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TAX PERSPECTIVES

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Introduction

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This Year-End Tax Planning edition of Tax Perspectives is devoted to tax strategies in difficult economic times.

Six months ago, I would have laughed at the very idea of such a collection of articles. It seemed likely that the excessive and irresponsible lending activities of opportunistic U.S. bankers would remain an isolated U.S. problem. But it did not help when former Federal Reserve Chairman, Alan Greenspan, told the U.S. Congress, and by that the world, that his model of how the global financial system worked was wrong. He had made a "mistake" in believing that banks would operate to protect themselves and their shareholders. In his words, "A critical pillar to market competition did break down. I still do not fully understand why it happened". Full marks for being truthful, but not helpful in allaying people's mounting fears.

The crisis that started in banking and housing quickly spread to oil, cars, and U.S. retail. Airlines came next, and by then the recession was so broadly based, everything was dragged in. Then came announcements from other countries that the infection was spreading – the U.K., Germany, Japan. A worldwide recession was in the making.

In Canada, the stock market followed the U.S. stock market and the Canadian dollar declined against the greenback, surrendering its gains of the past two years. We are now teetering on the brink of recession. How long and how deep? Nobody knows. Is there something fundamentally wrong with the Canadian economy? Nothing in particular is wrong, but we, too, are tied into the world economy, whether we like it or not. This is the price of globalization.

So what advice can we give to our clients on how best to weather the coming storm? In this edition of Tax Perspectives, we focus on tax losses, tax strategies for difficult economic times, the advantages that low asset values can bring, and other food for thought.

We hope you enjoy the mix of articles and find in them useful ideas and strategies to make the very best of the turbulent economic times ahead.

Losses in Your Portfolio, What the Tax Rules Say

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Bateman MacKay (Burlington)

In these difficult times, many people have losses in their portfolio. Many investors would welcome an opportunity to recover some tax from the capital losses they have sustained. Such losses are worth approximately 19% to 25% in tax savings (depending on the province) for a high income taxpayer with sufficient capital gains to absorb the losses. It is important to understand how these losses may be used, so that maximum advantage can be taken of them.

Capital losses may generally only be used against capital gains. If the capital losses exceed capital gains in any given year, the losses may be carried back for up to three years against capital gains in those years, and the balance of losses may be carried forward indefinitely.

The first step in analyzing a tax loss strategy is to determine the amount of losses in your portfolio. Then you should calculate the realized gains for the year to date. The difference, if a loss, is the amount that may be applied against capital gains of previous years. Then review your tax returns for the three previous years to

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determine the amount of capital gains that has been realized. Note that since capital gains are 50% taxable, only 50% of the gain will be reported on your tax return.

The loss is claimed on a special form, which computes the net loss for the year, divides it by two, and designates the year to which the loss will be applied. It is generally advisable to carry back the loss to the earliest possible year, although this strategy may be varied if the tax rate in that particular year is lower than in subsequent years.

In accordance with Canadian law, capital gains and losses are to be computed in Canadian dollars. Therefore, if the shares are, for example, those of a U.S. company, purchased in U.S. dollars, the actual exchange rates at the time of purchase and at the time of sale must be used to calculate the capital gain or loss.

Because capital losses may be applied only against capital gains if the shares are considered to be capital property, some taxpayers will take the position that their stock market trading is a business and that the shares represent inventory. Accordingly, the losses will be considered to be non-capital losses and may be deducted in full against any source of income. If this position is taken, the CRA will consider it binding for future years. It is not advantageous in most cases. Furthermore, to claim that a loss is a non-capital loss, there must be extensive trading, and generally borrowings to finance the trading, to indicate a speculative activity.

Persons wishing to use a tax loss realization strategy, while retaining the shares or investments should seek professional advice.

Some individuals, owning shares with significant losses, will not want to sell them, hoping that they will later appreciate in value. If such shares are sold and repurchased within 30 days, the loss will be denied. If the shares are transferred to a spouse, a spousal trust, a family trust in which the person or his or her spouse is the main beneficiary, or to a holding company controlled by such individuals, the loss may also be denied. Individuals wishing to follow a tax loss realization strategy, while retaining the investments should seek professional advice.

A question that often arises is whether a loss has actually been realized for tax purposes. For example, if shares are virtually worthless, but the company is still carrying on business, the loss will not be realized until the shares are disposed of. Even if a stock is de-listed, that does not mean a loss is realized for tax purposes. A special election can be made for worthless stock, but conditions apply. If the investment is in bonds, commercial paper, or other types of fixed income investments, a decline in value will not be sufficient to enable a loss to be realized. The debt issuer must be insolvent, which requires that the instrument is in default. The Canadian mortgage-backed commercial paper market was basically frozen in 2007. It is not clear that this action, or other subsequent events, have created an event that would cause a loss to be realized. Clearly, in some cases significant losses in value have occurred, but for tax purposes, the key event is realization of the loss, which will require a disposition.

Unfortunately, the CRA does not pay interest on the refund generated by claiming a capital loss until the related tax return is filed.

Lastly, note that foreign investments may result in gains or losses based on currency fluctuation. For a further explanation of these rules, see the article *Foreign Currency Gains and Losses, the Technicalities* in this issue.

Taking Advantage of Low Values, How About an Estate Freeze?

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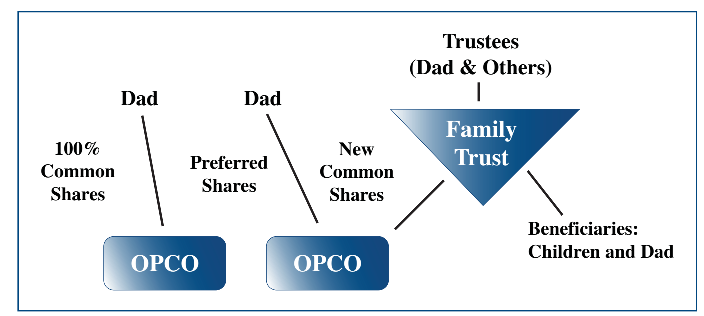
Given our current economic environment, the time to consider an estate freeze may never be better.

Many businesses and most industry segments have recently realized a significant reduction in value. If one believes that this is temporary and valuations will rebound in the future, consideration should be given to whether it is now the right time to carry out an estate freeze.

As many readers know, an estate freeze can be very useful when planning for the succession of a family business run as a private corporation. In a typical estate freeze, the shares of a private corporation ("Opco") may be owned by "Dad". Suppose Dad is age 65 or thereabouts and wants to gradually transition the business to his children. After carefully planning the succession, the estate freeze can be accomplished by having Dad exchange, on a tax-deferred basis, his common shares of "Opco" for a class of shares that are "frozen" in value. Such shares would be preferred shares with a redemption value equal to the value of Dad's common shares. The children would then purchase new common shares, possibly via a family trust. Through this, the future growth of the business will go to the next generation.



If the redemption value of Dad's preferred shares is higher or lower than the current value of Opco, negative tax consequences can arise to Dad. Therefore a reasonable attempt to value Opco must be made, and a price adjustment mechanism should be included in the bundle of rights of the preferred shares and/or transfer agreement.

Upon Dad's passing, his estate will deal with the preferred shares by either transferring them on a tax-deferred basis to his surviving spouse or distributing them to children in conjunction with his well-thought-out estate plan. If the shares are transferred to his children and not to his surviving spouse, then capital gains tax will arise at that time. Given this tax consequence, it is usually desirable to ensure that the redemption value of the preferred shares is as low as possible – hence the interest in carrying out an estate freeze now.

Dad does not need to wait until death to realize the value of the preferred shares. Given that the tax rate on dividends has declined in recent years, it may make sense for Dad to receive remuneration in the form of dividends from Opco by having Opco repurchase some of his preferred shares over time. The repurchase results in a dividend to Dad which, depending on Opco's situation, can be treated as either an eligible dividend (subject to preferred taxation rates) or as a non-eligible dividend. With careful planning, the preferred shares can be redeemed entirely over a number of years, thereby eliminating the ultimate tax implications upon Dad's passing.

Suppose Dad is concerned about having enough money for retirement and/or having control of the family business. Both matters can be resolved by using a family trust under which Dad is a beneficiary and possibly a trustee. Also, Dad can be issued special voting shares to control Opco into the future.

Given the current situation, Dad will eventually pay capital gains tax upon passing the business to the next generation. The prudent estate plan will always look for opportunities to freeze an estate – to the extent desirable – when current valuations are low so as to minimize the eventual tax consequences upon Dad's passing. Given the current economic environment, is today the right time to consider such planning? Logically, for certain situations, the answer should be, "Yes!".

Low Interest Rates and Income Splitting

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With interest rates at historical lows, opportunities now abound for income splitting.

If property is transferred to a spouse or minor children, any income earned from the property (and, in the case of a spouse, any gains from the sale of the property) are attributed to, and taxed in the hands of, the person who transferred the property. This rule, and other related provisions, are designed to stop income splitting between family members. The rule applies to direct transfers, and to indirect transfers through trusts. However, if the transfer is made by way of a loan, and interest is paid on the loan at the "prescribed rate" of interest, attribution does not apply.

The prescribed rate of interest is set each quarter, based on the average treasury bill yield, rounded up to the nearest integer. If the Treasury bill yield was say 2.88%, the prescribed rate would be 3%.

In this marketplace, if one believes that there is good potential for gains over the longer term, a strategy can be developed to split income with a lower income spouse or with minor children. This would involve a transfer of cash or investments to the spouse (or a trust for the children), in exchange for a promissory note paying interest at the prescribed rate (say 3%). Interest must be paid within 30 days of the end of the calendar year, or income attribution will apply.

While the higher income spouse will include the inter-family interest income on his or her tax return and pay tax on it, the lower income spouse (or the trust) will obtain a tax deduction. More importantly, any income earned on the property transferred, including capital gains, will not be subject to income attribution, and will be reported by the lower income spouse (or the trust). This could offer a very significant benefit.

In addition, it is possible to "have your cake and eat it" when income splitting with a spouse. If gains are realized, interest will be paid 30 days after the year-end, as required, so that income attribution will not apply. On the other hand, if losses result, deliberate failure to pay interest will cause the losses to be attributed back to the higher income spouse.

This simple but effective strategy can potentially yield significant tax savings.

Leaving Canada – Is Now the Time?

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The so-called "departure tax" is a serious deterrent to becoming a non-resident of Canada. Emigrants are deemed to have sold their property at fair market value immediately before departure. There are some exceptions, the principal ones being Canadian real estate and RRSPs. The result is likely to be a net deemed capital gain, on which tax must be paid, or security provided to the CRA to cover the tax liability. Payment of tax may be deferred (without interest) until the particular asset is actually sold.

An individual planning to leave Canada may have no flexibility with respect to the timing of departure, for example, because he or she is taking up employment in a foreign country. Others who may be contemplating departure will usually have flexibility in scheduling their departure date

For these latter individuals, the recent loss in value of many assets, such as stocks and foreign real estate, presents an interesting opportunity to leave Canada at a minimal departure tax cost. Consequently, you might ask, "Is it a good idea to leave Canada before values recover?"

Anyone contemplating departure from Canada in the future has a current opportunity to take action that will minimize their future departure tax liability. This can be achieved, for example, by a plan that involves the creation of a trust. While use of a trust can be an effective solution, it requires skilled professional assistance. Each planned departure will raise different tax issues and other questions.

While the valuation of quoted securities does not present a problem, other assets, such as shares of private corporations, will require a valuation acceptable to the CRA.

Careful planning will be required to ensure that any losses on assets transferred to a trust are realized for tax purposes. There are many pitfalls to navigate.

Once an effective plan has been implemented, future departure from Canada can take place with a much reduced departure tax cost.

So – to answer the question posed at the beginning of this article – now is not necessarily the time to leave Canada just because of the drop in stock prices. On the other hand, if future expatriation is contemplated, now is certainly the time to do some essential advance tax planning.

Securing the Equity in Your Business

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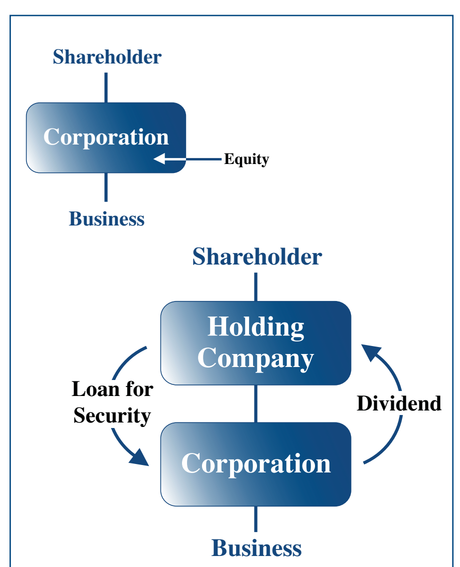
Businesses require working capital. The cheapest source of working capital is internally-generated profits, so we frequently see businesses self-finance. While this is smart from a financial perspective, if hard times hit the owners will find that their equity stands last in line, behind the bank, other secured and preferred creditors, and trade creditors.

Securing the equity in a business is not complex. It takes several steps, and some legal documentation.

The process, in its simplest form, involves paying out the equity of the business as a dividend. To avoid paying personal tax, a holding company should be put in place to receive the dividend. Then the funds may be loaned back and security taken on the assets of the business. The security should be registered in the appropriate way (which may involve a provincial filing, normally handled by legal counsel).

Some security registrations require renewal. It is prudent to review all such registrations regularly, to make sure that they remain in good standing.

There are restrictions on paying a dividend if the company will thereby be rendered insolvent. If the restrictions are not heeded, the directors may be personally liable to the creditors in a future insolvency. Directors should also be aware of the spectre of personal liability for unremitted source deductions and GST.



Stock Options in a Down Market

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Nothing lasts forever. Relationships can go from good to bad in a heartbeat. An economy can go from riches to rags in the blink of an eye. The U.S. stock market, save for some groundbreaking federal intervention, was apparently on the brink of financial collapse. The volatility of the U.S. stock market has had an understandably similar effect on the Canadian stock markets.

The initial reaction of those trading on the Canadian stock market would be to sell, to improve liquidity in these recessionary times. The obvious downside to this strategy is the economic loss that can occur on the sale.

For executives of public companies, there can be very serious income tax consequences if they exercise their options and subsequently sell the shares at less than the exercise price. The balance of this article will discuss two of the unforeseen problems arising from the exercise of stock options of public companies.

The first potential pitfall of exercising stock options is that the employment benefit from exercising them may be greater than the current trading price of the stock. Let us use an example to illustrate: Assume Mr. X exercises his public company stock option when the stock is worth $20 and that he pays no consideration for the shares.

Mr. X's employment benefit is $20 per share and this will also be the cost of his shares. Let us say that the next day – not farfetched in this volatile market – the stock plummets to $5 per share. Although the economic gain to Mr. X would also fall to $5 per share, the taxable benefit from his employment is fixed at the time of the option exercise: i.e. $20 per share. His tax on this amount will be around $9 per share.

As a further problem, the $15 capital loss per share ($20 - $5) arising on the sale of Mr. X's public company shares could be offset against capital gains, not against the $20 per share employment income benefit. Mr. X would have been better off holding the shares rather than selling them, because he would otherwise pay more tax than his economic gain.

The second potential problem lies with the quantum of the taxable employment income that Mr. X has to report in the year of disposition. Mr. X would have $20 per share of employment income A 50% reduction in employment income will be available to Mr. X if the price he must pay to exercise the option is not less than the stock price at the time of the option grant ($20). In this market, Mr. X would be foolish to exercise his stock option on these terms.

Let us assume that because of the economic downturn, the public company wishes to consider alternatives to make the stock option program more attractive. Scenario 1: Cancel the old option agreement and create a new option agreement with an exercise price of $5per share. Scenario 2: Reprice the current option agreement to $5 per share.

In the first scenario, Mr. X would be allowed a deduction equal to 50% of the employment income upon exercise because the new option agreement is considered to be distinct from the old option agreement.

In the second scenario, under current tax rules, Mr. X would be subject to full taxation on his employment income, because repricing the option is in respect of the same option agreement. Because the share exercise price ($5) is less than the share price at the time of the option grant ($20), the 50% deduction is not available to Mr. X.

Proposed legislation attempts to bring the tax result of the second scenario in line with the first scenario if certain conditions are met.

Appropriate tax planning is always needed regardless of the overall economic situation. Exercising a stock option is a risky strategy in a volatile market, especially if you plan to retain the stock!

Remuneration Strategies in Difficult Economic Times

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Business owners need to be concerned about the remuneration strategies they adopt in these difficult economic times.

It is typical for an owner-manager of an active business to take a bonus, so reducing the income of the corporation to $400,000. This is the limit for the small business deduction (the low rate of corporate tax). Above this, the corporate tax rate jumps from around 16% to around 33%. The time-honoured tradition of bonusing to the small business deduction limit may be a sensible remuneration strategy in normal times; however, in circumstances where the corporation incurs losses in a future year, this strategy can be very costly.

Assume that an owner-manager takes a significant bonus from a profitable corporation, and pays personal tax on the bonus at the top tax rate (about 46% in Ontario). Assume the corporation retains income of $400,000, which will have been taxed at the small business rate of around

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Foreign Currency Gains and Losses, The Technicalities

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Not surprisingly, the Canadian tax system is "denominated" in Canadian dollars. This means that income (and loss) and capital gains (and losses) are to be calculated in Canadian currency using exchange rates appropriate for the transactions that have given rise to them.

Many Canadians consider U.S. dollars a reference currency. If the Canadian dollar falls against the U.S. dollar, there is an economic loss because Canadians lose purchasing power. If the Canadian dollar appreciates against the U.S. dollar, there is an economic gain. However, for tax purposes, the reverse is true.

Suppose that, when the Canadian dollar was at 70¢ to the U.S. dollar, an individual converted Cdn $100,000 to U.S. dollars, and placed it in a savings account; when the Canadian dollar appreciated to parity, the U.S.$70,000 was converted to Canadian currency. The Canadian equivalent would be $70,000, resulting in a loss of $30,000. Alternatively, suppose that when the Canadian dollar reached parity with the U.S. dollar, Cdn $100,000 was deposited in the U.S. dollar account; when the Canadian dollar declined this year to U.S.$0.80, the funds (U.S.$100,000) were converted back. This would result in a gain of $25,000.

In these examples, the loss would be a capital loss, and the gain would be a capital gain.

This seems simple, but suppose the funds were invested in say a U.S. treasury bill that matured? Suppose the funds would be reinvested in a second U.S. treasury bill, not converted back to Canadian dollars. In this circumstance, a gain or loss would result from foreign currency translation, because the new U.S. treasury bill is considered a new investment, to be computed in Canadian currency, resulting in a gain or loss from foreign currency conversion at that time. While this may not seem to be intuitively obvious, the rules concerning foreign currency conversion mandate this treatment.

In our experience, this is frequently overlooked. Generally, when trading stocks, investors deal well with foreign currency conversion, but frequently ignore it when dealing with foreign bank accounts, treasury bills, and even bonds.

Because of the major fluctuations in the value of Canadian currency this year, many clients may have capital gains from U.S. currency conversion. Although not intuitive, this is the unfortunate result of a decline in the value of the Canadian dollar!

Using Corporate Losses

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Losses that are sustained by a Canadian corporation can be carried back for three years and carried forward for 20 years if the losses are operating losses, or indefinitely if the losses are capital losses. In difficult economic times, the key question to be asked is, "How can corporate losses be converted into cash through a tax refund?"

First, consider the income and taxes paid by the corporation for the past three years, to see how much tax can be recovered by way of a loss carryback. It is important to consider the rate at which tax will be refunded by using the losses. If the corporation carries on an active business, and had income subject to the high rate of tax, the refund rate will probably be about 36%. On the other hand, if the corporation had income taxed at the small business rate, the refund rate will probably be in the 16% to 18% range. For investment income, such as interest or rental income, the tax paid will be roughly 50%, unless dividends were paid by the corporation. If dividends were paid, the rate would be reduced to 22% to 24%. While operating losses may be used against any source of income, capital losses may only be applied against capital gains, except in rare circumstances.

If the loss carryback potential has been exhausted, the next consideration is other ways in which the losses can be used. A Canadian corporation is required to compute its income and file its tax returns on a stand-alone basis – consolidated tax filings within a corporate group are not permitted. To use corporate losses, there are two possible strategies that can be explored.

The first strategy is to merge the loss corporation with a profitable corporation, allowing the losses to be used against future income. This will not result in a tax refund but, after the two entities are merged, tax instalments can be reduced or eliminated, resulting in an immediate cash flow advantage.

The second strategy is to arrange for income to be earned in the loss company. There are a variety of effective approaches

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Using Corporate Losses

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to achieve this. Most involve transferring income earning assets to the loss company. An alternative, which should be approached with caution, is the payment of management fees to the loss company. Currently the CRA seems to take a lenient position with respect to the payment ofinter-corporate management fees. However, the loss company may be called upon to justify what it did to earn the management fees. If they cannot do so, the fees may be disallowed as a deduction to the paying company .

It is possible to vary the loss for tax purposes, to increase or reduce it. Certain deductions are discretionary, meaning that they need not be claimed. Since losses may be carried forward for 20 years, current thinking is that it is normally preferable to claim the maximum deductions, and so to create the largest possible loss, even if it may take many years for the loss to be used.

Special rules apply when control of a corporation changes to unrelated persons. Net capital losses cannot be claimed at all. Thereafter, operating losses, including non-capital loss carry-forwards, are restricted in how they can be used in the future. Depending on the circumstances, the use of certain other carryforward amounts, such as investment tax credits, are also restricted.

Corporate losses give rise to complex tax planning considerations. To obtain the maximum benefit, early identification of the possibility of losses is important. Adopting a strategy to maximize the tax benefit from the losses will be very beneficial.

Quick Facts

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Selected Provinces	AB	BC	MA	NB	NF	NS	ON	QC	SK
Highest Marginal Personal Tax Rates for 2008*									
Ordinary Income	39.00	43.70	46.40	46.95	45.00	48.25	46.41	48.22	44.00
Capital Gains	19.50	21.85	23.20	23.48	22.50	24.13	23.20	24.11	22.00
Canadian Dividends Eligible	16.00	18.47	23.83	23.18	28.11	28.35	23.96	29.69	20.35
Canadian Dividends Non-Eligible	26.46	31.58	37.40	35.40	33.33	33.06	31.34	36.35	30.83
Corporate Tax Rates									
High Rate	29.50	31.00	33.00	32.50	33.50	35.50	33.50	30.90	32.00
Small Business Rate	14.00	15.00	13.00	16.00	16.00	16.00	16.50	19.00	15.50
Investment	44.67	46.16	48.16	47.67	48.67	50.67	48.67	48.67	47.16

****The top marginal tax rates apply on personal taxable income (after all deductions) that exceeds $123,185.***

Small Business Limit				
	2008	2007	2006	2005
Federal	400,000	400,000	300,000	300,000

- Capital losses are deductible only against capital gains. Capital losses may be carried back three years, and carried forward indefinitely.
- 50% of overall capital losses can be applied, with a tax refund rate of19.5% to 25%, depending on the province.
- Non-capital losses may be carried back three years, and carried forward 20 years
- The last date for 2008 trading on the Toronto Stock Exchange is December 24, 2008
- The period before stock can be repurchased is 30 days, excluding the day the investment was sold or repurchased. (These days do not include the day the investment was sold or bought back.)
- Prescribed rates of interest during the fourth quarter of 2008 are as follows:
  - 7% on overdue taxes, Canada Pension Plan contributions, and Employment Insurance Premiums;
  - 5% on overpayments; and
  - 3% on taxable benefits for employees and shareholders from interest-free and low-interest loans.

Remuneration Strategies in Difficult Economic Times

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16%. In a subsequent year, the corporation has a large loss. This loss can be carried back to any or all of the three prior taxation years. Unfortunately, since there is only $400,000 of income retained and taxed in each of these years, the maximum amount of the loss that can be deducted will be $1,200,000. Worse still, the recovery rate will be at around 16%. Meanwhile personal tax was paid at almost three times this rate!

It may be preferable to leave income in the corporation if losses are anticipated in the future, even if the income is subject to tax at the higher corporate tax rate. In this way, if the corporation sustains future losses, a much larger potential tax recovery will be available.

A similar strategy will apply to corporations that earn investment income, including rental income. Often dividends will be paid to realize a lower tax rate in the corporation, in exchange for paying personal tax. If the corporation suffers a future loss that is carried back, the tax recovery from the carryback will be much lower than if dividends had not been paid.

At this point in the economic cycle, it is time to question the traditional rules of thumb for taking remuneration from private corporations. The chosen strategy should take into account the possibility that a future loss could be sustained, and consider how to reduce its cost through tax recoveries should these circumstances arise.

TAX PERSPECTIVES

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