bankruptcy exclusion:** The exclusion applies only to a bankruptcy as defined in the *Bankruptcy and Insolvency Act* (Canada). This will not cover all types of insolvency that shareholders may want to include in an agreement.
- **Disability exclusion:** According to the Canada Revenue Agency (CRA), the disability is considered to be permanent only if:
 - it prevents the individual from exercising control over his/her shares; and
 - there is no reason to believe it will not continue throughout the individual's life.

The CRA has stated in particular that the disability exclusion will not apply if the shareholders' agreement defines permanent disability as a state of disability that continues for six months or one year.

These tax implications are of concern only if persons (other than the corporation) are granted the right to buy out the shares. If the shareholders' agreement gives the corporation itself the right to buy out the shares of the shareholder upon an Event, these tax implications should have limited application.

Mandated buy-out by the corporation

If an agreement requires the corporation to buy out the shares of a shareholder upon an Event, the implications of Part VI.1 tax must be considered.

For tax years ending after 2011, Part VI.1 tax generally makes a corporation liable for an additional 40% tax on any taxable dividends paid on "short-term preferred (STP) shares" or "taxable preferred (TP) shares." There are exceptions to Part VI.1 tax, including when the shareholder's shares meet certain minimum ownership levels and when the buy-out terms specify that the purchase is an amount that does not exceed the shares' fair market at the time of buy-back (determined without reference to the agreement).

When shares are purchased back by a corporation, the shareholder will be deemed to have received a dividend equal to the proceeds received less the paid-up capital of the shares. This dividend could be subject to Part VI.1 tax if the shares purchased are STP or TP shares.

Common shares are not normally STP or TP shares, but a shareholders' agreement requiring the corporation to buy back shares upon an Event can make them qualify as STP or TP shares.

While Part VI.1 tax creates a deductible expense for the corporation, if the corporation can't use the expense in the year of buy-out (i.e., if the available deduction exceeds the net revenue), the corporation will have to make a cash tax payment in addition to the cash payment needed to buy out the shareholder.

Funding buy-outs

Whether the buy-out by the corporation is mandated or discretionary, the corporation has to find the funds to pay for the shares. Disability insurance can be used for this purpose, but can be prohibitively expensive for the amounts that may be needed in the event of a disability. As well, unlike life insurance, proceeds from the insurance on a disability will not be added to the capital dividend account of the corporation and therefore cannot be used to fund a tax-free buy-out of the shareholder.

Because of the financial hardship that may arise if the corporation were required to purchase all of the shares at once with cash, shareholders typically look for alternative ways to structure the buy-out.

One option is to buy out the shareholder with a promissory note that is payable over a set period of years. This will alleviate the immediate financial strains on the corporation, but triggers an undesirable tax consequence for the shareholder.

The deemed dividend that occurs on the buy-out of the shares can be a sizeable amount if the corporation has increased in value over the years. For tax purposes, the proceeds received include the value of the promissory note. The result is that the shareholder is treated as having received proceeds for tax purposes, without actually having cash in hand.

For example, if the shares had a value of \$1 million and paid-up capital of just \$100, the shareholder would be deemed to have received a dividend of \$999,900. That creates a tax liability of \$277,000 to \$412,000, depending on the province or territory of residence. If the terms of the promissory note provide that it will be paid in equal instalments over 10 years, the taxpayer will be in the situation of having received \$100,000 in cash in year 1, but subject to a tax bill of \$277,000 or more.

To avoid this result, the corporation can buy back the shares over the set number of years so that the shareholder is subject to tax only on the cash received. The drawback: the shareholder potentially benefits from continued growth in the corporation to which he or she may not be contributing. For this reason, some shareholders agree to an automatic conversion of common shares to fixed-value preferred shares upon an Event. These preferred shares can be bought out over a set number of years without the shareholder continuing to benefit from an increase in the value of the business.

Common shares that are convertible or exchangeable under the terms of a shareholders' agreement might qualify as STP or TP shares, resulting in the potential application of Part VI.1 tax discussed above.

Other considerations

When planning for provisions to address the occurrence of one or more of the Events, keep in mind that a shareholders' agreement is a legal document and various legal considerations and options should also be considered. Having your tax adviser and legal counsel work together can ensure the right provisions have been included.

Next Steps?

Consult your tax adviser to determine if your shareholders' agreement has the appropriate provisions. Make sure it:

- includes terms that address all situations for which a severing of the business ties is warranted or desired;
- ensures that these terms are drafted so as not to trigger unintended tax consequences; and
- contemplates how any such buy-out should be funded.

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In Part 4: Valuation considerations

Each triggering event in a shareholders' agreement could require its own valuation method and criteria. In the next edition of *Wealth and tax matters*, Part 4 of this series will examine the valuation considerations for various buy-sell provisions.

Uncle Sam's (other) long arm

Thinking of purchasing U.S. rental property? Tax could hold the key

Canadians have always flocked to the United States to shop, vacation and, in some cases, retire. However, the recent drop in U.S. housing prices, strong Canadian dollar and low lending rates have turned the U.S. into a hotbed of opportunity for potential investors.

In addition to performing the due diligence that should be standard when purchasing a residential rental property, Canadian individuals looking to invest in the U.S. real estate market also ought to understand the Canadian and U.S. tax implications.

This article outlines basic Canadian and U.S. tax considerations that should be taken into account by a Canadian resident individual investor who is considered to be a non-resident alien (NRA) for U.S. tax purposes. However, given the intricacies of the Canadian and U.S. tax systems and the unique facts of each situation, professional tax advice should be sought before taking any action.

Key U.S. and Canadian income tax rules

Typically, Canadian investors that are considered NRAs for U.S. income tax purposes are subject to U.S. income tax only to the extent of their U.S. source incomes. U.S. source income can be classified as either income that is effectively connected with a U.S. trade or business (ECI) or income that is not (non-ECI).

ECI is taxed on a net basis (i.e., gross revenues less permitted deductions) at the same graduated rates applicable to U.S. citizens and residents. In contrast, non-ECI is subject to a flat 30% rate of income tax rate, unless reduced by the Canada-U.S. Tax Convention (the Treaty).

Canadian-resident investors are subject to Canadian income tax on their total worldwide incomes. Foreign income taxes paid to another country (e.g., U.S. income taxes) generally can be claimed as foreign tax credits (FTCs), subject to certain limits, and used to reduce the Canadian income tax that would otherwise be payable on that same income.

Rental income earned from U.S. property

Normally, U.S. rental income earned by an NRA is considered to be Non-ECI. As such, the gross rental income is subject to a 30% tax rate that is not reduced by the Treaty. This 30% tax is withheld by either the U.S. tenant or a U.S. agent for the owner (such as a local property manager) and is remitted directly to the Internal Revenue Service (IRS) in the taxation year. A Form 1042-S “Foreign Persons’ U.S. Sourced Income Subject to Withholding” should be issued to the NRA by March 15 of the year following the year of payment to report the gross rental income earned and the withholding taxes paid by the NRA.

An NRA, however, can have the related rental income (on a net basis) taxed as ECI by electing to treat its U.S. real property rental activity as a U.S. trade or business. Filing this election allows the NRA to make certain deductions that offset gross U.S. rental income received. The resulting net U.S. rental income is subject to the graduated income tax rates that apply to U.S. citizens and residents.

The election applies only to income from U.S. real property and not, for example, to income from the rental of personal property that may be associated with the income-generating real property. The election must be filed with the NRA’s tax return, Form 1040NR (“U.S. Non-resident Alien Income Tax Return”), in the first year the gross rental income is earned from the U.S. real estate and remains in effect until revoked.

U.S. residents

If you are a U.S. citizen, hold a U.S. green card, or are otherwise considered a U.S. resident for U.S. income tax purposes, the Canadian and U.S. income tax implications of owning a U.S. rental property could be substantially different from those outlined in this article.

Form W-8ECI (“Certificate of Foreign Person’s Claim That Income is Effectively Connected With the Conduct of a Trade or Business in the United States”) should also be filed with the U.S. withholding agent (not the IRS) to inform the agent that:

- the election has been or will be filed by the NRA; and
- the NRA’s U.S. rental income is to be considered ECI for U.S. tax purposes and is therefore not subject to U.S. withholding tax.

In the absence of a fully completed Form W-8ECI, which includes a valid U.S. Individual Taxpayer Identification Number (ITIN) for the NRA, the U.S. withholding agent must withhold and remit the 30% tax to the IRS.

The NRA must still ensure that Form 1040NR is filed annually and on time. A late-filed return could result in the denial of expenses claimed against the U.S. rental income and potential penalties and interest.

Form 1040NR is generally due on June 15 following the close of the calendar year (or April 15 if the NRA is an employee in the U.S. receiving wages subject to U.S. income tax withholding). The due date can be extended for up to six months. If Form 1040NR is filed more than 16 months after its original due date, the IRS may deny deductions related to the rental income.

The NRA could also be subject to state income tax filing requirements and due dates which may differ from federal requirements.

For Canadian income tax purposes, regardless of whether the U.S. election is filed, the implications to the NRA are as follows:

- All U.S. rental income earned and expenses incurred to earn that rent must be reported in Canadian dollars and included in computing the Canadian investor’s income for the year. An FTC in respect of U.S. income taxes paid on the rent (or on the net rental income, depending on whether the election discussed above is made) could potentially reduce the Canadian income tax that would otherwise be payable on that same rental income.
- The Canadian investor must also report the cost of the U.S. rental property and the related net rental income on Form T1135 (“Foreign Income Verification Statement”) on an annual basis if the total cost of the individual’s “specified foreign property” (which includes certain foreign investments in addition to the U.S. rental property), exceeded \$100,000 at any point in the taxation year.



Sale of U.S. rental property

An NRA disposing of U.S. rental property is subject to a 10% U.S. withholding tax on the gross sale proceeds under the *Foreign Investment in Real Property Tax Act* (FIRPTA). The purchaser is required to withhold this amount and remit it directly to the IRS on behalf of the NRA. This withholding tax is treated as a prepayment of the ultimate U.S. federal tax that is payable with respect to the sale of the U.S. rental property.

Before the sale, however, to reduce or eliminate the required 10% withholding, the NRA may apply to the IRS for a “withholding certificate.” This could be appropriate if the ultimate tax liability arising on the sale of the U.S. property is expected to be significantly less than the 10% withholding rate. However, the application typically requires more information to be provided by the NRA than for federal or state tax returns.



If the deadline is missed and tax is withheld, the seller must wait until the close of the tax year before the IRS will consider a claim for refund (i.e., if the 10% withholding exceeds the actual tax liability). Some U.S. states (e.g., California and Hawaii) impose similar withholding taxes while others (e.g., Arizona) do not.

Federal and state income tax returns must be filed to report the disposition of the U.S. rental property. Therefore, the NRA must file an annual tax return for the disposition-year on Form 1040NR reporting all U.S. income, claiming any FIRPTA withholding as a prepayment of tax, and paying any balance due or claiming any allowable refund.

Unlike for Canadian income tax purposes, the full gain realized on the sale is taxable. The U.S. tax rates applicable to a realized gain will depend on the length of time the U.S. real estate was owned, among other factors. Property held for less than one year is subject to regular federal graduated income tax rates, whereas property held for over a year may qualify for the federal long-term capital gains rate of 15%. Most U.S. states

do not distinguish between capital gains and ordinary income for income tax purposes, and state income tax rates vary between nil and 11%.

A gain or loss on the disposition of U.S. rental property will also have to be reported in the investor's Canadian income tax return. The U.S. gain or loss is calculated for Canadian income tax purposes by converting the cost and proceeds into Canadian dollars using exchange rates on the dates of purchase and sale. Accordingly, the Canadian investor's gain or loss as computed for U.S. income tax purposes could be significantly different from the gain or loss computed for Canadian tax purposes due to foreign currency fluctuations over the ownership period. Foreign exchange gains or losses could also arise for either U.S. or Canadian tax purposes if borrowed money was used to acquire the property. A U.S.-dollar debt could produce a gain or loss for Canadian tax purposes, while a Canadian-dollar debt could produce a gain or loss for U.S. tax purposes. These risks of debt financing should be considered carefully.

Again, to the extent U.S. income taxes are paid by the NRA in respect of the disposition, an FTC may be available to reduce any corresponding Canadian income tax liability on that disposition.

Canadian investors looking to purchase a U.S. rental property should be cognizant of their exposure to U.S. estate tax.

U.S. estate tax considerations and alternative ownership structures

In addition to the various Canadian and U.S. income tax considerations noted above, Canadian investors looking to purchase a U.S. rental property should also be cognizant of their exposure to U.S. estate tax. This tax, if applicable, is levied on the full value of an NRA's U.S.-situs assets (which include shares of U.S. corporations, U.S. real estate, and U.S. business assets) on death, rather than only the accrued gains on those assets.

This U.S. estate tax is payable in addition to any Canadian income tax arising from the deemed disposition of the property on death. While the Treaty allows an FTC for U.S. estate tax to be claimed to reduce the related Canadian income tax liability, the U.S. estate tax can often be greater than the Canadian income tax, in which case the Canadian investor effectively pays the higher amount.

Accordingly, Canadian investors may wish to consider alternative structures that could facilitate the ownership of the U.S. real estate property and also provide protection from U.S. estate tax exposure.

(For more details, see page 16 of “Uncle Sam’s long arm: Estate tax law and your U.S. vacation home” in *Wealth and tax matters*, 2011 issue 1.)

Selecting the optimal structure requires a thorough assessment of the Canadian investor’s overall situation and a customized plan to help achieve personal and business objectives. If you are considering the purchase of U.S. real estate for rental purposes, or are already an owner, consultation with your professional tax adviser is highly recommended.

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Leaving Canada

Will tax turn the greener grass brown?

You and your family might have many reasons for wanting to leave your country of residence. Some could be to escape to a warmer climate, emigrate permanently for a different lifestyle, retire overseas, or maybe to seize an opportunity to work in another country (perhaps under a fixed employment contract or on a global secondment). Whatever the drivers, beyond the various lifestyle and personal issues, the tax consequences should not be ignored.

In this article, we explore the major implications of leaving Canada from a Canadian tax perspective and point out other questions to consider. As always, the key is to plan ahead and ensure you speak to your legal and taxation advisers.

Be aware of the destination country's tax regime

Investigate the tax regime of the destination country. For example, will you be living in a higher- or lower-tax rate regime? Does that country charge tax on worldwide or local income? Does some form of wealth or estate tax apply and what is your exposure? If you hold a family trust, what will be the impact on the trust?

Your destination country may have a specific taxation agreement with Canada (referred to as a double tax treaty) that generally avoids double taxation if you retain any assets here—good news!

Before you go

Before you leave Canada, you need to determine if you want to terminate your Canadian residency. This may depend on the reason for your relocation, i.e., is it a permanent move or will it last for two years or less? Perhaps the duration is undecided. It is useful to sit down with your adviser and go through a checklist of matters such as these.



The tax impact: are you a Canadian resident or not?

Generally speaking, if you are a Canadian resident, you are liable to Canadian tax on your worldwide income. As a non-Canadian resident, you are taxed on certain Canadian source income.

Under current legislation “residence” is an undefined term. Therefore, sources such as case law, guidance issued by the Canada Revenue Agency (CRA) and other interpretations should be consulted. If the destination country does have a double taxation agreement with Canada, that may also help determine your residency position.

From a Canadian tax perspective, you are considered resident in Canada if this is the place where you regularly, normally or customarily live in the settled routine of your life. The amount of time that you might spend in return visits back to Canada (to see family and friends, for example) should also be considered, in case you find yourself deemed a resident of Canada.¹

Other factors to take into account when determining residency status include the location of your permanent home, where your family members live, and where your economic and social interests lie. These are often referred to as the primary ties.

Sometimes these indicators point to residence in two different jurisdictions, and secondary ties come into play, including your bank accounts driver’s licence, health care coverage and club memberships.

If you wish to cease residency in Canada, take care to sever your residential ties sufficiently. On a permanent emigration this may be clear cut. Always seek advice in this area, particularly if certain ties are maintained.

The “departure tax”

On leaving Canada and ceasing your residence, you will be deemed to have disposed of most property that you own immediately before your departure, for proceeds equal to each asset’s value at departure. Some assets that you hold might be excluded from this deemed disposition. These include Canadian real estate, stock options, Canadian business property; RRSPs/RRIFs and certain rights or interests in a trust.

1. An individual deemed resident by “sojourning” in Canada for 183 days or more is deemed resident throughout the year. Under certain circumstances, these provisions might be overridden by the tie-breaker rules of a double tax treaty.

Your income tax return must be filed on or before April 30 following the tax year in which you leave Canada.

If you have a deemed gain on certain assets, a departure tax is applied. This is due for payment by April 30 following the tax year in which you leave Canada. It may be possible to defer the tax payment by way of an election, together with an adequate posting of security.² The first \$100,000 of the deemed gain is considered to be covered by the security posting. The remaining security will have to be negotiated with the CRA.

The decision to post security on the deemed gain should be considered carefully if you wish to leave Canada permanently or temporarily. You should also consider whether the assets may fall or increase in value while you are overseas, because this could affect the decision to defer the tax. If you intend to rent out your former Canadian home while you are overseas, advice should also be sought on the taxation of any future gain.

Also, find out if the destination country will recognize the increase in the base cost of your assets when you leave Canada.

Reporting requirements

Your income tax return must be filed on or before April 30 following the tax year in which you leave Canada. If you or your spouse (this includes your common-law partner) carried on a business in Canada, the return must be filed on or before June 15 following the tax year of your departure.³ In your return, a list of properties that you own on departure must be included on Form T1161 (*List of Properties by an Emigrant of Canada*⁴). If the total value of all property is less than \$25,000, this form is not required. Assets that need not be listed are cash, pensions (including RRSPs and RRIFs) and any item of personal use property worth less than \$10,000 (for example cars, artwork and jewellery).

2. Interest and any penalty calculated by reference to the unpaid tax do not apply to the amount secured.

3. Any balancing tax that is owed must be paid by April 30 following your tax year of departure, regardless of the due filing date of the return.

4. This form is used by individuals who ceased to be a resident of Canada for tax purposes.



After you leave Canada

Generally, you will continue to pay tax to Canada on income that you receive from Canadian sources. Canadian bank interest will be exempt from Canadian withholding tax.

Dividends, rent and royalty payments will be subject to withholding tax and you must advise the payer that you no longer reside in Canada and confirm your country of residence. This will ensure the correct amount of tax is withheld.⁵ Beware! You may have to continue to file a Canadian T1 tax return in respect of certain employment, rental or business income.

It is not just about tax

Personal factors are the most significant part of the decision making process and it will be necessary to weigh the pros and the cons of moving overseas. During the process, you may be asking yourself questions such as:

- How accessible will my home country be while I live abroad?
- Are there any personal safety issues?
- Is the school system different?
- What is the quality of health care like?
- What is the predominant weather?
- How stable is the political regime?
- What are the cultural differences?
- Should I revise my will or have more than one will in place? (See “Where there’s no will there’s no way” on page 5)

Beyond tax

Many factors must be taken into consideration when relocating. Wherever you decide to reside, it will always form part of your life’s rich experiences. Clearly, tax should not be the sole driver; your own and your family’s lifestyle objectives are key. As John Berger (English art critic, novelist, painter and author) wrote, “Emigration, forced or chosen, across national frontiers or from village to metropolis, is the quintessential experience of our time.”

If you have questions regarding your residency status, plans to leave Canada or cross-border estate planning generally, please consult your tax adviser for specialist insight.

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5. You may be able to elect to file a Canadian tax return to claim a refund on rental or certain pension income.

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