

Private Company Services  
High Net Worth

# Wealth and Tax Matters

for individuals and private companies

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See “How to get *Wealth and Tax Matters*,” on page 29.

## Editorial

The economy remains a focal point for Canadians, as jobs are cut and many planned retirements are postponed because of weakened investments. As well, governments are spending to kick-start and stabilize the economy. Eventually, repayment time will come. In this climate, *Wealth and Tax Matters* again focuses on ideas for increasing and preserving your hard-earned dollars, because it’s not what you make that really matters in the end, it’s what you keep.

The first three articles focus on splitting income with family members. Taxpayers often hope to improve after-tax rates of return by shifting income to family members that have lower incomes and lower marginal rates. Missteps will accomplish little and could create unpleasant surprises.

The next article discusses the pitfalls of trying to recover taxes paid on previous investment gains by selling depressed investments and using the losses to offset previous gains. Generally, it doesn’t work if not executed properly.

Residents of Canada are required to pay tax on world-wide income no matter where it is earned. If you have not completely complied, the fifth article, “Voluntary Disclosure,” should be of interest. With winter around the corner, many “snowbirds” flee harsh weather, spending extended periods in the U.S. This could lead to the IRS knocking on your door, and we explain the issues in the “Snowbird” piece.

The remaining articles deal with a variety of topical issues, including increased merger activity in Canada (“Cautious Optimism”), taking advantage of newer laws as they relate to charitable giving (“Enhancing tax benefits: Donation of Flow-Through shares”) and the new sales tax regime in British Columbia and Ontario (“More PST Audits: Harmonization”).

Finally, to help you get the most out of *Wealth and Tax Matters*, we have added an index that covers previous editions.

As always, your comments and suggestions are appreciated.



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# Whose asset is this anyway?

## A primer on the attribution rules



Professional tax advisers are frequently asked about schemes for splitting income with family members. Previous articles in this publication have dealt with legitimate ways to split income, often involving use of trusts and/or corporations. The “attribution rules” in our *Income Tax Act* are designed to discourage income splitting by Canadian taxpayers. This article is a basic primer on those rules.

As the name implies, for tax purposes the rules attribute income actually earned and owned by one taxpayer to another taxpayer. Nothing in the tax rules dictate what a person can or cannot do—they merely create tax consequences that would not arise otherwise. For instance, if someone wishes to make a gift to their spouse or child, our governments have no right to control that decision. However, they do have the right to determine who pays tax on any resulting income. That is exactly what the attribution rules accomplish.

### Persons not dealing at “arm’s length”

The rules apply only to transactions between persons not dealing at “arm’s length.” By definition, “related” people are deemed to not be dealing at arm’s length, but for others this is always a question of fact. For tax purposes, “related” persons include your parents and grandparents, children and

grandchildren (natural or adopted), your brothers and sisters (including by marriage), and your “partner,” whether this is your spouse by legal marriage or your common-law partner. The rules also extend to apply to loans or gifts to minor individuals who are your nieces or nephews, and that includes nieces or nephews of your partner.

### Loans or gifts of property or money

In concept, the rules are simple. They apply to loans or gifts of property or money. If you make a loan or a gift to a non-arm’s length person, any property income arising from the property they acquire with the loan or gift (or from property substituted for the original property) is taxed to you forevermore, not to the person who actually owns the property.

As usual, some vitally important nuances complicate the simple concept:

1. The attribution rules do not apply to a loan that carries interest at least equal to the CRA-prescribed rate in effect when the loan was made, if the loan interest was actually paid during each year, or within 30 days after the end of each year. That rate is just 1% for the third quarter of 2009, the lowest ever, so this is the perfect time to lend to family members, without being subject to the attribution rules, as long as the borrower pays at least 1% interest to the lender yearly in future.
2. Only income from “property” is subject to the attribution rules. Business income is not attributed in any case. This means you can give or lend property to non-arm’s length individuals for use in their active business activities without risk of the attribution rules applying to the business income that results.
3. The attribution rule that applies to gifts or loans to minor children or minor nieces and nephews (i.e., those under 18), affects only income from the attributed property. The rule does not apply to capital gains or losses arising on the attributed property. So you could give or lend money to such a minor, and as long as the funds produce only capital gains or losses in future, those gains and losses would not attribute back to you. Rather, they would be taxed on the minor’s tax return.
4. In respect of loans or gifts to nieces and nephews who are minors, the attribution rules cease to apply once the minor reaches 18 years of age.
5. In respect of gifts to minor children, the attribution rules cease to apply once the child reaches 18 years of age.
6. In respect of loans to minor children, the attribution rules cease to apply once the child reaches 18 years of age, unless one of the main purposes of the loan was to reduce tax by having income from the loaned property taxed to the now adult child. The same purpose rule applies to loans to children who are already adults.
7. Gifts to adult children or adult siblings are not subject to the attribution rules.
8. In respect of loans or gifts to spouses or common-law partners, both income and capital gains attribute.
9. “Income on income” does not attribute. Consider a generous wife who lends her husband \$1,000,000. The husband invests the money, which earns 5% interest per year on a compounding basis for five years. As a result:
  - The first-year interest of \$50,000 is attributed to the wife, who must pay tax on it.
  - In the second year, \$52,500 interest is earned, of which the simple interest of \$50,000 is attributed to the wife, but the remaining interest on interest portion (compound interest) of \$2,500 is not, and the husband pays tax on that.
  - Similarly, in the years that follow the growing compound interest component each year is legitimately taxable to the husband. Over the five years, of the total interest \$276,282 interest, the wife would pay tax on \$250,000 simple interest and the husband would pay tax on the remaining \$26,282.
  - At the end of the five-year period, if the husband pays back the original \$1,000,000 principle of the loan, he would be left with \$276,282 (before tax) to invest that would not be subject to the attribution rules.

10. If the property given or lent is not used for the purposes of earning property income, the attribution rules have no tax impact. For instance, you can give or lend funds to a relative to purchase a home, and as long as that home is not used for an income-earning purpose, the attribution rules do nothing.
11. Regarding gifts or loans to spouses, the attribution rules cease to apply to income or loss from the property after a legal separation. However, attribution of capital gains and losses continues unless the spouses sign a joint election for it not to apply.
12. Divorce terminates the application of all attribution rules between the former spouses. Likewise, “related” status to an in-law (brother- or sister-in-law, father- or mother-in-law) also terminates on divorce (or death) so the attribution rules applicable to gifts or loans to those types of individuals also terminates.

These attribution rules also apply to certain other situations that might surprise you. For example, if instead of directly lending money to your spouse (or child) you arrange for a financial institution to make the loan, the attribution rules will apply if you guarantee or provide security for their loan. Similarly, the attribution rules will apply if you lend or transfer property to a person on condition that person lend or transfer property to a person not arm’s length to you.

### The corporate attribution rule

Another rule—a nasty one—applies to direct or indirect transfers or loans to corporations. This “corporate attribution” rule is very different than the other attribution rules, in that it potentially deems income to exist, and taxes that income to the lender or transferor, even though the actual income from the property might be taxed to some other person. In other words, this rule can create double taxation. The corporate attribution rule has its own important nuances:

1. This rule does not apply as long as the corporation qualifies as a “small business corporation,” but once it fails to qualify, the attribution rule is activated if there had ever been a previous direct or indirect transfer or loan. The definition of “small business corporation” is rather restrictive, so this particular attribution rule has broader application than many people think.
2. An exchange of shares, such as might happen in a typical estate freeze, constitutes a “transfer” for purposes of this rule. Thus, one must be acutely aware of this corporate attribution rule in contemplating an estate freeze on any company that is not currently a small business corporation, or that might stop being a small business corporation at any time in future.

3. Unlike the other attribution rules, a purpose test must be met before the provision can apply. One of the main purposes for the loan or transfer must have been to reduce the income of the transferor and to benefit, directly or indirectly, another designated person. A designated person is basically a spouse or minor child, niece or nephew.

A full discussion of all the aspects of the corporate attribution rule is beyond the parameters of this primer.

A previous article (“Trust basics part 3: Handcuffs and no keys” on pages 5 to 7 of the Autumn 2008 edition) discussed subsection 75(2), which is a particularly harsh attribution rule relating to trusts.

### Understanding the tax consequences

There you have it—a basic primer on the attribution rules. If you are contemplating any loans or gifts to non-arm’s length individuals, please contact your tax professional before proceeding. Understanding the tax consequences is essential.

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See “How to get *Wealth and Tax Matters*,” on page 29.

# “In-Trust” accounts



Parents and other relatives are using in-trust accounts more and more to split income and save money for a related minor. These accounts can be used to provide additional funds for future education costs, down payments on cars or homes, or other purposes. Unfortunately, sometimes in-trust accounts are set up without a full understanding of the legal and tax implications.

## What is an in-trust account?

An in-trust account is typically set up with a financial institution by a parent or relative to invest funds for a minor. The account is set up in-trust because children under the age of majority cannot enter into legally binding financial contracts. In most cases, the in-trust account, often referred to as an informal trust, is:

- created in the absence of a formal trust agreement;
- used as a convenience and to avoid the costs of setting up a formal trust;
- set up for the benefit of someone, but no trust deed accompanies the creation of the account and no document describes the relationship among the parties involved;
- only the investment contract itself; and
- is not a bona fide trust relationship, in spite of the name “in-trust.”

In contrast, a formal trust typically is drafted by a lawyer and documents the three “certainties” which are required at law to validly establish a trust:

Certainty of intention	The settler must clearly intend in making a transfer that the property be held in trust, by a named trustee, for the benefit of others, and that no other result was intended, such as agency, a transfer or gift of property.
Certainty of object	Who the property is to benefit (i.e., the beneficiaries) must be clear.
Certainty of subject matter	The property that is to be held in trust must also be clear. That is, the property must be clearly identified.

## Three alternative legal interpretations of an “in-trust” account

One of three legal interpretations can apply when an in-trust account is established for a minor. The account could be interpreted as:

1. a gift;
2. a revocable transfer; or
3. an undocumented trust.

Each is described in more detail below, along with its tax consequences:

### **A gift**

In the case of a gift, the transfer of property is an outright irrevocable gift to the minor and the parent acts as agent because minors lack the legal capacity to enter into legal binding contracts, and therefore cannot purchase investments in their own names. The minor is the ultimate owner of the property and, upon reaching the age of majority, can spend the funds as he or she likes. Usually this is what the parties intend.

In the case of a gift by a Canadian resident to a related minor child, niece or nephew, any income or loss from the property is deemed for income tax purposes to be the income of the contributor, who must report it on his or her tax return, by virtue of the attribution rules contained in the *Income Tax Act* (discussed in more detail on page 1).

An exception is made for a minor who has attained the age of 18 before the end of the year, in which case the income or loss is reported on the child's return. Taxable capital gains or allowable capital losses earned on the property are not attributed back to the contributor but are instead taxed in the hands of the minor child.

In the case of a gift by a Canadian resident to a minor that is not their child, niece or nephew, the income or loss from the property, as well as capital gains or losses from the property, is properly reported on the tax return of the minor.

### **A revocable transfer**

If characterized as revocable, the purported transfer to the minor would not constitute a legal transfer, because the property could revert to the person who made the transfer. Any income or loss from the property, including taxable capital gains or allowable capital losses, would be taxable in the hands of the contributor and not the minor.

Parents who establish and contribute to in-trust accounts but take money out for their own use when personal circumstances change, must include in their personal income tax returns all income or gains earned since the inception of the account.

### **An undocumented trust**

An undocumented trust has the most complex of the three characterizations. A true undocumented trust would be governed by applicable trust legislation and common law. Tax results would be dictated by the *Income Tax Act*, including the attribution rules and subsection 75(2). For more details, see "Trust basics part 3: Handcuffs

and no keys" on pages 5 to 7 of the Autumn 2008 edition.

Whether a valid trust exists depends on the factual relationships among the settlor who created the trust, the trustees and the beneficiaries, determined case by case. These relationships may or may not be defined in writing.

Any attempt to establish a trust will fail if any of the three certainties is not present. In other words, unless it is certain that the settlor intended to bring a trust relationship into existence and both the property and the beneficiaries of the trust are described with sufficient certainty, no trust will have been created.

In the absence of a formal document, certainty of intention is hard to prove, and tax authorities generally view contributions to an in-trust account at a financial institution as simply being a gift.

If the three certainties are present regarding a particular transfer of property to an in-trust account for a minor, an undocumented trust exists with the following tax consequences:

- The trust will be required to file a T3 trust income tax and information return for any year in which the property produces income.

- Taxation of the annual income depends on the facts, and will be determined by the interplay between the attribution rules and subsection 75(2) of the *Income Tax Act*.
- No matter what the relationship, if any, between settlor and beneficiary, if the settlor falls afoul of any provisions of subsection 75(2), all income and capital gains or losses from the property must be reported on the settlor's own tax return for the duration of the trust. To avoid this result:
  - the property can neither revert to the settlor nor pass to persons determined by the settlor after the trust is created; and
  - the settlor cannot have control over the disposition of the settled property.
- If the settlor is a sibling, parent, grandparent, aunt or uncle (including by marriage) of the minor beneficiary, any income or loss for a taxation year from the property will be deemed to be that of the settlor and taxed on the settlor's tax return.
- If the settlor is a sibling, parent, grandparent, aunt or uncle (including by marriage) of the minor beneficiary, taxable capital gains or allowable capital losses earned on the property could be taxed differently, depending

on the facts. Only if the provisions of subsection 75(2) (described above) are avoided can the capital gains or losses be reported by the beneficiary themselves, or on the trust's own tax return.

### Opportunities

The logic of the tax analysis above is complicated further by some exceptions. Fortunately, these have beneficial results.

The income or loss from funds deposited in an in-trust account that arises solely from child tax benefit payments, an inheritance or the minor's own employment income is properly taxed in the hands of the minor. To obtain this potentially favourable tax treatment, the source of the funds for the investment must clearly be traceable. A separate bank account is suggested.

As well, one could lend funds to the minor at the prescribed interest rate, after which those funds could be deposited in an in-trust account. The income or loss from these funds would be taxed in the hands of the minor. Using a prescribed rate loan to minors was discussed in further detail on page 36 of our Spring 2009 edition of *Wealth and Tax Matters* in "Opportunity Knocks: How to use low interest rates to reduce taxes."

### U.S. family members

An in-trust account can create special problems if the child beneficiary is a U.S. citizen or resident. The child must comply with U.S. income tax rules, and minor children generally do not have access to low U.S. tax rates. In addition, contributions to the account may require disclosure to the Internal Revenue Service (IRS), and the assets of the in-trust account may be subject to the U.S. estate tax if the child dies. U.S. taxation advice is a must in this situation.

### Conclusion

With competent planning, splitting income with minors can potentially reduce a family's tax burden. Time should be invested with your professional advisers to ensure you understand the in-trust account, and the relevant legal and tax rules you must meet to effectively achieve your goals.

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# Family trusts

## A way to finance a child's education and reduce your family's overall tax bill



A Registered Education Savings Plan (RESP) can be a good way to save for your children's future post-secondary education costs (see "The ABCs of RESPs" on pages 29 to 32 of the Spring 2009 edition of *Wealth and Tax Matters*). But what if contributions made to the RESP are insufficient and your children are about to go to college or university? This article discusses tax-efficient strategies that use a trust to fund your children's education and other expenses. We also discuss planning to split income with a low-income spouse.

Trusts can be a valuable tool for a family to use to minimize its overall tax burden by shifting income from a family member in the highest tax bracket to one or more family members with a lower tax rate and a separate set of personal tax credits. A discretionary family trust is often the chosen vehicle for income splitting, because it is possible to reduce tax while maintaining a great deal of practical flexibility. Planned properly, use of a trust can significantly reduce the cost of funding your children's education and other costs and in some cases, can take advantage of a lower-income spouse's personal tax credits and lower tax rates.

Any income-splitting plan must be carefully designed to avoid the attribution rules, as discussed in "Whose asset is this anyway? A primer on the attribution rules" on page 1 and in other editions of *Wealth and Tax Matters* publications (such as "Trust basics part 3" on pages 5 to 7

in Autumn 2008 and "Opportunity Knocks: How to use low interest rates to reduce taxes" on pages 36 to 38 in Spring 2009). The attribution rules are designed to prevent families from inappropriately splitting income through gifts or loans when the lower-income family member has neither earned the capital nor paid for its use. When the attribution rules apply, the income earned by an individual will be subject to tax in the hands of the person who provided the funds.

Three strategies for income splitting using a trust for the Smith family are outlined below. With careful planning, these should avoid the attribution rules. Assume that Paul Smith is the higher-income spouse, with 45% marginal tax rate. His spouse, Mary, and their three children have no income. Two of the children are over the age of 17 ("adult children") and one is a minor. The adult children both attend university and the minor child is in a private school.

### Option 1 – Paul gives cash to a trust and the trust invests the funds to earn investment income

In this scenario, Paul settles a trust with a non-income producing asset, such as a gold coin, and gives cash to the trust. The trust will invest the funds to earn interest, dividends and capital gains. Paul, Mary and their friend, Barney, will be the trustees. Decisions will be made by majority vote. The discretionary beneficiaries of the trust will include Mary and their children. Paul cannot be a beneficiary of the trust; that would trigger the attribution rule in subsection 75(2) of the *Income Tax Act* (see “Trust basics part 3” on pages 5 to 7 in Autumn 2008).

In this case, whether the trust earns interest, dividends or capital gains, the income can be allocated to Paul’s adult children for tax purposes and used to fund their tuition and other expenses. Because each child has no other income, the income will be tax-free up to their personal basic tax credits, currently \$10,320 for federal income tax. Income above this threshold will be taxed at the children’s graduated rates and can be reduced by an additional tax credit for tuition paid, as well as an education credit and a textbook credit that are based on the number of months the child was a part-time or full-time student.

For example, assume that the trust earns \$50,000 of interest income and allocates \$25,000 to each adult child. In addition, each child attends university full time for eight months in that year. Tuition of \$10,000 is paid for each child. Total tax savings of approximately \$20,000 should result for Paul in each year that the plan is in place.

Possible drawbacks of this strategy include:

- It will not be possible to use Mary’s basic tax credit and low tax rates — any interest, dividends or taxable capital gains that are allocated by the trust to Mary would be subject to tax in Paul’s hands as a result of the attribution rules.
- It will not be possible to use the minor child’s basic tax credit and low tax rates unless the trust realizes net capital gains and allocates them to the minor child for tax purposes.
- It will not be possible for Paul to receive his capital back from the trust once the children’s education is completed. However, if the trustees agree, the remaining trust assets could be distributed to Mary if she is still living. However, if Mary invests the funds to earn investment income, depending on the situation, some or all of that income would be attributed to Paul and taxable in his hands.

To avoid these disadvantages, Paul could consider options 2 or 3.

### Option 2 – Paul lends cash to the trust at the prescribed rate and the trust invests the funds to earn investment income

This scenario is identical to option 1, except that rather than giving the cash to the trust, Paul makes a prescribed-rate loan to the trust. For this strategy to work, the loan must, among other requirements, bear interest at the federal prescribed rate in effect when the loan is made (a record-low 1% to at least December 31, 2009) and the interest must be paid by January 30 of the following year (and by January 30 following the end of every subsequent year during which the loan is in place).

Paul will pay tax on the interest income he receives from the trust. The trust can allocate to any of Paul’s family members any income it earns in excess of the interest it pays Paul. This allocated income will be taxable in their hands.

The main advantages of this strategy are:

- It will be possible to use Mary and the three children’s basic tax credits and lower tax rates, provided that the trust’s income for tax purposes exceeds its annual interest expense on the loan.
- Paul will be able to receive his capital back from the trust once the children’s education is completed by demanding the repayment of his loan to the trust.

A similar approach, described in option 3, does not involve interest being charged on the loan and has some advantages in certain circumstances.

### Option 3 – Paul lends cash to the trust for no interest and the trust invests the funds to earn capital gains

This plan is the same as option 2, except that rather than making a prescribed-rate loan to the trust, Paul makes an interest-free loan to the trust and the trust invests the funds to earn primarily capital gains (and nominal dividend and interest income).

This approach simplifies the administrative burden associated with making timely interest payments and having to include interest income in Paul's tax return. As with option 2, Paul will be able to receive his capital back from the trust once the children's education is complete by requesting the repayment of his loan to the trust.

Under this plan, the trust can allocate the taxable portion of its capital gains to all three children, so that the family can take advantage of the children's basic tax credits and low tax rates. However, Paul's ability to split income

with his family members using this strategy is severely reduced. Paul's loan to the trust does not bear interest at the prescribed rate, so any interest, dividends or taxable capital gains that the trust allocates to Mary would be subject to tax in Paul's hands. Paul would also be taxable on any interest and dividend income that the trust allocates to any of his children, regardless of age.

### Conclusion

The income-splitting plan that is best for your family will depend on your family's specific situation and on your objectives. In Paul Smith's situation, the prescribed-rate loan in option 2 maximizes his opportunity to split income with his family members. The federal prescribed rate is at its lowest level ever—creating exceptional opportunity for long-term income splitting with family members. To lock in the 1% rate, you must act before it increases. The rate is subject to change every quarter, so after December 31, 2009, it could be higher, lower or remain the same.

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See "How to get *Wealth and Tax Matters*," on page 29.

# Your loss?

## The Superficial Loss Rules



Taxpayers are allowed to arrange their personal affairs in a way that ensures they pay as little tax as possible. That's probably what David had in mind when he thought about the following strategy. David owns 5,000 shares in Pubco, a public corporation. They cost \$15,000, but have a market value of only \$7,500. David intends to sell the shares and deduct the capital loss from capital gains he realized on other investments. However, he expects the value of the Pubco shares to increase over the coming months, and plans to buy new Pubco shares in the days following the sale of the 5,000 shares.

David's idea of selling his shares and buying new ones is tempting, since it seems to allow him to benefit from his loss while maintaining his investment in Pubco. Unfortunately, when preparing his income tax return, David's tax adviser will have to explain that the *Income Tax Act* includes "superficial loss" rules that deem the capital loss on the sale of the 5,000 shares to be nil, because he acquired new Pubco shares in the days following the sale and still owned them 30 days later.

### About superficial losses

David will have learned how, because of the superficial loss rules, an individual cannot easily materialize losses without actually disposing the

property outside an affiliated group. Generally speaking, the expression "superficial loss" refers to a loss resulting from the disposition of property:

- when the individual or a person affiliated with him or her purchases the same property or identical property (collectively referred to as "substituted property") during the period that begins 30 days before the disposition and ends 30 days after the disposition of the property;
- if, at the end of the period, the individual or an affiliated person owns the substituted property or has the right to purchase it.

The superficial loss concept therefore applies to situations when, according

to the tax authorities, there is no economic disposition of the property, because it is actually reacquired by the taxpayer or certain persons or entities related to him or her, known as affiliated persons.

In this context, the expression “affiliated person” generally refers to the spouses or common-law spouses, as well as the entities they control. However, many family members are not included. For example, one sibling is not affiliated with another, and a parent and child are not affiliated with each other.

## Sample situations

In addition to situations like David’s, the superficial loss rules apply and prevent the deduction of a loss in the following examples.

### 1. Sale to spouse or common-law spouse

Luke owns 1,000 Pubco shares whose value is lower than their cost. Luke sells his 1,000 shares to his wife, who still owns them 30 days after the sale. Luke’s capital loss will not be deductible because he and his wife are affiliated persons.

### 2. Purchase of substituted property by a spouse or common-law spouse

On March 15, Mark sold all 200 of the Pubco shares he owned and incurred a capital loss of \$2,000. On April 1, his common-law spouse, Laura, purchased 200 Pubco shares and still owned them 30 days after the sale. Mark and Laura are affiliated persons and the new shares are deemed to be substituted property. Superficial loss rules prevent the deduction of the \$2,000 capital loss.

### 3. Sale to a controlled company

Martine sold some of her investments to her holding company at a loss, and the company still owned them at the end of the 30-day period following the sale. Martine’s capital loss will not be deductible, because Martine and the company she controls are affiliated persons. The outcome would have been the same if Martine had sold her shares to a company controlled by her common-law spouse or to a company controlled by the couple.

### 4. Purchase of substituted property by a controlled company

Maria owns all the shares in a holding company “Investco.” Maria and Investco respectively own investment portfolios. Maria’s broker sold the Pubco shares, which had lost value since they were purchased. In addition, Investco’s

broker purchased other Pubco shares on the open market which were still held 30 days after the sale. Superficial loss rules prevent the deduction of the capital loss that Maria would have otherwise realized.

## Planning opportunities

The definitions of “superficial loss” and “affiliated persons” do, however, provide some planning opportunities. In the following examples, superficial loss rules do not apply and the capital losses are deductible.

### 1. Acquisition of substituted property after the 61-day period

A month and a half after selling all her Pubco shares and incurring a significant capital loss, Nancy bought new Pubco shares. That was more than 30 days after the sale, so the shares are not considered substituted property and Nancy will be able to deduct her capital loss.

### 2. Transfer between a parent and his or her child

Louise has an investment portfolio in which the value of some shares is lower than the cost. To realize the unrealized losses, Louise sold her shares to her adult son Daniel who is not an affiliated person. This strategy allowed Louise to recognize and deduct a capital loss, even though the shares were still owned within the same family.

### 3. Transfer to an unaffiliated company

The following situation received a favourable technical interpretation from the tax authorities. Individuals each held 25% of the shares in Opco, a private corporation that operates a business. The business partners were not related persons and dealt at arm's length. The tax cost of the shares was higher than the market value for each individual. As part of a commercial transaction, all the individuals transferred their Opco shares to a newly incorporated company, Newco, and realized a capital loss on the disposition of their shares. This capital loss is not a superficial loss, because the individuals and Newco are not affiliated persons.

### Future use of a superficial loss

Although superficial loss rules can result in the denial of a capital loss deduction, they are not designed to prevent a deduction permanently. Rather, they defer recognition to a time when tax authorities consider that the loss will actually be realized. More specifically, the capital loss that had been deemed to be nil is added to the cost of substituted property for the individual or affiliated person, depending on the case.

In one of the situations described above, Mark's \$2,000 capital loss on selling his 200 Pubco shares was deemed to be nil due to the acquisition of new Pubco shares by his common-law spouse, Laura. In this instance, the tax cost of the 200 new shares for Laura will be increased by the \$2,000 superficial loss amount. This increase will enable Laura to increase the capital loss or reduce the capital gain upon her eventual disposition of the shares.

### Conclusion

Superficial loss rules apply to individuals. However, similar provisions (but with different mechanisms) apply to corporations, trusts and partnerships, as well as to the disposition of certain types of property, e.g., depreciable property or intangible property, or (in specific situations) shares. Caution is essential when attempting to realize a loss on a property without actually disposing of it outside an affiliated group. Consult your tax adviser to ensure the loss will not be deemed to be nil and that sophisticated transactions aimed at deducting the loss against a gain are not in vain.

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# Voluntary Disclosure

## Come clean or come out with your hands up!



Canada's tax system is complicated and is becoming more so as governments introduce new rules to cope with an increasingly fast-paced global economy. This increased complexity makes it harder for taxpayers to comply with Canada's tax legislation. Even so, the responsibility for complete and accurate tax filings under Canada's self-assessing tax system continues to rest with taxpayers.

Also, this past summer was full of developments that could increase the risk of detection for taxpayers who have not been compliant:

- In July, the Minister of National Revenue warned that the Canada Revenue Agency (CRA) will start to target eBay sellers, after eBay provided the CRA with the names, contact information and sales records of eBay sellers. This followed a decision of the Federal Court of Canada confirming the CRA's ability to demand such information.
- In August, the U.S. Internal Revenue Service (IRS) was successful in negotiating an agreement that would give it unprecedented access to information on U.S. holders of accounts at the Swiss bank, UBS. How long will it be before the CRA obtains similar access?
- Also in August, Canada signed its first Tax Information Exchange Agreement with the Netherlands in respect of the Netherlands Antilles. While this agreement in and of itself may not seem significant, it does show that Canada is moving forward with its intention to sign similar agreements

with other non-tax treaty jurisdictions to combat tax evasion and the use of tax havens. (For more information, see our September 3, 2009 *Tax Memo*, "Canada Signs its First Tax Information Exchange Agreement (TIEA)," available at [www.pwc.com.ca/taxmemo](http://www.pwc.com.ca/taxmemo).)

### The Voluntary Disclosures Program (VDP)

To avoid penalties and prosecution, taxpayers who have not complied with Canada's tax laws may want to consider a submission under the CRA's Voluntary Disclosures Program (VDP). The VDP promotes compliance with Canada's tax legislation by allowing taxpayers to make a voluntary disclosure to correct inaccurate or incomplete information in tax filings.

Taxpayers will not be charged penalties or prosecuted with respect to information provided in the disclosure, but only if the submission under the VDP is considered valid. The taxpayer will be responsible for any taxes and interest resulting from the disclosure. Partial interest relief may be granted in certain circumstances.

### **Who should consider a submission under the VDP?**

Any taxpayer who has not filed a tax or information return for a particular year or has filed incomplete or inaccurate information as part of a tax or information return, whether inadvertent or not, should consider making a submission under the VDP.

For example, making a submission could be worth considering for a taxpayer that:

- owns investments or has business dealings offshore and has not properly reported these interests, or the income from these offshore investments or activities, to the Canadian tax authorities;
- earned income from activities outside ordinary business or income earning activities (including selling merchandise on eBay) that was not previously reported to the Canadian tax authorities;
- claimed expenses in tax returns that would be considered ineligible under Canadian tax legislation; or
- failed to file information returns or remit source deductions on behalf of employees.

### **What is required to make a submission under the VDP?**

Four conditions must be met for the CRA to consider a submission under the VDP to be valid:

1. The disclosure must be voluntary. That is, the taxpayer must be submitting a disclosure without having knowledge or awareness of an audit, investigation or other enforcement action set to be conducted by the CRA with respect to the information being disclosed. If the CRA has issued any requests or queries related to the non-compliance, a VDP may no longer be possible. It is crucial that a VDP be submitted before the CRA starts asking questions—you cannot wait to see if the CRA will discover the non-compliance before making a submission under the VDP.
2. The disclosure must be complete. The taxpayer must provide full and accurate facts and documentation for all periods for which there was inaccurate, incomplete or unreported information.
3. The disclosure must involve the application or potential application of a penalty.
4. Generally, the disclosure must relate to information that is at least one year past due. A disclosure may be valid, however, if it relates to information that is less than one year past due if it corrects a previously filed return or it relates to other information that is at least

one year past due. For example, the CRA usually will accept as valid a disclosure relating to several years if all but the most recent year are at least one year past due.

### **How often can a taxpayer make a submission under the VDP?**

Normally, the VDP is available to a particular taxpayer only once. Taxpayers are expected to remain compliant after using the VDP; however, the CRA may consider a second submission if the situation resulting in the disclosure is beyond the taxpayer's control. A second submission that fails to acknowledge the previous submission may be deemed invalid.

### **Final thoughts**

With government revenues down and budgets back in the red, Canadian tax authorities are likely to explore new avenues to increase tax revenues. Audit activity is already up and is expected to continue at increased levels, which leaves taxpayers who have not been in compliance more exposed than in the past. Now might be a good time for taxpayers to avoid penalties by coming clean before the CRA says: “come out with your hands up.”

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# The Snowbirds sing... and the IRS listens



For many Canadians, the opportunity to avoid a harsh Canadian winter by fleeing to the southern United States is irresistible. Plummeting U.S. housing prices and the soaring Canadian dollar have enticed many Canadians to purchase accommodations in the region, rather than renting. But some may have overlooked important tax implications.

## Snowbirds

Snowbirds—Canadians who spend a significant amount of time in the United States during the winter—may not realize that simply by being present in the United States they may have exposed themselves to a predator, or at least the Internal Revenue Service (IRS), hungry for U.S. income and estate tax. The IRS considers foreigners who meet the U.S. “substantial presence test,” along with U.S. citizens and greencard holders, to be residents and therefore potentially liable for U.S. income tax.

A Canadian meets the substantial presence test if he or she spends:

- at least 31 days in the United States during the year; and
- 183 days or more in the United States under the following formula:

Total days present in the U.S.  
in the current year

+ 1/3 of the days present in the U.S.  
in the year before

+ 1/6 of the days present in the U.S.  
in year before that.

It doesn’t matter whether the purpose is business or otherwise.

Sample calculations are shown below for three of the more than 48 million possible combinations of days present in the United States in the last three years. Notably, 122 days presence (about four months) in each year produces a total of 183 days or more and constitutes a substantial presence in the United States. In each example, one less day in any year would save the individual from meeting the United States substantial presence test.

		Same number of days each year			About 20% fewer days each year			About 20% more days each year		
<b>Total days present in the U.S. in:</b>	Current year	122	x 1 =	122	109	x 1 =	109	131	x 1 =	131
	Previous year	122	x 1/3 =	40 2/3	137	x 1/3 =	45 2/3	110	x 1/3 =	36 2/3
	Year before that	122	x 1/6 =	20 1/3	170	x 1/6 =	28 1/3	92	x 1/6 =	15 1/3
<b>Formula total</b>				<b>183</b>			<b>183</b>			<b>183</b>

## Two exceptions

Two important exceptions can save Canadians from being considered U.S. residents and having to pay U.S. tax.

### The closer connection exception

A Canadian who meets the substantial presence test in a year may still be able to avoid being considered a U.S. resident by successfully demonstrating:

- a “closer connection” to Canada; and
- that they were in the United States less than 183 days in the year.

A closer connection generally exists if the Canadian is still considered a tax resident of Canada and his or her social and economic ties remain closer to Canada. The IRS looks at such things as:

- the location of a permanent home or homes, family connections, and business and banking ties; and
- access to healthcare coverage, etc.

To claim the closer connection, the individual must file a U.S. form (Form 8840) for each year for which the substantial presence test is met and the closer connection exception is claimed. This form is due on June 15.

### The treaty exception

Canadians who spend more than 183 days in the United States during the year can still avoid being considered U.S. residents if the “tie-breaker” rules in the Canada-U.S. Income Tax Treaty work in their favour. This is far more detailed and requires much more disclosure than the closer connection exception. To claim

the treaty exception a U.S. non-resident income tax return (Form 1040NR) must be filed, including a disclosure (Form 8833) explaining why the person should be considered a resident of Canada. Both are due on June 15 each year.

Even if the treaty exception results in Canadian residency for tax purposes, the individual may still have other IRS disclosure requirements, including those that apply to Canadian bank accounts, interests in Canadian corporations and Canadian trusts of which the individual is a beneficiary or trustee. Severe penalties can be imposed for non-compliance. For these reasons, in spite of the treaty, Canadians generally should limit their presence in the United States to 182 days in any calendar year.

## Owning the vacation property

Canadians who personally own their U.S. vacation properties face additional tax considerations. If they rent out their properties for any part of the year, federal and potentially state income tax returns must be filed each year to preserve deductions that can be claimed on the eventual sale of the home. Net rental income or loss must be reported on U.S. Form 1040NR, which is due on June 15.

The actual sale of the vacation home must be reported on the U.S. federal return, Form 1040NR. A state income tax return also may be required, depending on the location—but no return is required in Florida. U.S. withholding tax may also apply at the time of the sale, but it can be claimed

as a payment against the final U.S. tax liability. While the Canadian will be required to report the sale on a Canadian tax return, the final Canadian tax will be reduced by the amount of any U.S. tax paid on the sale, preventing double taxation.

## U.S. estate tax

In addition to income tax, the ownership of U.S. real estate can expose Canadians to U.S. estate tax, regardless of the amount of time spent in the United States. The U.S. estate tax applies to a Canadian holding U.S.-situs assets at the time of his or her death. U.S.-situs assets include such items as stocks of U.S. companies, and of course U.S. real estate.

For more on this topic, see “Owning A U.S. Vacation Property,” on pages 14 and 15 of the Autumn 2008 edition of *Wealth and Tax Matters* or the April 7, 2009 edition of *Estate Tax Update* of the same name.

Estate tax is calculated at graduated rates based on the fair market value of the person’s assets net of liabilities at the time of death. Current rates range from 18% to 45%, depending on the size of a person’s estate, with the maximum rate applying when the taxable estate exceeds \$US 1.5 million.

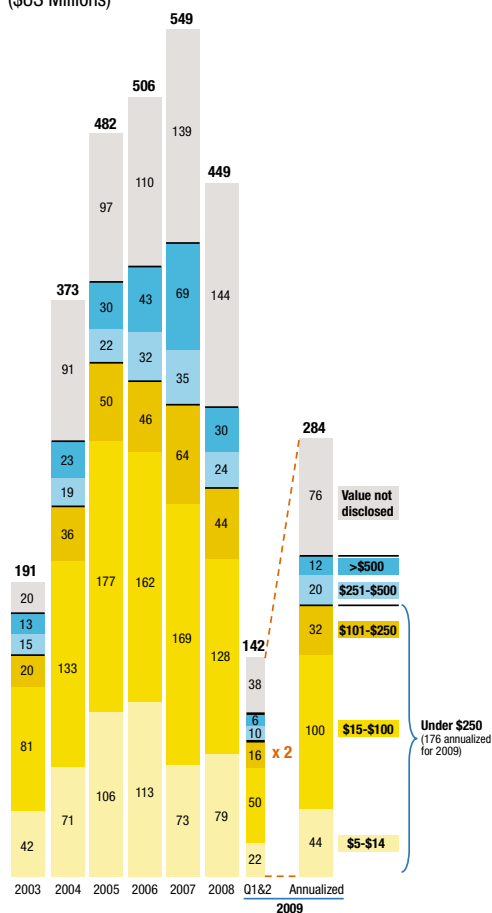
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# Cautious optimism

## Canadian middle market mergers and acquisitions today

Canadian M&A Volume  
(\$US Millions)



Source: Merrill Datasite mergermarket

### Merger and Acquisition Update: 2009 – First and Second Quarters

Merger and acquisition activity, in step with the economy at large, was at a virtual standstill during the final quarter of 2008. However, recent activity suggests that M&A activity is back from the brink: between January and June 2009, more than 1,200 deals worth approximately US\$350 billion in total were completed in North America. Although this is a precipitous 46% decrease in volume from the same period in the previous year, most agree that 2008, which included a plethora of large leveraged buyouts at speculative valuations, is not an appropriate benchmark, because it was an overbought market, far from normal.

The Canadian middle market, largely dominated by private companies, relies less than its American counterpart on public markets, excessive leverage or complex financial engineering. Here, annualized M&A volumes are only down 29%. As the graph shows, 88 deals (16 + 50 + 22) valued at less than US\$250 million closed during the first half of 2009, an annualized volume of 176 versus 251 (44 + 128 + 79) in 2008.

We are clearly in an M&A upturn, but what does this really mean for Canadian middle market business owners and investors seeking to transact in today's economic climate? This article presents an overview of what the new normal for M&A is shaping up to be.

### Getting a deal done in 2009

It is an oversimplification of current M&A market dynamics to assume that the start of an M&A upturn is a good time to buy and a bad time to sell.

While this may be true sometimes, before embarking on an M&A strategy in today's market, it is critical to understand the following four key trends that differentiate deal-making in 2009 from the 2003-2008 period:

1. New Buyer and Seller Landscape
2. Decreased Valuation
3. Creative Deal Structures
4. Increased Focus on Deal Protection

### New buyer and seller landscapes

In the buyer landscape, notable changes include:

- **Private equity (PE) firms:** In recent years, North American PE firms were active in the Canadian middle market, both responding to solicitations and making unsolicited approaches. These financial buyers were trying to achieve targeted hurdle rates within three to five years, often using leverage to boost returns. That business model relied on earnings

growth, easy credit and plentiful exit options.

Today's economic climate is characterized by slower earnings growth, limited exit options and tighter credit. Many PE firms are adopting business models that rely on maximizing value via the creation of long-term operating efficiencies within existing portfolio companies. As a result, PE firms tend to be inactive and those who are pursuing acquisitions are seeking small to mid-size tuck-under deals that are synergistic to existing portfolio companies. Although this shift in focus may not bode well for owner-managers who have been waiting to auction off their firms in PE bidding wars, some Canadian middle market companies may stand to benefit from increased interest by PEs in smaller strategic deals.

- **Strategic buyers:** During 2003 and 2008, many strategic buyers were "priced out" of M&A transactions. Today, in the absence of PE bidding wars and leveraged buy-outs, many well-capitalized strategic buyers are eager to finally successfully close acquisitions, although the wave of opportunistic M&A by strategic buyers that some predicted for the first half of 2009 did not materialize. Given that most boards and banks are not willing to take on the risk associated with large mergers, many strategic buyers have expressed a specific interest in middle-market transactions with compelling value propositions.

- **Foreign entrants:** At the upper end of the middle market, some foreign buyers are more active in Canada now than in recent years. Two new foreign buyer groups are:

- Companies and Sovereign Wealth Funds in China remain flush with billions in cash. These entities are actively using M&A to secure their supplies of resources through partnerships, asset purchases or outright acquisitions.
- The investment arms of Kuwait, Saudi Arabia, Dubai, Abu Dhabi and Qatar combined are reported to hold an estimated \$1.5 trillion. These countries reportedly are seeking to diversify from oil and gas holdings.

The emergence of these buyer groups bodes well for potential sellers in targeted segments, particularly mining and energy.

- **Management buy-outs (MBOs):** In recent years, it was common for management teams at middle-market Canadian companies to pool their resources to acquire their employer, either as part of a planned succession plan or by participating in a broader divestiture processes. More often than not, these transactions relied on the ability of private investors to secure substantial acquisition financing at reasonable commercial terms. In today's restrained and more expensive lending market, to complete an MBO increased seller financing may be required. Owner managers, in particular, may want to take this into consideration when formulating succession plans.

In the seller landscape, notable changes include:

- **Fewer good companies for sale:** Collateral damage from the recent credit crisis has resulted in a disproportionate number of distressed companies on the market. In addition, valuation concerns and lower 2008/2009 earnings mean that shareholders of stronger companies are deferring divestiture plans. Acquirers should be aware that, while distressed M&A can result in high returns, realizing value typically requires expertise in turnaround and restructuring. These transactions are fraught with risk and should not be pursued without careful consideration and extensive due diligence, particularly in respect of quality of earnings and protectionist deal structures.
- **Fewer turnkey operations for sale:** Many companies, seeking to bolster liquidity and de-leverage, are carving out non-core assets, brands or divisions. Middle-market acquirers may want to consider adding value via acquisition of these assets or lines of business. Although integration of piecemeal acquisitions may be challenging, for the right buyers, these transactions may offer the opportunity to acquire strategic assets at a discount.

### Decreased valuation

The most palpable characterization of today's M&A market is lower deal valuation. While there have been too few disclosed private transactions to generalize on valuation trends in the Canadian middle market, in our view values are lower than the 2007 peak for the following reasons:

- **Lower transaction multiples:** According to Capital IQ, in the seven months ended July 31, year-to-date M&A transactions across all sectors were completed at average EV/EBITDA multiples at least 30% lower than the for same period in 2007.
- **Lower earnings:** Lower multiples are being applied to lower earnings. Earnings weakness continues across all sectors: in Q3, S&P 500 companies are earning roughly 35% less than the same quarter in 2007. While no statistics are available on Canadian middle-market earnings, most observers believe that private companies are experiencing a similar trend.
- **Post-closing adjustments:** Overall transaction proceeds may be even lower than initial valuations, as a result of post-closing purchase price adjustments to reflect adverse changes in pre-closing net working capital or post-closing EBITDA results.

### Creative deal structures

To bridge valuation gaps, buyers prefer structures that limit downside risk by incorporating some or all of the following:

- Purchase price earn-outs and/or contingent consideration based on the achievement of one or more financial or operational targets.
- Vendor take-back notes (VTBs), where the vendor lends funds to the acquirer to help facilitate the purchase of the company. The VTB often is a secondary lien on the property, because most buyers will have a primary source of funding other than the seller.
- In the case of less than 100% acquisitions, equity sweeteners, including warrants and rights and, in some cases, secured debt positions.

Banks continued disinclination to provide acquisition financing to all but the most highly rated credits is also influencing transaction structures. The most obvious implication is lenders' increased need for greater equity contributions. For example:

- S&P reports that equity contributions required for North American acquisition loans increased to 46% in 2008, where they remain, up from 30% in 2007. Our experience is that funding of Canadian transactions is consistent, with most lenders not prepared to fund more than 40% to 50% of the purchase price.
- Sub-debt and other alternative lenders may seek to fill the void left by senior lenders but pricing and other terms will be more onerous. While sub-debt will facilitate the completion of more transactions, valuations are not anticipated to increase significantly.

### Increased buyer focus on deal protection

Partially as a result of an increase in perceived risk, and partially reflecting buyers' stronger negotiating positions, M&A deals are incorporating more for acquirers. These include:

- quantitative material adverse change (MAC) benchmarks, with fewer carve outs, to protect against the deterioration of financial and business conditions.
- clearer remedies for deal termination, which can include substantial lockup or break fees.
- tighter seller representations and warranties, with longer survival periods for seller indemnifications, reduced "caps" on indemnity claims and escrows.

### Conclusion

Most commentators agree that no steep uptick from current levels is in store for the M&A market, given the remaining uncertainty regarding exit options and access acquisition financing. This does not mean it is impossible to complete a deal. Instead, middle-market Canadian acquirers and divisors alike must appreciate what it takes to get a deal done in 2009 and strategize accordingly.

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# Enhancing the tax benefits of charitable giving

## Donation of Flow-Through Shares and Lifetime Giving



Charitable giving is an integral part of the financial and estate planning strategy many individuals develop. While the tax benefits associated with charitable donations are generally secondary reasons for giving, it is important to recognize how the nature of the donated asset and the timing of the donation can maximize the tax savings related to these gifts.

### Donation of flow-through shares

Since May 2, 2006, when the federal government enhanced the tax benefits with respect to the donation of publicly listed securities to charities, gifts of this nature have become more common. The enhanced tax benefits come in the form of the elimination of income tax on the capital gains realized on the donation of the securities to public charities<sup>1</sup> after May 1, 2006, and to private foundations after March 18, 2007. The tax benefit can be further enhanced when the gift is in the form of flow-through shares of publicly listed entities.

### Investments in flow-through units or shares

Flow-through units or shares are generally resource-based investments that allow the issuing entity to renounce its exploration expenditures in favour of the investor. As a result, the investor is entitled to claim tax deductions for its allocated share of renounced

expenditures such as Canadian exploration expenditures (CEE) and Canadian development expenditures (CDE).

The investor's tax cost base of their investment in the flow-through units are reduced by the amount of the renounced expenditures allocated to the investor. Typically, the magnitude of the expenditures allocated to the units or shares equals the initial costs of the investment; thus, the tax cost base of the shares is nominal after the exploration activities have been completed. The investor then converts his or her interest in the flow-through entity on a tax-deferred basis into a publicly listed security that is listed on a designated stock exchange. The publicly listed security could then be sold in the open market and/or donated to a Canadian registered charity or other qualified donee.

1. Public charities are generally registered charities other than those designated as private foundations.

### Donation of flow-through shares

An individual donor is entitled to a donation tax credit equal to the fair market value of the publicly listed securities when the securities are donated to a qualified donee. The tax benefits that are associated with gifts of publicly listed securities, coupled with the tax relief associated with the renounced expenditures allocated to the investor, significantly reduces the after-tax cost of making a charitable donation of flow-through share investments.

Example A illustrates the enhanced tax benefits to an individual of donating “flow-through shares,” assuming an initial investment of \$100,000, renounced expenditures of \$100,000 allocated to the individual, a donation of publicly listed securities having a fair market value of \$100,000, and a tax cost base of \$0 for the flow-through shares at the time of donation. The example compares the tax benefits and cost of the donation of the flow-through shares to a similar donation of publicly listed securities that are not flow-through shares. The example assumes that the donor is a Canadian individual who is subject to a combined federal and provincial marginal tax rate of 45%.

### Example A: Publicly listed security donation (non flow-through share versus flow-through share) by an individual donor (after May 1, 2006)

	Publicly Listed Non Flow-Through Shares	Publicly Listed Flow-Through Shares
Initial cost of investment	\$100,000	\$100,000
Less: CEE and CDE	N/A	(100,000)
<b>Tax cost of investment</b>	<b>\$100,000</b>	<b>\$ NIL</b>
Proceeds of disposition/donation	\$100,000	\$100,000
Less: tax cost	\$100,000	\$ NIL
Capital Gain	\$ NIL	\$100,000
<b>Tax on capital gain</b>	<b>\$ NIL</b>	<b>\$ NIL</b>
Initial cost of investment	\$100,000	\$100,000
Tax (benefit) of CEE and CDE to investor	N/A	(45,000)
Tax on capital gain	(NIL)	(NIL)
Tax (benefit) of donation tax credit	(45,000)	(45,000)
<b>After-tax cost of donation</b>	<b>\$55,000</b>	<b>\$10,000</b>

### **Additional considerations**

Although the donation of flow-through shares can be a tax-efficient method of charitable giving, the following potential issues should be considered by the donor and/or the charity:

- The fair market value of the security being donated must be determinable at the time the gift is made. The valuation issue affects the amount the charity will report on the donation tax receipt, and therefore the associated tax benefits for the donor.
- The donor should consider whether any tax implications could impair his or her access to the tax benefits related to resource deductions and related to the full fair market value of the donated property, including the incidence of alternative minimum tax.
- The donor must gift the qualifying shares to the charity. If the donor makes a gift to the charity of the proceeds on the sale of the shares, or grant the rights to those proceeds, he or she will not receive capital gains tax relief.

- As part of the transaction, the donated shares must be registered in the name of the charity, so that the charity can decide independently whether to retain or dispose of the shares.
- The charity should consider if there are any restrictions (e.g., holding periods), market risks or unusually high expenses related to the disposition of the donated property, and whether these outweigh the benefits of accepting the gift.

### **Lifetime giving**

Consistent with humourist Jim Hightower's observation "I never saw a hearse pulling a U-Haul," individuals generally make their most significant charitable donations through their wills. While these gifts are often extremely generous, they can prove to be ineffective for tax purposes.

### **Annual net income limitation**

In general, an individual's annual donation claim is limited to 75% of net income.<sup>2</sup> However, the limit is increased to 100% of net income in the year of death and the year immediately preceding death.

### **Gifts at death**

Charitable donations made through a will are deemed to be made in the year of death and can therefore be claimed in the individual's final tax return. Any excess donations can be carried back one year, subject to the 100% of net income limitation.

Example B illustrates that an individual may be better off making a donation in annual instalments during his or her lifetime rather than making a significant donation upon death. The example compares the tax benefits associated with a will that makes a \$600,000 cash donation upon death to a lifetime giving plan of \$600,000 in cash spread over four years. It is assumed that the individual dies in 2012, his or her annual net income is \$200,000 from 2009 to 2012, no other charitable donations were made during that period, and the individual's combined federal and provincial marginal tax rate is 45%.

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2. Generally, net income includes total income received from all sources, such as employment, pension, interest, dividends, capital gains, and business, less certain items such as Registered Retirement Savings Plan (RRSP) deductions, carrying charges, and employment expenses.

## Example B: Lifetime giving plan versus bequest at death by an individual donor

### Total tax liability associated with the bequest:

	2009	2010	2011	2012	Total
Net Income	\$200,000	\$200,000	\$200,000	\$200,000	\$800,000
Maximum donation <sup>3</sup>	0	0	166,666	166,667	333,333 <sup>4</sup>
Income tax	75,000 <sup>5</sup>	75,000	75,000	75,000	300,000
Donation tax credit	0	0	(75,000)	(75,000)	(150,000)
<b>Net income tax</b>	<b>\$75,000</b>	<b>\$75,000</b>	<b>\$0</b>	<b>\$0</b>	<b>\$150,000</b>

### Total tax liability associated with the lifetime giving plan:

	2009	2010	2011	2012	Total
Net Income	\$200,000	\$200,000	\$200,000	\$200,000	\$800,000
Maximum donation	150,000	150,000	150,000	150,000	600,000
Income tax	75,000 <sup>3</sup>	75,000 <sup>3</sup>	75,000 <sup>3</sup>	75,000 <sup>3</sup>	300,000
Donation tax credit	(67,500)	(67,500)	(67,500)	(67,500)	(270,000)
<b>Net income tax</b>	<b>\$7,500</b>	<b>\$7,500</b>	<b>\$7,500</b>	<b>\$7,500</b>	<b>\$30,000</b>

### Lifetime giving plan and bequest compared:

	Lifetime giving	Bequest
Net income	\$800,000	\$800,000
Net income tax	(30,000)	(150,000)
<b>After-tax income</b>	<b>770,000</b>	<b>650,000</b>
<b>Unused donation</b>	<b>\$0</b>	<b>\$266,667</b>

The enhanced tax benefit provided on the donation of publicly listed securities to charities, as discussed previously, has generally made the lifetime giving plan more tax-efficient than satisfying charitable bequests in a will with the donation of marketable securities.

## Summary

This article has highlighted two potential strategies for enhancing tax benefits when contemplating a charitable gift plan:

- donation of flow-through shares; and
- giving during one's lifetime.

For a further discussion of donation strategies and income tax incentives associated with charitable giving, please refer to our publication *Reaching Out — Charitable Giving Guide for Donors*, which is available on our website ([www.pwc.com/ca](http://www.pwc.com/ca)) or from a local PricewaterhouseCoopers contact.

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3. As discussed previously, the annual donation claim limit is 100% of net income in the year of death. Excess donations made in the year of death can be carried back to 2011 and applied against 100% of net income. However, tax credits cannot be carried back to 2009 and 2010.

4. Only \$333,333 of the \$600,000 donation is required to eliminate the tax liabilities for 2010 and 2011. As a result, the tax benefit on unused donations of \$266,667 (\$600,000 - \$333,333) is lost.

5. The \$75,000 tax liability is less than 45% of \$200,000 because the assumed 45% top marginal rate applies only to taxable income above a certain level (\$126,264 in 2009).

# More PST audits

## Harmonization in British Columbia and Ontario sparks scrutiny



If you do business in British Columbia or Ontario, you should be more prepared than ever for an audit of provincial retail sales tax (PST).

After 18 years of maintaining PST alongside the federal Goods and Services Tax (GST), Ontario and British Columbia will be harmonizing their PST systems with the GST. Effective July 1, 2010, the new harmonized sales tax (HST) will be 12% in B.C. (7% PST plus 5% GST) and 13% in Ontario (8% PST plus 5% GST).

The tax base and basic operational rules of HST in B.C. and Ontario will be substantially the same as the GST, and the Canada Revenue Agency (CRA) will administer the new tax. Registrants will file a single return for the GST and provincial portions of the HST.

A significant difference from the GST is that the Ontario and B.C. portions of the HST will not be recoverable by large businesses (those with annual taxable sales in excess of \$10 million) for the following purchases:

- energy (except when purchased by farms or used to produce goods for sale);
- telecommunication services (other than internet access fees or charges for toll-free numbers);

- automobiles and other road vehicles weighing less than 3,000 kilograms;
- parts and certain services for vehicles and fuel for such vehicles; and
- food, beverages, and entertainment expenses.

It is proposed that the above restrictions would apply in full for the first five years of the HST (i.e., from July 2010 through to June 30, 2015). During the subsequent three years, full input tax credits would be phased in.

Preparing for the implementation of the HST, (e.g., updating IT systems) could stretch resources, but the potential of a PST audit must not be overlooked. With less than one year to go before harmonization, PST audit activity seems to be increasing. Many companies have seen a somewhat more “liberal” approach to traditional auditing techniques that have been used by the authorities.

In what some call the final opportunity to squeeze every last penny out of the system, the provincial taxing authorities appear to be undertaking a full offensive to audit as many companies

as possible before the end of PST as we know it. Although technically a company may be audited up to four years after the implementation of the HST in Ontario and B.C. (longer under certain circumstances), early indicators show that most audits will be conducted within two years after HST implementation. This is primarily because provincial auditors will become employees of the CRA and will ultimately be auditing the federal GST and the new HST. As a result, many PST audits likely will be undertaken within the next few years.

With more audits to carry out and the gradual dilution of qualified personnel, the provinces will be reticent to pursue time-consuming, contentious PST issues. Instead, audits are more likely to focus on taxpayers that have clearly not complied, for example by not charging tax and not self-assessing.

Although most assessments undoubtedly will be fair, reasonable and acceptable to the taxpayer, some will warrant being challenged on account of perceived errors by the auditor. In these circumstances, the greatest opportunity for success and to minimize cost is to dispute an assessment during the audit period (i.e., before a final assessment is issued). Success becomes less likely

and more costly in the subsequent objection stage and even more so during court proceedings.

While a quickly turned around audit may sound like a welcome surprise, you must be wary of the audit techniques that may be used, in particular the sample periods selected. When an auditor detects an error and sample months are used to extrapolate the issue over the years of the audit period, ensure that those sample periods correctly reflect the actual activities of the business during the audit period.

In addition, emphasis on getting as many audits as possible completed within the next few years may well encourage auditors to request more assistance than usual to quantify potential liabilities.

Many PST assessments will be based on negotiated estimates that you and the auditor agree to. Understanding issues that are the object of the assessment is critical, but so is the ability to negotiate an acceptable assessment. Negotiating with tax authorities is an art that develops with experience, making assistance from practiced professionals an investment that can pay off well.

## Managing the audit process

If contacted for a PST audit, the following guidelines for managing the audit process from beginning to end will prove useful.

### 1. Understanding the auditor's rights

Auditors have the right to inspect, audit or examine the books and records of registered taxpayers to ensure that the appropriate amount of tax has been charged or self-assessed, reported and remitted.

### 2. Scheduling the audit

Most audits begin with a letter from the respective provincial authorities notifying you that the business is scheduled to be audited for PST. Subsequently, the auditor will contact you to propose a start date. If that date is not suitable, for example, if it is during budget time or when other authorities are conducting their audits, suggest an alternative. The audit should be scheduled to start when management and employees are not overwhelmed with other work responsibilities.

### 3. Giving the auditor workspace

When the auditor arrives at your place of business to start fieldwork, designate a separate office, usually away from the office staff, for the auditor to use. This office should be separated from the employees and have a suitable work area—not just a storage room with files, for example. Segregating the auditor from the general office and tax area limits the auditor’s opportunity to come across documents or information that is not part of the audit, or to engage in casual conversations with employees, other than the designated audit contact personnel.

Audits can go “off-the-rails” when an auditor receives incorrect information from a junior employee or from a department other than Tax. Time and effort can be absorbed in correcting the misinformation. As a result, employees should be made aware that a PST auditor is on premises and encouraged to not discuss business or accounting issues with the auditor or in the auditor’s presence.

### 4. Dealing with the auditor

One person should be appointed as the contact person to whom the auditor can direct questions and requests for additional information. This person should be knowledgeable about the company operations and able to respond.

The initial meeting with the auditor should be professional and positive. During the meeting, the contact person should be introduced to the auditor. The contact person should respond to questions truthfully, but should not volunteer additional or extraneous information not requested by the auditor.

### 5. Providing books and records to the auditor

Auditors have the authority to audit or examine books, records, accounts and other documents relating to the collection and payment of tax. The auditor’s letter to you will list the documentation they will be reviewing in respect of the audit period.

It is not in a company’s best interest to provide free access to all accounting files. Only the specific information requested by the auditor should be made ready and available for review. Before the auditor arrives, review the files to ensure no additional information, such as research and calculation of a tax liability, is included.

### 6. Concluding the audit

At the end of the audit, the auditor will issue a proposed assessment. You normally have thirty business days to review the proposed assessment and provide additional information to dispute the amount(s) assessed. If you need more time to respond and request an extension, it is likely to be granted.

To avoid surprises when an assessment is issued, try to make all possible arguments and provide supporting information during the audit stage, and maintain regular contact with the auditor during the audit process.

## Conclusion

In light of the many issues companies are facing in this troubled economy, ensuring compliance with the impending HST can be yet another potential strain on resources. If you are notified of an audit, managing the audit process—with expert assistance, if possible—can make the experience much less taxing.

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