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TAX PLANNING FOR THE PRIVATE INVESTOR

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PERSONAL TAX PLANNING CALENDAR

JANUARY

- 15th—Deadline for an employee to inform their employer of any deferred stock options benefits related to a stock option exercise from previous year.
- 30th—Deadline to pay interest for previous year on a family loan at prescribed interest rates.
- Consider making maximum lump-sum RSP contribution for current year.
- Consider making $2,000 lifetime over-contribution to your RSP.
- Review your personal financial plan, including your estate plan to ensure it is still appropriate.

FEBRUARY

- 28th—Deadline for employers (even for those employing a nanny or babysitter) to send in T-4 Summary to the Canada Customs and Revenue Agency (CCRA). In addition, a copy of the T-4 slip must be delivered or mailed to the employee by February 28th.

MARCH

- 1st—RSP contribution deadline. If it's a leap year, the deadline is February 29. This deadline applies for regular RSP contributions, retiring allowance RSP contributions, or Home Buyers' Plan or Lifelong Learning Plan RSP repayments.
- 1st—Labour-Sponsored Fund contribution deadline. If it's a leap year, the deadline is February 29.
- 15th—1st quarterly Canadian tax installment is due.
- 31st—Inter-vivos/Living Trust tax return deadline. If it is a leap year, the deadline is March 30th.
- If you are expecting a tax refund, consider filing your personal tax return early—but only after you have received all your necessary tax information.

APRIL

- 15th—U.S. resident tax return or four-month extension request deadline. Deadline for extension request for non-resident aliens who are subject to withholding tax. Deadline for the balance owing to avoid interest charges.
- 30th—Deadline to file your Canadian personal tax return and pay any balance owing, to avoid paying interest and a late filing penalty.
- Consider the impact of the new Federal and Provincial Budgets on your personal finances.

Please note: if any deadline falls on a weekend, the deadline is moved to the following Monday.

JUNE

- 15th—2nd quarterly Canadian tax installment is due.
- 15th—Deadline for filing Canadian tax return if you or your spouse has self-employment income. However, if there is a balance owing, the tax must be paid by April 30th to avoid underpayment interest charges.
- 15th—Deadline for filing U.S. tax return for U.S. citizens living in Canada and non-resident aliens, not subject to withholding tax. However to avoid interest charges, any balance owing of unpaid taxes must be paid by April 15th.

SEPTEMBER

- 15th—3rd quarterly Canadian tax installment due.

NOVEMBER

- Consider the use of an investment tax shelter to reduce your current year taxes payable.
- If you expect significant tax deductions next year, consider applying now for a tax waiver to the CCRA on Form T1213 to reduce withholding taxes at source on employment income.

DECEMBER

- 15th—4th quarterly Canadian tax installment is due.
- Consider selling securities with accrued losses that no longer meet investment objectives, to offset realized capital gains. Ensure that the trade settles in the current calendar year and superficial losses are avoided.
- To obtain a tax deduction in the current year, pay your deductible expenses and make charitable donations before the end of the year.
- If you turn 69 during the year, make your final RSP contribution before the end of the year. Contributions to your RSP cannot be made after the end of the year in which you turn 69. If you are over age 69 and still have unused RSP contribution room, you can make your RSP contribution to a spousal RSP if your spouse is age 69 or under.
- Consider delaying purchasing new mutual funds in non-registered accounts to avoid prepayment of tax on year-end distributions.
- 31st—RESP contribution deadline

Please note: if any deadline falls on a weekend, the deadline is moved to the following Monday.

CANADIAN INCOME TAX SYSTEM

The Canadian personal income tax system is based on progressive or graduated tax rates. This means that there are increasing tax rates that apply to increasing levels of taxable income (except for provincial taxes in Alberta which are based on a flat tax for all levels of income).

AVERAGE VERSUS MARGINAL TAX RATES

Your average tax rate (also referred to as "effective" tax rate by some people) is the percentage calculated when the total taxes paid is divided by your taxable income. Your marginal tax rate is generally the percentage of tax paid on the final dollar of taxable income. There is a difference between the two rates because as mentioned above, Canada has a system of progressive tax rates. The average tax rate is always equal to or less than the marginal tax rate.

Figure 1 shows the marginal tax rate for each of the major tax brackets. Some provinces have tax brackets that may slightly differ from those indicated in **Figure 1**. The rates are based on the federal and provincial tax rates. The illustrated provincial tax rates are based on an average of all the provincial tax rates.

CALCULATING YOUR TAX LIABILITY

In order to estimate how much tax you will have to pay, you must first calculate what your taxable income will be for the year.

To start, add up all your various types of income (e.g. salary, interest, grossed-up Canadian dividends, taxable capital gains, etc.), and subtract the various deductions such as RSP contributions, investment management fees and deductible interest expense. The total income less deductions represents your taxable income.

The total federal taxes payable can then be calculated by multiplying the taxable income amount by the appropriate federal tax rates. Then various tax credits (e.g. basic personal credit, donation credit, dividend tax credit, foreign tax credit, etc.) are subtracted from the federal tax calculated to arrive at a Net Federal Tax amount.

FIGURE 1

Marginal Tax Rates

Taxable Income*	Up To $32,000	$32,000 to $64,000	$64,000 to $104,000	more than $104,000
Federal Tax	16%	22%	26%	29%
Provincial Tax	10%	14%	17.5%	17.5%
Combined Tax	26%	36%	43.5%	46.5%

* As the marginal tax brackets are indexed to inflation, these values are subject to change each year. All amounts are approximate.

The method of calculating provincial taxes has significantly changed for all provinces (with the exception of Quebec). In the past, provincial and territorial taxes were calculated as a percentage of basic federal taxes. Under the new Tax On Income (TONI) system, provinces and territories now are able to set their own tax brackets and tax rates based on taxable income, similar to the federal government, to meet their needs and priorities. Quebec already has a system of setting their own tax brackets and tax rates based on taxable income.

However, under the TONI system, individual taxpayers will not have to file a separate provincial tax return like Quebec taxpayers. Instead, the new provincial tax calculation will continue to be calculated on one harmonized federal and provincial tax return administered by the CCRA.

As a result of the TONI system, a similar set of calculations has to be completed to determine the taxable provincial income and then the provincial taxes owing.

The Net Federal Tax plus the provincial taxes owing are added together to determine the total tax payable. Credits such as tax withheld at source and tax installments paid during the year are subtracted from the total tax payable to determine any refund or balance owing at the time the tax return is filed.

Note that Canadian residents are required to

report their worldwide income for Canadian tax purposes. In the majority of cases, this means that all taxable income regardless of where in the world it is earned must be reported for Canadian tax purposes. Canadian citizenship is generally irrelevant in determining one's obligation to pay Canadian tax.

The Canadian tax system requires taxpayers to declare income based on the honor system, whether the CCRA has a trace to the income or not. If taxable income is not reported for Canadian tax purposes, there can be punitive penalties to the individual taxpayer.

INVESTMENT INCOME

It is important to recognize that different types of investment income are not taxed in the same manner. For example, Canadian dividends and capital gains are taxed at more favourable rates than interest income and foreign income.

Since various types of investment income receive different tax treatment, you should look beyond the investment's pre-tax rate of return and consider the after-tax return.

This assessment of investment rates of return should be done on an individual basis, taking into consideration your income level and marginal tax rate, as well as any other tax benefits that may be available.

While evaluating investments based on their after-tax return is important, you should also consider such other factors as the investment's risk, the opportunity for capital appreciation, liquidity and so on.

It is important to note that in most cases, you will retain more after-tax income from capital gains than either Canadian-sourced dividends or interest income. **Figure 2** illustrates how much income you will keep from an additional $1,000 of interest, Canadian-source dividends and capital gains, relative to each tax bracket.

INTEREST INCOME

Interest income is fully taxable within each tax bracket at the applicable combined tax rate. **Figure 3** illustrates the amount of interest income you keep after tax.

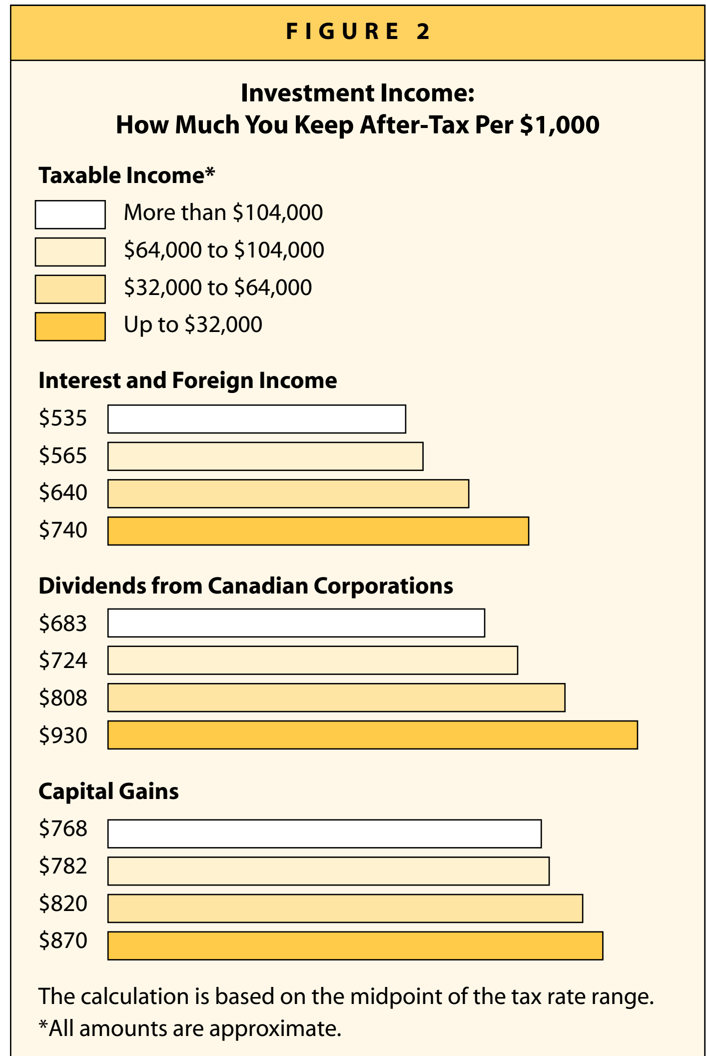

FIGURE 3

Interest Income: How Much You Keep After-Tax Per $1,000

Taxable Income*	Up to $32,000	$32,000 to $64,000	$64,000 to $104,000	more than $104,000
Interest Income	$1,000	$1,000	$1,000	$1,000
Combined Tax	$260	$360	$435	$465
You Keep	$740	$640	$565	$535

*All amounts are approximate.

TAX PLANNING TIP

Structure T-bill purchases so maturity dates are after the end of the current calendar year. This can defer tax for up to 16 months.

Interest income can be paid at varying frequencies during the year, such as semi-annually or monthly, and is taxable in the year it is received. It is also possible that you may not actually receive interest income in the year but will still be required to declare this "accrued" interest on your tax return.

For investments made in 1990 and later years, accrued interest is required to be reported annually. Investments that require the annual accrual of compound interest include compound Canada Savings Bonds, strip coupons and compound GICs.

Where the term of the investment is not more than one fiscal year, income should be reported in the year the interest is received (e.g. T-bills).

In the year that a compound-interest-paying investment matures, the taxable amount in the year is equal to the amount of interest received, less the amount of interest declared in prior tax years. This ensures that the interest income is only taxed once. If this investment is sold prior to maturity, a capital gain or loss may have to be recognized in addition to the interest income.

DIVIDEND INCOME FROM CANADIAN CORPORATIONS

Dividends received from Canadian corporations are effectively taxed at a lower rate than interest income, due to the dividend tax credit that is applied to the federal and provincial tax payable.

The use of a tax credit is meant to recognize that the Canadian corporation paying the dividends has already paid tax on its earnings which are now being distributed to its investors.

The tax payable on Canadian dividend income is calculated by grossing-up the actual dividends received by 25% (i.e. actual dividend x 1.25); net federal tax payable is calculated using this grossed-up amount and deducting a federal dividend tax credit of 16.66% of the actual dividend received or 13.33% of the grossed-up dividend. Provincial tax is then calculated using the provincial tax rates and

FIGURE 4

Canadian Dividend Income: How Much You Keep After-Tax Per $1,000

Taxable Income*	Up To $32,000	$32,000 to $64,000	$64,000 to $104,000	more than $104,000
Dividend Income	$1,000	$1,000	$1,000	$1,000
Gross-up (25%)	$250	$250	$250	$250
	$1,250	$1,250	$1,250	$1,250
Federal Tax	$200	$275	$325	$362
Less Tax Credit	$166	$166	$166	$166
Federal Tax	$34	$109	$159	$196
Provincial Tax	$36	$83	$117	$121
Combined Tax	$70	$192	$276	$317
You Keep	$930	$808	$724	$683

* All amounts are approximate.

a provincial dividend tax credit rate. See **Figure 4** for an illustration of this calculation.

FOREIGN INCOME

Foreign income is fully taxable at the applicable marginal tax rate. Dividends received from foreign companies are also taxable at the same marginal tax rates as interest income. That is, dividends from foreign corporations do not receive the dividend tax credit that is eligible for dividends from Canadian corporations. Therefore, dividends from foreign corporations are taxed at a higher rate than dividends from Canadian corporations.

RETURN OF CAPITAL

There are instances when an investment will distribute a non-taxable payment to you called a "return of capital." The reason why an investment may distribute a return of capital must be determined on a case-by-case basis. Real Estate Investment Trusts (REITs), Royalty Income Trusts, as well as some mutual funds are typically the types of investments that distribute return of capital. Return of capital distributions reduce the Adjusted Cost Base (ACB) of the investment for income tax

purposes. As a result, although the distributions are not taxable currently, the reduced ACB results in a larger capital gain or smaller capital loss when you dispose of the investment in the future. Therefore, return of capital distributions can be thought of as tax-deferred income.

THE DIVIDEND/INTEREST RELATIONSHIP

It is important when evaluating investments to compare the after-tax return on various types of investments. A factor can be calculated to compare the after-tax return on interest and Canadian dividend-yielding investments. The current range is between 1.18 and 1.30, and will vary somewhat between provinces.

For example: for the tax bracket greater than $104,000, the dividend/interest ratio is calculated:

$$= \frac{\text{After-tax dividend}}{\text{After-tax interest}} = \frac{\$683}{\$535} = 1.28$$

In other words, an interest rate would have to be approximately 28% higher than a dividend yield for after-tax returns to be similar, assuming all other factors are equal. *Remember, however, that the risk associated with receiving dividend income will, in all likelihood, be different than the risk associated with receiving interest income.*

Figure 5 shows the interest yields which would provide the same after-tax income as the corresponding dividend yields, for an investor in the top marginal tax bracket.

FIGURE 5

Interest Yields Required To Provide The Same After-tax Income As The Corresponding Dividend Yields
(At Top Marginal Bracket)

Dividend Yields	4.00%	5.00%	6.00%	7.00%
Interest Equivalents	5.12%	6.40%	7.68%	8.96%

CAPITAL GAINS AND LOSSES

Note: this information only relates to non-depreciable assets.

A capital gain will occur upon the sale of an asset for proceeds in excess of the cost base of the asset. The capital gain is further reduced by any costs incurred to sell the asset (e.g. transaction fees).

TAXABLE CAPITAL GAINS

To determine what amount of capital gain will be taxable in the year, you must first calculate the net capital gain recognized in the year. This is calculated by summing your total capital gains and subtracting total capital losses. A taxable capital gain is equal to half of the net capital gain. It is taxable at the marginal tax rate applicable in the year. See **Figure 6** for an illustration of this calculation.

FIGURE 6

Capital Gains: How Much You Keep After-tax Per $1,000

Taxable Income*	Up To $32,000	$32,000 to $64,000	$64,000 to $104,000	more than $104,000
Capital Gain	$1,000	$1,000	$1,000	$1,000
Taxable Portion	$500	$500	$500	$500
Marginal Tax	$130	$180	$218	$232
You Keep	$870	$820	$782	$768

*All amounts are approximate.

SUPERFICIAL LOSS RULE

A common year-end tax planning strategy is tax loss selling. However, if you sell an investment at a loss, but wish to re-acquire that same investment (due to long term potential), be careful of the superficial loss rules.

A superficial loss will occur when both of the following conditions are met (next page):

✓ TAX PLANNING TIP

- You can elect to include all of your spouse's taxable Canadian dividends in your income, if the election will increase your married tax credit. This election can provide a tax savings if the increased married tax credit exceeds your increased tax liability.
- Ask your advisor about a dividend reinvestment plan that allows investors to reinvest their dividend income in additional shares of the corporation.

i) a security (including mutual funds) is sold for a loss and the identical security is acquired during the period beginning 30 days before the disposition and ending 30 days after the disposition of the original security; and

ii) at the end of the above period, the taxpayer or a person affiliated with the taxpayer owns, or had a right to acquire the property.

According to the Income Tax Act, a person "affiliated" with a taxpayer is essentially their spouse or a corporation controlled by the taxpayer or their spouse. Therefore, based on this definition of "affiliated," some tax loss selling opportunities arise since a child or parent are not considered "affiliated" with the taxpayer. Furthermore, an RSP or RIF is not considered affiliated with the taxpayer even though the same taxpayer may be the annuitant of the RSP/RIF.

If the superficial loss rules are triggered, the capital loss will be denied. The denied capital loss will be added to the ACB of the substituted investment. Therefore, the net effect of triggering the superficial loss rules is that the capital loss cannot be immediately claimed for tax purposes. However, by adding the denied capital loss to the ACB of the substituted investment, the tax benefit of this denied capital loss may be realized in the future when the substituted investment is ultimately sold and the superficial loss rules do not apply at that time.

✓ TAX PLANNING TIP

- If an individual has no other income, they can receive up to $29,280 of Canadian dividend income with no federal tax to pay (although provincial tax may be payable).
- Generally speaking, Canadian dividends should be received outside an RSP or other tax-sheltered vehicles in order to take advantage of the dividend tax credit.
- The mix of assets in your portfolio should be examined to take advantage of the lower tax rates applied to Canadian dividend income and capital gains.
- Prior to the end of the calendar year, consider selling investments to recognize a capital loss. This loss can be used to reduce other capital gains recognized in the year. If you intend to repurchase the investment, ensure that you do not invoke the superficial loss rules.

Note that if you delay your repurchase until after the 30-day period, the superficial loss rules will not apply and the capital loss can be claimed.

USING CAPITAL LOSSES TO OFFSET CAPITAL GAINS

Realized capital losses must first be used to offset capital gains realized in the same tax year. If a net capital loss is remaining, it can be carried back and applied against capital gains in any of the three previous calendar years. If a net capital loss still remains, it can then be carried forward indefinitely and used to offset capital gains in future years.

BORROWING TO INVEST

When interest rates are low, you may be attracted by the strategy of borrowing to invest, also known as leveraged investing. This section will explain the issues that you should be aware of before using leverage.

WHO SHOULD CONSIDER LEVERAGING?

Unfortunately, when deciding whether to use leverage, many people simply consider the current interest-rate environment and past market performance without evaluating their complete financial situation. Borrowing money to purchase investments is definitely not a strategy for the faint of heart. It involves significant resolve as well as various factors that should be considered and adhered to. These factors include:

- Risk tolerance—Most investments have some degree of risk associated with them. Your risk tolerance is a measure of how comfortable you are with taking risk in the hope of earning greater returns on your investments. Diversification of your leveraged assets will help reduce the volatility of the investments.
- Time horizon—The use of a leverage strategy requires a commitment of approximately 10 years. Collapsing this strategy early increases the chance that a loss may result.
- Cash flow—You must have sufficient surplus cash flow (i.e. after-tax income less expenses) to tolerate fluctuations in the borrowing costs incurred on the investment loan or margin account.

One of the primary reasons that leveraging does not work is that one does not adhere to a long investment time horizon. A long investment time horizon creates two benefits in a leveraging strategy. These benefits are:

- Increased probability that your total investment assets will exceed their loan plus interest costs; and,
- Potential of lower volatility on investment returns.

TAX PLANNING TIP

Always repay non-deductible debt before you repay tax-deductible debt. If you have a non-deductible mortgage and a portfolio, consider liquidating your portfolio to repay your mortgage—then re-borrow sufficient funds to repurchase your portfolio. Note that the liquidation of your portfolio could create immediate capital gains.

In order for you to increase your chances of having a successful leverage strategy you should:

- Be prepared to accept the risks associated with leveraging investments;
- Be prepared to invest the borrowed assets for a long time horizon regardless of intermediate volatility—if the investment fundamentals continue to remain strong;
- Be willing to diversify the leveraged assets in order to reduce investment risk; and
- Be comfortable that you have adequate surplus cash flow based on your expected income sources to cover any increase in borrowing costs or margin calls.

INTEREST DEDUCTIBILITY ISSUES

Another major attraction of leveraging investments is the deductibility of the interest expense for personal income tax purposes. This deductibility allows one to increase their after-tax rate of return on the investment. Some of the more important issues regarding interest deductibility that you should be aware of are as follows:

- A recent Supreme Court case (i.e. Ludco case) has increased confidence that interest expense is generally deductible if the purchased investments have a potential to pay taxable interest or taxable dividends, and the borrowed monies were used directly to purchase non-registered investments. There may be an argument that investments

purchased with borrowed monies that are expected to generate only capital gains also could have a potential to pay dividends in the future and therefore is eligible for the interest expense deduction.

- If leveraged investments are sold at a loss, the proceeds may not be adequate to pay off the outstanding investment loan balance. In this case, the CCRA's position is that the interest expense on the remaining loan generally continues to be deductible as long as the original loan was used to purchase portfolio assets.

- Interest paid on an investment loan continues to be fully deductible even when the property originally purchased with the borrowed funds is replaced with property of a lesser value. As long as you can trace the cost of the replacement property to the entire original borrowed amount, the full amount of the interest expense is deductible.

- If a portion of the leveraged investment is transferred to an RSP, then that proportion of the interest expense related to the transferred investments will not be deductible for tax purposes.

INCOME SPLITTING

Income splitting is the reallocation of income among family members to reduce the total amount of tax paid by the family unit. The shifting of income from a family member in a high tax bracket to one in a lower tax bracket will result in greater after-tax income retained by the family. The use of income splitting with family members is recognized as an acceptable tax planning method, although the use of these strategies are restricted by the income attribution rules.

ATTRIBUTION RULES

Under the income attribution rules, income earned on capital that has been transferred as a loan or gift to family members may be "attributed" or taxed in the hands of the individual that gifted the capital. **Figure 7** (next page) provides a detailed summary of these rules.

For example: If Mrs. Smith were to gift capital to either Mr. Smith or their minor children, any income (except for business income; or capital gains/losses recognized by the children) would be taxed back or attributed to Mrs. Smith.

If income splitting is achieved by transferring property to a family member, the accumulated capital gains or losses must be recognized as of the date of transfer and declared on the transferor's tax return. However, a capital loss cannot be recognized at the date of transfer for property transferred to a spouse due to the superficial loss rules.

Although the income attribution rules restrict the number of income splitting opportunities available, there are still a number of effective ways of splitting income with family members.

Note: to ensure the desired results are achieved, income splitting methods should be discussed with a qualified tax advisor prior to implementation.

FIGURE 7			
Summary Of Income Attribution Rules: Relationship To Transferor (i)			
Method Of Transferring Capital	**Spouse (includes common-law partner)**	**Minor (ii)**	**Adult Child Or Other Non-Arm's - Length Individuals (iii)**
Capital transferred as a gift (iv).	Income/Loss and Capital gains/losses are attributable.	Income/loss is attributable. Capital gains/losses are not.	No attribution of any type of income
Capital transferred as a loan (v).	Same as above.	Same as above.	Income/loss is attributable. Capital gains/losses are not.

(i) The transferor is the individual that is gifting or lending the capital to the related party.
(ii) A minor is an individual that is under the age of 18 throughout the taxation year.
(iii) Includes individuals connected by blood relationship, marriage or adoption such as grandchildren, brother, sister, brother-in-law, sister-in-law, niece and nephew, etc.
(iv) Gifted capital must be made with no restriction as to its use or requirement of future repayment.
(v) This assumes that the capital has been lent to the individual as a low or no interest loan. If the CCRA prescribed rate (set each quarter) or a fair market rate of interest is charged, the attribution rules do not apply (see Prescribed Rate Loan).

INCOME SPLITTING WITH YOUR SPOUSE

1. INVEST THE EARNINGS OF THE LOWER INCOME SPOUSE

To establish investment capital in the hands of the lower-income spouse, their employment earnings should be kept separate from the family's finances and invested in their name. This will allow the investment income earned to be taxed at the spouse's lower tax rate. The earnings of the higher-income spouse should then be used to pay all living expenses for the family as well as the family's tax liabilities.

2. CONTRIBUTE TO A SPOUSAL RSP

One objective of income splitting is to equate each spouse's income in retirement. In order to ensure equal retirement income, make RSP contributions to the spouse with the lower expected retirement income.

In the future, when the funds are withdrawn from the spousal RSP, the income will be taxed in the hands of the spouse. Income attribution to the RSP contributor will not occur provided a spousal contribution to any spousal plan did not occur in the year of the withdrawal or the previous two years. Minimum RIF withdrawals are also not subject to the attribution rules.

3. LOANS TO A SPOUSE USED TO FINANCE A BUSINESS

Business income is not attributable, therefore any business income earned will not be taxed in the hands of the spouse that provided the capital.

4. PAY YOUR SPOUSE A SALARY

For individuals who own a business, it is possible to pay a salary for the work the spouse performs. The amount of salary paid to a spouse must be reasonable in relation to the duties they perform.

TAX PLANNING TIP

For parents who are supporting their children's education costs, there may be a more tax-effective method of providing this support and reducing capital requirements by up to one half. If you are currently paying $5,000 per year for your child's education and you are paying this expense with income from your investments, you require approximately $120,000 of capital to produce $5,000 after tax (assuming a 7% investment return and a marginal tax rate of 40%). If instead you were to gift your adult child $72,000, they could invest the capital and this would provide approximately $5,000 of after-tax income, assuming they have little or no other income.

This will put income into the hands of the lower- income spouse, which will be taxed at their lower rate. Also, this will allow your spouse the opportunity to contribute to the Canada or Quebec Pension Plan and to their own RSP.

5. INCOME ON INCOME

Although the income earned on property transferred to a spouse is attributed back to the transferring spouse, this income does become the recipient spouse's capital for reinvestment.

The income earned on the reinvested capital will be taxed in the recipient spouse's hands, hence the term "income on income." The income earned on the original loan capital will continue to be attributed (taxed) back to the lending spouse.

Over a number of years this method can result in the accumulation of substantial capital in the hands of the lower income earning spouse.

For example: Mrs. Smith gifts $100,000 to Mr. Smith, the lower-income spouse, who invests the capital at 5% (interest and dividend income). Each year $5,000 of income is taxed in Mrs. Smith's hands, but becomes Mr. Smith's capital for reinvestment.

FIGURE 8

Income On Income Capital Accumulation Over 10 Years

Year	Gift Amount	Income taxed to Mrs. Smith	Mr. Smith's Capital*	Mr. Smith's Income
1	$100,000	$5,000	$5,000	—
2	100,000	5,000	10,250	250
3	100,000	5,000	15,763	512
4	100,000	5,000	21,551	788
5	100,000	5,000	27,628	1,078
6	100,000	5,000	34,010	1,381
7	100,000	5,000	40,710	1,700
8	100,000	5,000	47,746	2,036
9	100,000	5,000	55,133	2,387
10	100,000	5,000	62,889	2,757
Total				**$12,889**

*This assumes that Mrs. Smith will pay any tax liability incurred by Mr. Smith. Based on the stated assumptions, Mr. Smith could accumulate $62,889 by the end of the tenth year.

Figure 8 illustrates the capital accumulation that would occur over a 10-year period.

Note: if the income received on the capital transferred by gift or loan is in the form of a realized capital gain, the future income earned on the capital gain is still attributable to the transferring spouse.

6. PRESCRIBED RATE LOAN

When the higher-income spouse loans money to the lower-income spouse at an interest rate at least equal to the Canada Customs and Revenue Agency's (CCRA) prescribed rate for these loans, income attribution can be avoided. This means that all of the income and capital gains earned by investing the borrowed funds will be taxed in the hands of the spouse who borrowed the money. The higher-income spouse must declare the interest received on the loan but this income should be less than the amount of income earned by the lower-income spouse.

In order for this strategy to work, a formal written loan agreement must be in place and payments of interest must be made each year or by January 30 of following year. If the interest payments are not made within this time limit, attribution will apply for current and all future years and this income splitting strategy will no longer work.

7. SPLITTING CANADA PENSION PLAN (CPP)/QUEBEC PENSION PLAN (QPP)

CPP/QPP retirement pensions can be shared between spouses based on the length of the time the spouses lived together. The application to share the CPP/QPP can only be made once the younger spouse is old enough to receive a retirement pension. The benefit of splitting the CPP/QPP retirement pensions is that a portion of the higher-income spouse's CPP/QPP can be received by the lower-income spouse and taxed in the lower-income spouse's hands without the attribution rules applying.

INCOME SPLITTING WITH YOUR CHILDREN

AGE 18 AND OVER

Since the income earned on capital transferred as a gift to adult children is not attributed back to the giftor, any outright gift will achieve family income splitting. Low interest or no-interest loans to adult children result in the attribution of income on the loaned capital back to the loaning family member. Only the capital gains/losses earned on the loaned capital will not be attributed to the loaning family member.

UNDER AGE 18

Since the income earned on capital transferred as a loan or gift is attributable to the transferring family member, with the exception of capital gains and losses, income splitting opportunities are restricted to the following strategies:

CHILD TAX BENEFIT

A parent may gift the monthly Child Tax Benefit payment to a minor child for their investment. Income earned on the gifted payments is taxed in the hands of the minor child.

GROWTH STOCKS

Since capital growth recognized on capital transferred as a gift or a loan is taxed in the child's hands, the purchase of growth-oriented investments will avoid attribution.

OTHER OPPORTUNITIES

If a parent owns a business and employs their children in that business, the income earned on the children's invested salary is not attributable to the parent. The use of the "income-on-income" strategy (discussed in the spousal income splitting section) can also be used with minor children to accumulate capital in their hands.

EDUCATION FUNDING

This section will focus on Registered Education Savings Plan (RESP) and In-Trust accounts, which are the two main types of accounts that many individuals consider in order to save for their children's or grandchildren's post-secondary education costs.

Let's first look at RESPs and In-Trust accounts more closely and then compare the two vehicles.

REGISTERED EDUCATION SAVINGS PLANS

A Registered Education Savings Plan (RESP) is a tax-deferred savings plan designed to provide a tax-effective method of saving for a post-secondary education. Contributions to the RESP are non-deductible and are limited to $4,000 per beneficiary per calendar year, up to a lifetime maximum per beneficiary of $42,000. Contributions to an RESP must be made within the calendar year (i.e. December 31st deadline) and there is no ability to carry forward unused RESP contribution room for use in a later year. All investment income earned within an RESP and not withdrawn is tax-deferred.

MULTIPLE BENEFICIARIES WITHIN A FAMILY RESP

While it is possible to establish an RESP for individual beneficiaries, it can be more effective to establish a single plan with multiple beneficiaries (a family RESP). The main advantage of setting up a family RESP is that the funds in the plan do not have to be shared equally by each of the beneficiaries. More income from the RESP can be directed to the beneficiaries who have higher educational expenses at the discretion of the plan's subscriber (i.e. the person that contributed to the plan).

In order for a family plan to have multiple beneficiaries, all of the beneficiaries must be connected to the subscriber by a blood relationship. This means that children, grandchildren, brothers, sisters and adopted children and grandchildren can be included in a single family RESP. Note that nieces and nephews are specifically excluded from being a beneficiary of a family plan. Furthermore, family plans will not allow any individual to become a beneficiary if the individual is 21 years of age or older at the time they are added to the plan.

THE CANADA EDUCATION SAVINGS GRANT (CESG)

The Canada Education Savings Grant (CESG) is a government grant of 20% on the first $2,000 contributed to an RESP per eligible beneficiary per year. To be an eligible beneficiary that receives the CESG, the beneficiary must be turning age 17 or younger in the year, must have a Social Insurance Number (SIN), and must be a resident of Canada. The maximum lifetime CESG a beneficiary could receive is $7,200.

Beneficiaries who are turning 16 and 17 years old in the year will only qualify for the CESG if the following criteria are met:

- A minimum of $2,000 of RESP contributions were made in respect of the beneficiary before the year in which the beneficiary turned age 16; or
- A minimum of $100 in annual RESP contributions were made in respect of the beneficiary in any four years before the year in which the beneficiary turned age 16.

One of the features of the CESG is that eligibility can be carried forward for use in future years if a $2,000 contribution for the beneficiary is not made in the present year. Note that the maximum CESG that can be received in any one year is $800. However, only eligibility for the grant can be carried forward, there is no carry forward of actual RESP contribution room.

Contributions made starting on January 1, 1998 are eligible to receive the CESG. The CESG will not count towards the annual or lifetime contribution limits as described above.

EDUCATION ASSISTANCE PAYMENTS

Once a beneficiary is enroled in a qualifying educational program at a post-secondary educational institution as a full time student, they are eligible to receive funds from the RESP in the form of Educational Assistance Payments (EAPs). The EAPs are paid at the direction of the subscriber for the benefit of the beneficiary. EAPs may consist of accumulated income and CESG.

Note that a beneficiary can even receive EAP if attending an educational institution outside Canada, provided the course being taken is at a post-secondary level and lasts at least 13 consecutive weeks. However, in order to receive any CESG as part of an EAP, the beneficiary must be a considered a resident of Canada at the time that the EAP is received.

EAPs are taxable to the beneficiary student, however, with the student's basic personal exemption of $7,756 (2003 amount), as well as tuition and education credits, there is generally little or no income tax the student will have to pay on the EAP amounts received.

For plans opened after 1998, a maximum $5,000 in EAP is allowed in the first 13 weeks of enrolment in the educational program. Thereafter EAP payments to the beneficiary student should be reasonable. Each time an EAP is requested from an RESP, proof must be supplied to your advisor that the beneficiary is enroled in a qualifying educational program at a post-secondary educational institution as a full-time student.

IF THE BENEFICIARIES DO NOT PURSUE POST SECONDARY EDUCATION

It is possible for a subscriber to receive the income from an RESP called Accumulated Income Payments (AIP), if all the following conditions are met:

- The RESP must have been open for at least 10 years;
- The youngest beneficiary of the plan must be at least 21 years of age and no longer eligible to receive education assistance payments, and,
- The subscriber is a resident of Canada.

When all these conditions are met, AIP withdrawn from the RESP is included in the taxable income of the subscriber in the year it is withdrawn, and is thus taxed at the subscriber's marginal rate of tax. In addition to being included in taxable income, the income withdrawn is also subject to an additional 20% tax. Thus if a subscriber were subject to a top marginal rate of tax of 46%, the total tax on AIP withdrawn from an RESP would be 66%.

To avoid this potential tax hit, original subscribers are permitted to contribute up to $50,000 of accumulated RESP income into an RSP, provided that the subscriber has sufficient regular RSP contribution room available. Joint spousal subscribers are permitted to contribute up to $50,000 each of AIP for a total of $100,000 if they each have the respective unused RSP contribution room. Only the portion of the RESP income that is contributed to a RSP avoids current taxation and the 20% additional tax. Note that only original subscribers or the surviving spouse of a deceased original subscriber are permitted to transfer up to $50,000 of AIP directly to an RSP if they have the unused RSP contribution room.

The CESG received by the RESP may have to be returned to the government if the beneficiary does not pursue post secondary education.

IN-TRUST ACCOUNTS

Typically, an In-Trust account is established by a parent or other relative to save money for a child, often for education purposes. The In-Trust account offers a unique opportunity to split investment income among family members and thus benefit from a lower overall tax burden.

The donor of the asset into the In-Trust account is called the settlor. The person that has legal ownership of the asset is called the trustee. With this legal ownership comes a duty of care

(fiduciary duty) that is owed to those that have beneficial ownership, referred to as beneficiaries.

In-Trust accounts set up at financial institutions often have standard documentation that cannot be customized and are sometimes referred to as an "informal" trust compared to a customized "formal" trust set up by an external lawyer/notary that will allow amendments to their document.

TAXATION OF IN-TRUST ACCOUNTS

When there is a related minor beneficiary (includes child, grandchild, niece and nephew), the answers to the following two questions will generally determine who must declare the investment income in the In-Trust account:

1) Who contributed the funds in the account?
2) Is the trustee a different person than the donor?

The related person who contributed the funds into the In-Trust account (i.e. donor) must always declare the interest and dividends earned where there is a minor beneficiary. If the donor is also the trustee, then the donor controls the asset and therefore it may be perceived that the contribution is revocable (i.e. donor can get back their contribution from the account). If this is the case, our tax rules state that the donor may have to also declare the capital gains realized in the In-Trust account. Therefore, if the donor and trustee is the same person, it is possible that no income splitting will be achieved. However, if the trustee and donor are different people, then a stronger argument can be made that the contribution was irrevocable and thus the minor beneficiary may declare the capital gains realized in the account for tax purposes.

If the monies in the In-Trust account came from the beneficiary through such sources as Child Tax Benefit payments, their own employment income or an inheritance, then all investment income (interest, dividends and capital gains) is taxed in the beneficiary's hands.

Furthermore, if the beneficiary is an adult and an argument is made that the donor made an irrevocable contribution, then interest, dividends and capital gains may be taxed in the adult beneficiary's name.

RESPs VS. IN-TRUST ACCOUNTS—SO WHICH ONE IS BETTER?

Prior to the 1998 Federal Budget, the preferred method of saving for a child or grandchild's education was through the use of an In-Trust account. With the 1998 Budget announcement that the government will contribute up to $400 per year per beneficiary to an RESP, interest in RESPs has grown considerably.

The major differences between the two types of accounts are:

- Income earned in an RESP is tax-deferred until withdrawn, while income in an In-Trust account is taxable each year.
- Annual and cumulative contributions to an RESP are limited, while there are no limits to amounts that can be contributed to an In-Trust account.
- Permitted uses for RESP funds are limited to post-secondary education, while as long as the amounts are used for the beneficiary's benefit, there is no restriction on the use of funds in an In-Trust account.
- The life span of an RESP is limited to 25 years and contributions can only be made until the beneficiary's 21st year, while there is no maximum life of an In-Trust account and contributions can be made at any time.
- Income from the RESP may be taxed in the hands of the beneficiary if the beneficiary pursues post-secondary education; otherwise the income is taxed in the subscriber's hands (see exception on next page). In an In-Trust account, interest and dividends are taxed in the contributor's hands (attribution rules) if the beneficiary is under age 18 years and capital gains may be taxed in the beneficiary's hands.

- When the RESP is wound up by the subscriber and there remains unused RESP income, if certain criteria are met, the unused income can be returned to the subscriber (but not CESG) and is taxed at their marginal tax rate plus an additional 20% unless the original subscriber has adequate unused RSP contribution room.
- Capital gains and Canadian source dividends do not receive beneficial tax treatment when withdrawn from the RESP, while in an In-Trust account, only 50% of a capital gain is taxable and Canadian source dividends receive the dividend tax credit.
- RESPs can receive matching grants of up to $400 per year per beneficiary, while In-Trust accounts do not receive any money from the federal government.
- The contributions in an RESP belong to the subscriber, while in the In-Trust account, those contributions belong to the trustee for the benefit of the beneficiary.

CONCLUSION

As demonstrated above, the rules regarding RESPs make these accounts more restrictive than the rules governing In-Trust accounts. In comparison, In-Trust accounts have a broader range of potential uses and considered a more flexible alternative.

Subscribers who set up family plans with multiple beneficiaries have an advantage over subscribers who set up RESPs for a single beneficiary. Multiple beneficiaries give some insurance of getting the income taxed in a beneficiary's hands because the chance of a beneficiary pursuing post-secondary may be increased if there are more potential beneficiaries to choose from. This is important because if the beneficiary of an RESP does not pursue post-secondary education, all of the income would be potentially taxable in the hands of the subscriber and the CESG would have to be returned to the government. It should also be noted that if it is the subscriber who withdraws the income from an RESP, the total taxes on that income earned in an RESP may or may not be higher than the total taxes on that same income had it been earned in an In-Trust account.

From a tax perspective, RESP accounts are much easier to maintain than In-Trust accounts because amounts from an RESP are only taxable when they are withdrawn. As well, income attribution rules are not a concern with RESP accounts, while these rules must be actively considered with an In-Trust account.

For all of the reasons listed above, it is vital that the benefit of the new maximum $400 per beneficiary per year CESG be weighed against the potential higher tax cost and decreased flexibility in an RESP before making the decision to choose an RESP over an In-Trust account.

REGISTERED INVESTMENTS

There are numerous types of registered investment vehicles available: Retirement Savings Plans (RSPs), Retirement Income Funds (RIFs), Locked-In Retirement Accounts (LIRAs), Life Income Funds (LIFs), LRIFs (Locked-In Retirement Income Funds) and Registered Education Savings Plans (RESPs). Of the available registered vehicles, the RSP is by far the most utilized tax-planning tool. This section will only serve to outline the basic details of RSPs. For further information on RSPs, speak to your advisor.

RETIREMENT SAVINGS PLANS (RSPs)

RSP CONTRIBUTION LIMITS

Deductible RSP contributions are limited to 18% of the prior year's earned income to a maximum of $14,500 in the 2003 tax year. In 2004, the limit becomes $15,500, followed by $16,500 in 2005 and $18,000 by 2006. Contributions will be indexed thereafter.

Contribution limits are based on the prior year's earned income and will also be reduced by the prior year's pension adjustment factor (PA).

"Earned income" generally includes employment income, net self-employment income, net rental income, taxable alimony or child support payments received and CPP/QPP disability pensions. However, earned income is reduced by deductible alimony or child support payments paid, rental losses and most deductible employee expenses. Note that earned income does not include investment income, pension benefits, RSP/RIF income or retiring allowances.

An RSP offers a double advantage in saving for retirement—a tax deduction and thus a tax savings in the year the contribution is deducted and tax-free compounding of income on the contributions.

TAX PLANNING TIP

- Make RSP contributions early in the year to maximize the deferral of income.
- Consider making an over-contribution of up to $2,000 to your RSP.
- If you are over 69, make RSP spousal contributions, as long as you have earned income and your spouse is 69 or under.
- If your income is unexpectedly low in a particular year, make a contribution but defer taking a deduction until a future year when income is higher.
- RSP contributions can be made for individuals who have no earned income in the current year, but who did have earned income in the prior year (e.g. retirees).
- Consider holding investments yielding Canadian dividends and capital gains outside the RSP and interest-bearing vehicles inside the RSP.

RSP CONTRIBUTION CALCULATIONS

- Non-members of an employer pension plan: 18% of earned income from the previous year, to a maximum of $14,500.
- Member of a DPSP or a defined contribution pension plan: 18% of earned income from the previous year, to a maximum of $14,500, less the previous year's pension adjustment (PA).
- Member of a defined benefit pension plan: 18% of earned income from the previous year, to a maximum of $14,500, less the previous year's PA; less a past service pension adjustment (PSPA), if applicable.

TAX SHELTERS

In an attempt to reduce the amount of tax that is paid each year, many investors consider the use of a tax shelter to reduce their tax liability. A tax shelter is simply an investment that provides significant deductions against your other taxable income.

By taking these deductions, you can reduce your total taxable income and thereby reduce the amount of tax payable to the Canada Customs and Revenue Agency.

Investors generally view the reduction in taxes payable as a tax savings, but it is more accurately viewed as a tax deferral, since ultimately either income derived from the investment or upon the sale of the investment will incur a tax liability.

EVALUATING TAX SHELTERS

Although the main selling feature of a tax shelter is the tax deduction, it is important that it be evaluated based on its investment quality —not just the potential write-offs.

In order to assess a tax shelter's investment quality, investors should assess both the risk involved in the venture itself as well as the likelihood of a continued cash flow once the deductions have been taken.

The tax shelter structure should also be considered when evaluating these investments. Most tax shelters are set up as either a limited partnership or as a flow-through share.

LIMITED PARTNERSHIPS

With a limited partnership, only the amount invested is at risk should any partnership liability arise. Since the limited partner's risk exposure is limited to their investment, this also tends to limit the amount of deductions available to the amount invested or the "at-risk" amount.

This amount is generally defined as the limited partner's investment plus or minus any income received or expenses deducted.

TAX PLANNING TIP

Tax shelters are generally only appropriate for investors in the top marginal tax bracket, since the value of any tax deductions is maximized. Consult a qualified tax advisor prior to purchasing a tax shelter to ensure it is appropriate in your situation.

FLOW-THROUGH SHARES

A flow-through share is a share that allows you to claim resource exploration expenses incurred by resource companies. The resource expenses simply "flow through" the company and are deductible against your other income.

The expenses that flow through also serve to reduce your cost base, which over time can result in a zero, or in some cases a negative cost base. Any time a negative cost base occurs, a capital gain has to be recognized in the year to bring the cost base up to zero.

Upon the sale of these flow-through shares, you may incur a capital gain.

POTENTIAL PROBLEMS

As a result of the substantial deductions that occur with a tax shelter the investor must remember that they may become subject to the Alternative Minimum Tax (AMT—see next page for details).

The large tax deductions may also result in a positive Cumulative Net Investment Loss (CNIL) balance, should the investor's cumulative investment expenses exceed their cumulative investment income. A positive CNIL balance will restrict the investor's access to their $500,000 qualified small business or qualified farm property capital gains exemption.

It is also important to recognize that for most tax shelters there is a very limited secondary market for these investments, especially once the tax deductions have been taken. Therefore, investors should generally view a tax shelter as a long-term investment.

Once the investor is comfortable with the risk involved in the investment and has consulted a qualified tax advisor to ensure its appropriateness, the use of a tax shelter can be an effective tax deferral vehicle.

ALTERNATIVE MINIMUM TAX (AMT)

Alternative Minimum Tax (AMT) is designed to target high-income individuals who have significant deductions (i.e. over $40,000) such as the write-offs from tax shelters. To determine whether AMT applies, the taxpayer must do two calculations—their regular tax calculation and an AMT calculation. The AMT calculation can be complicated. If the taxes calculated for AMT are greater than the regular tax calculation, then the difference is the AMT amount that is payable in the year.

Items that can lead to an AMT liability include stock option deductions, limited partnership losses and CCA claimed on tax shelter investments.

Note: RSP contributions no longer impact the AMT calculation. Thus, large RSP contributions, including retiring allowance rollovers, will not cause an AMT to be payable.

If you are subject to minimum tax, the excess of minimum tax over the regular tax payable is identified as a minimum tax carryover.

This carry-over can be carried forward for seven years and credited against tax payable in future years to the extent that regular tax exceeds the minimum tax calculation.

Note: there is also a provincial AMT calculation that varies from the federal calculation.

TAX PLANNING TIP

- Both deductible interest expense and business losses do not affect the AMT calculation. Consider using these deductions to reduce your taxable income without triggering AMT.
- One exception is that deductible interest expenses related to tax shelters do affect AMT.

INVESTING THROUGH A HOLDING COMPANY

Years ago, earning investment income inside a Canadian corporation (generally referred to as an Investment Holding Company) was considered an attractive tax-planning technique. In the past, the use of a Canadian investment holding company allowed for both the deferral of taxes and the payment of less total tax compared to holding investments personally in a non-registered account. The combined corporate/shareholder tax rates on interest, dividends, foreign income, rent, royalty, and taxable capital gains income ("investment income") were, in many cases, lower than personal tax rates on such income. It was therefore possible to save taxes by investing through an investment holding company. Furthermore, since corporate tax rates were lower than personal tax rates, a tax-deferral opportunity was also available by investing and retaining income in the investment holding company.

As a result of changes to the Canadian tax system over the last several years, the tax advantages associated with investment holding companies have all but been eliminated. It is no longer possible to defer taxes through an investment holding company and in general, the combined corporate/shareholder tax rates on investment income now exceeds the personal taxes paid on the same income.

A high corporate tax rate is initially imposed by the Canadian tax authorities on income earned by an investment holding company to prevent the use of an investment holding company to defer tax. There are no progressive tax rates and brackets in an investment holding company like there is for personal taxes. There is simply one high tax rate applied to all income earned in an investment holding company. However, similar to individuals in the highest tax bracket, Canadian dividend income received in a corporation is taxed lower than interest or foreign income. Capital gains are taxed lower than Canadian dividend income. The 50% inclusion rate for capital gains also applies for capital gains realized in a corporation.

A portion of the corporation's taxes paid is refunded when the holding company pays a taxable dividend distribution to its shareholders. An investment holding company should therefore consider distributing its income to its shareholders in the same fiscal year that it is earned to minimize the net amount of corporate taxes paid for the year

Even though the potential for tax deferral has been for the most part completely eliminated and Capital Tax could be applicable to the corporation, investing through an investment holding company can provide some benefits. The following paragraphs illustrate some of the potential advantages.

INCOME SPLITTING

It is possible to split income with adult children through the use of an investment holding company. Assets can be transferred into the holding company on a tax-deferred basis and the adult children can subscribe for shares of the company. Dividends can then be paid to the adult children and taxed in their hands.

ESTATE FREEZE

An investment holding company can also be used in a tax-planning strategy called an "estate freeze." The goal of an estate freeze is to "freeze" a company's share value for the original shareholders, while ensuring that future increases in the fair market value of the company pass to the next generation or to other desired individuals. This way, the amount of income taxes at death and probate tax can be minimized. Another use of an estate freeze may be to crystallize the $500,000 enhanced capital gains deduction on the sale of qualifying small business corporation shares. It should be noted that shares of holding companies that are only used to hold investment portfolio assets will not qualify for the $500,000 enhanced capital gains deduction since the company is not engaged in an active business.

U.S. ESTATE TAXES

Another reason for using a bona fide Canadian investment holding company is to hold U.S. situs investments in order to shelter a Canadian resident shareholder (non-U.S. citizen or green card holder with a U.S. domicile) from U.S. Estate Taxes. That is, U.S. Estate Taxes are not applicable to a Canadian resident shareholder that has U.S. situs assets in a bona fide Canadian corporation. The pros and cons of using a Canadian corporation to avoid U.S. Estate Tax are complex and you should seek a professional tax consultant well versed in this area.

CONCLUSION

Due to lowering of personal tax rates compared to corporate tax rates over the last several years, the use of a holding company to earn investment income may actually cause the prepayment of taxes and the ultimate payment of extra tax.

However, there are certain benefits that still exist for using an investment holding company that may outweigh the additional investment income tax and professional costs incurred. Furthermore, if you currently have an existing investment holding company, although there is a potential disadvantage of earning investment income in the company, winding up the corporation may not be in your best interest as it may result in a realization of previous tax deferrals. You should consult with a qualified tax advisor to determine if an investment holding company should be set up, or an existing one should be dissolved.

INVESTING IN THE UNITED STATES

Generally, Canadian residents are taxed in Canada on income earned from their worldwide sources, including income received from U.S. sources. Prior to receiving U.S.- source income, a withholding tax is applied to income received from certain debt obligations, most shares of U.S. corporations and U.S. real estate.

To prevent U.S. income from being taxed twice (i.e. withholding tax paid in the United States and fully taxed in Canada), a foreign tax credit is applied to the tax payable on the investor's Canadian tax return, thereby recognizing the foreign tax paid.

INTEREST AND DIVIDENDS

Unlike dividend income received from Canadian corporations, U.S.-source dividends are not subject to the dividend gross-up and tax credit that results in a lower effective tax rate. Therefore, U.S.-source dividend and interest income are taxed at the same rates.

When declaring U.S. interest or dividend income on a Canadian tax return, this income should be converted at the Cdn/U.S.-dollar exchange rate in effect at the date of payment or the average exchange rate for the year. However, the taxpayer should be consistent with the method of conversion used throughout that year's return.

Note: it is also important that the taxpayer is consistent from year to year in the use of an exchange rate method on the same investment.

CAPITAL GAINS

Capital gains on U.S. assets are treated in the same manner as Canadian assets. When calculating the capital gain/loss on the sale of a U.S. investment, the cost and proceeds must be converted to Canadian dollars at the exchange rate applicable on the transaction dates.

WITHHOLDING TAX

Under the terms of the Canada/U.S. income tax treaty, dividend income from a U.S. source is subject to a withholding tax of 15%.

Interest income is subject to a 10% withholding tax except for the following debt issuers:

- U.S. federal, state and municipal debt obligations.
- U.S. corporate bonds issued after July 18, 1984.
- Interest earned on bank or savings and loan deposits.

Generally, tax is not withheld on capital gains recognized on U.S. investments with the exception of real property (e.g. real estate).

REAL ESTATE INVESTMENTS

Upon the sale of U.S. real estate owned by Canadian residents, the recognized capital gain is subject to tax in both the United States and Canada.

U.S. TAX IMPLICATIONS

A vacation property in the United States is regarded for tax purposes as an investment and the disposition of such a property, if at a gain, will be subject to U.S. tax in most circumstances.

A withholding tax of 10% is generally levied based on the proceeds of the sale of the property. However, this withholding tax may be reduced or eliminated in certain circumstances. A U.S. non-resident tax return (a 1040NR) should be filed with the Internal Revenue Service (IRS) reporting the disposition, with any withholding tax applied against the actual tax payable.

Many states also require a tax return to be filed when real property located within the state is sold.

CANADIAN TAX IMPLICATIONS

To avoid double taxation, tax paid in the United States as a result of the sale of U.S. real property can be applied as a foreign tax credit against the tax payable in Canada.

U.S. ESTATE TAX

For Canadian residents (non-U.S. citizen and non green-card holders) with assets in the United States, Estate Tax is calculated on the fair market value (at the date of death) of all U.S. situs property including real estate, shares of U.S. corporations, U.S. debt obligations (with certain exceptions), and other tangible property such as vehicles, boats or art. U.S. situs property means any property that is considered to be situated in the United States.

The tax is calculated on the value of U.S. situs property, reduced by certain expenditures and deductions, such as an apportionment of funeral expenses, foreign taxes paid on U.S. property and certain indebtedness.

Deductions are then pro-rated based upon the value of U.S. assets in relation to worldwide assets (for most Canadians facing U.S. Estate Tax, this pro-ration will result in only a minor deduction).

HOW MUCH DO I OWE?

For Canadian residents that are not U.S. citizens (or U.S. green-card holders), U.S. Estate Tax is only potentially applicable if the value of your U.S. situs assets exceed $60,000 US and your worldwide estate exceeds $1,200,000 US (if you do not have U.S. real estate) or $1,000,000 US (if you do have U.S. real estate).

The tax rates imposed on the value of the U.S. situs assets range from 18% on taxable estates of $10,000 US up to a marginal rate of 49% for estates with values greater than $2,000,000 US.

The Estate Tax imposed on Canadians with U.S. situs property may no longer result in a double tax since the U.S. Estate Tax paid can now be used as a credit against Canadian income taxes payable at death (related to U.S. situs assets).

The U.S. Estate Tax is calculated by first applying the U.S. Estate Tax rates on the value of the U.S. situs assets less a U.S. Estate Tax "Unified" credit. The Unified Credit for 2003 is $345,800 US which is pro-rated based upon the value of U.S. assets in relation to worldwide assets.

TAX PLANNING TIP

- Consider gifting intangible assets such as U.S. stocks to avoid the gift and Estate Tax.
- Ensure that gifts of other U.S. property to any one individual do not exceed $11,000 US per year and gifts to spouses do not exceed $112,000 US per year.

U.S. GIFT TAX

In addition to Estate Tax, the U.S. tax system also levies a tax on gifts of tangible property situated in the United States (e.g. U.S. real estate, art and automobiles.)

Gifts of intangible U.S. property such as stocks and bonds are not subject to the gift tax as long as the giftor is not a citizen or resident of the United States. Otherwise, any gift of tangible assets in excess of $11,000 US per year (2003 value) to an individual will be subject to the gift tax.

Gifts made to a spouse who is not a U.S. citizen, is exempt from the gift tax, if the gift is not in excess of $112,000 US per calendar year (2003 value).

If in any year a gift exceeds the outlined annual gift limits, then a gift tax is levied on the excess. The gift tax rate applied is based upon the graduated tax rates of the Estate Tax system.

Although transferring assets by gift may avoid or defer U.S. Estate Tax, the gifting of assets would be considered a disposition for Canadian tax purposes and could result in a Canadian capital gains tax liability.

For further information regarding the tax implications of investing in the United States, speak to your advisor.

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