

## Issue 2008-02

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## Tax Rules to Remember When Triggering Capital Losses

With the recent volatility in capital markets, many investors will consider whether it makes sense to trigger capital losses to produce a tax benefit. Although the rules behind how a capital loss is calculated are relatively straightforward, a number of additional rules can apply and in some cases, a capital loss can be denied. If you do want to trigger a capital loss, it is crucial to ensure that the loss you created won't be lost.

For individuals who are part of an employer stock/security option plan, there are additional rules that need to be considered. One key point is that gains arising from these options in the past will most likely have been partially or completely taxable as employment income even if only one-half of the gain was taxed. Therefore, if a capital loss is triggered on securities this year, you won't be able to offset a prior income inclusion that was taxed as employment income with the loss. Be sure to read *The Tax Consequences of Security Options for Employees* in the 2005-02 issue of *The Tax Factor* (available on [www.bdo.ca](http://www.bdo.ca)) before you trigger a loss on securities purchased through an option program.

In the balance of this article, we have dealt with common questions that arise for investors and we'll restrict our focus on capital gains and losses on publicly-traded securities. For those people who are in the business of buying and selling property for a profit, a gain or loss may be an income gain or loss (meaning that the gain is 100% taxable or the loss is 100% deductible). For more information on these transactions, contact your BDO advisor.

### What are the basic rules?

The calculation of a capital gain or loss on most property is pretty simple—you take the proceeds you receive on the sale and reduce this amount by the “adjusted cost base” or ACB and the transaction costs (if any) you paid on the disposition. For most types of capital property, ACB means the original cost of the property (although special rules apply for property owned at the end of 1971). In addition, when the general \$100,000 capital gains exemption (CGE) was eliminated in 1994, individuals were allowed to use their remaining exemption to step up the ACB of property with an accrued gain held at that time.

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If a capital loss arises, that loss will offset any capital gains you realize this year. If the overall result is still a loss, you can then carry that loss back to offset capital gains in the past 3 taxation years or carry that loss forward indefinitely.

**I have an accrued capital loss this year that is roughly equal to a capital gain I realized earlier in the year. I was in a higher tax bracket last year. Can I trigger the loss and carry the loss back to my 2007 tax return?**

No. When capital losses are created, it is important to keep in mind that these losses must first be applied to current gains (this offset is not optional) before the loss can be carried over to another taxation year. In your case, the capital gain had already occurred, so there wasn't any way to avoid the offset.

This question does highlight an important point when triggering accrued capital losses—if you want to trigger a capital loss and carry it back to a prior year, you should try (if possible) to avoid selling property later in the year that has an accrued gain (that is, sell the gain property next year if possible). We say “if possible”, as it is generally a good idea to make the right investment decision first, and then try to fit this decision around the tax rules.



**If I sell an investment to create a capital loss, can I buy the investment back if I still want to hold it? What if the investment is repurchased by my spouse?**

The answer to the first question is yes, but you must wait 31 days until you buy the property back. On the second question,

losses that arise on a direct or indirect sale of property to an affiliated person are subject to either “superficial loss” or “stop-loss” rules which can deny a capital loss. These rules apply where a person sells a property directly to an affiliated person or if the affiliated person repurchases the same property or an identical property within 30 days of a disposition.

Although the rules are fairly complex, common affiliated persons include you (that is, you're affiliated with yourself), your spouse, a corporation controlled by you and/or your spouse and a trust where you and/or your spouse have a beneficial interest in a majority of the property.

A superficial loss will arise when any taxpayer sells a property and reacquires the same property or an identical property within 30 days. In addition, where the taxpayer is an individual, a superficial loss will occur where an affiliated person repurchases the property. The good news is that where you have a superficial loss, the loss that is denied can be added to the cost of the property for the purposes of a future disposition. The loss will be allowed as long as you or your spouse wait 31 days before you repurchase the investment.

In the case of mutual funds, a relatively easy solution might be to switch to a similar fund within the family of funds. Since the new fund purchased wouldn't be identical, the superficial loss rule won't apply. Be sure to ask whether the switch to a new fund is a disposition for tax purposes and that no fees will be charged.

**What happens if I transfer a loss investment to my RRSP?**

Unfortunately, the news is worse if you transfer a property with an accrued loss to your RRSP. Where you transfer the property as a contribution or sell it directly to your RRSP, the loss is simply denied and you will get no future benefit from the denied loss. Even if you sell the loss property and have your RRSP acquire it on the open market, the loss will still be denied, as your RRSP will be an affiliated trust. Consequently, you will need to again make sure that you wait 31 days before your RRSP acquires the property.

**Can I trigger a loss by transferring a property to other family members?**

Yes. Our tax rules will generally not prevent you from triggering a loss on the transfer of a property to a family member other than your spouse. In other words, if you have a property with an accrued loss and transfer the property to the family member for fair market value (FMV) consideration or gift the property, you can create a loss.

An important point to remember is that adverse rules can apply on transfers for consideration that is less than FMV. For example, let's assume you have a property that cost \$20 and it is currently worth \$18. If you sell that property to a child for \$16, you will still have proceeds equal to \$18 (and a loss of \$2 will arise). Your child, however, will have an ACB for tax purposes of only \$16. So, if he or she were to sell the property for \$18, a gain of \$2 would arise. Gifts are subject to a different rule—a gift of property for no consideration will result in a FMV disposal for you and a FMV acquisition by the family member. Therefore, any loss planning with family members (other than your spouse) should involve FMV transfers or gifts.

**I have a property with an accrued loss in my corporation. Can the corporation sell that property to a family member to create a loss?**

Loss denial rules also apply to corporations and other entities, other than an individual. In the case of a corporation, the person controlling the corporation plus his/her spouse and certain other entities will be affiliated with the corporation, and a loss triggered on a transfer of property to an affiliated person will be denied. In the case of a corporation, the denied loss remains with the corporation, and will be realized later. One common event triggering recognition of the denied loss will be a future sale by the affiliated person to someone else who is not affiliated. As was the case with property you own personally, your corporation can create an allowable capital loss by transferring the loss property to other family members, such as your children.

**I have bought shares of my employer (at fair market value) through a stock purchase plan and I bought additional shares in my margin account which have declined in value. Can I sell just the shares in my margin account and trigger a capital loss?**

To determine whether you have a capital loss, you will need to consider the cost of the shares in your margin account and the cost of the shares you hold as part of the stock purchase plan. Under our tax rules, you have to calculate your ACB based on all identical properties that you hold and average that total cost over all the shares you own. Note that an exception to this rule does apply where securities are bought under an employer stock option plan (which was not the case here).

If you have been a member of your employer's stock purchase plan for some time, there is a good chance that the average cost per share for all of your shares is lower than the specific per share cost for the shares held in your margin account. In fact, selling the shares in your margin account might even produce a capital gain.

**The per unit price of my income trust has fallen below the purchase price and I'm thinking of selling the units to trigger a capital loss. Are there any rules I need to consider?**

Investors in trusts and partnerships, including ordinary open-ended mutual funds and income trusts, need to remember that the ACB of their investment will vary based on the income allocated by the entity and whether capital distributions have been made.

In the case of open-ended mutual fund trusts, the fund issuer will generally provide you with a detailed ACB calculation



annually and capital distributions are relatively rare. In the case of publicly-traded income trusts or partnership units, you will need to do more of the ACB tracking yourself (or with the help of your BDO advisor). One key point to remember about these investments is many will distribute capital plus the income earned. So it is quite common for the ACB to decline over time. Therefore, if your income trust is worth less now when compared with when you bought it, this doesn't necessarily mean that you will have a capital loss if you sell the units.

**I bought a publicly-traded U.S. stock a number of years ago, and the stock price has declined. Can I trigger a loss on this investment?**

If you sell a foreign property, the decision becomes more complicated. First (although this won't be an issue for a U.S. public company), you'll need to determine whether there are any foreign tax issues associated with selling the property as some countries reserve the right to tax property situated in that country. In addition, for Canadian tax purposes, you'll need to remember that a capital gain or loss will be based on the ACB, selling costs and the net proceeds expressed in Canadian dollars. So, if you buy and sell U.S. investments in a U.S. dollar brokerage account, you'll need to determine what the exchange rates were when you bought and sold an investment. Therefore, before you sell, it is crucial to determine what your gain or loss would have been if you had transacted in Canadian dollars. Note that the Bank of Canada's website has a wealth of information on historical exchange rates (<http://www.bankofcanada.ca>).

*Triggering capital losses is a common element of personal tax planning. However, you do need to make sure that any loss you trigger will be allowed and can be claimed to reduce tax. So, discussing capital loss planning with your BDO advisor before you sell is recommended.*

## Answering Your Questions on the New Tax-Free Savings Account

In the 2008 Federal Budget, the Minister of Finance proposed a new savings plan for Canadians—the Tax-Free Savings Account or TFSA. Although the TFSA will share a number of definitions and rules with other plans such as a registered retirement savings plan (or RRSP), there are some important differences.

Unlike RRSPs, the TFSA will be a tax-paid savings vehicle. It will allow individuals to save for many purposes, such as buying a home, starting a small business, buying a new car or putting money away for a child's wedding. TFSAs will also be a lot more flexible than an RRSP, as you'll be able to put money in or take money out without impacting your ability to use a TFSA again in the future. RRSPs are ill-suited for these shorter term savings goals. And TFSAs can also be used to save for retirement. In fact, for some individuals, having a TFSA at retirement may be more beneficial than an RRSP as TFSA withdrawals won't impact income-tested benefits.

What makes a TFSA significantly different than other tax-deferred plans such as an RRSP is how contributions and withdrawals are handled. Unlike an RRSP, contributions to a TFSA will not give rise to a tax deduction (and that's why we say a TFSA represents tax-paid savings). When money is withdrawn, the accumulated contributions and income you receive will not be taxable.

In the rest of this article, we'll address many of the common questions people are asking about the TFSA.

### Who can open a TFSA and when?

The proposed rules for TFSAs will become operative on January 1, 2009 if passed into law. Any individual (other than a trust) who is resident in Canada and 18 years of age or older can open a TFSA. Like an RRSP, you can hold as many TFSA accounts as you want as long as you do not exceed the contribution limit. In terms of when you can practically buy a TFSA, that may depend on your financial institution.

### Where can I buy a TFSA?

Although it will be up to individual financial institutions to decide on whether they will offer TFSAs, we believe that you will be able to open a TFSA account at most financial institutions, such as Canadian trust companies, investment dealers, life insurance companies, banks, and credit unions (basically the same institutions that currently offer RRSPs). You will have to provide the institution with your social insurance number when the account is opened.

### How much can I contribute?

The amount you can contribute annually will be governed by your contribution room for the year. Your TFSA contribution room will be made up of three amounts:

- ◆ The annual contribution room for the year. Each year, you will be entitled to a contribution limit of \$5,000. According to the government, this limit will be indexed to inflation and rounded to the nearest \$500 on a yearly basis. With our current low inflation rates, the limit will likely be \$5,000 for the first 2 or 3 years.
- ◆ Any withdrawals made in the previous year will be added to the contribution room for the year.
- ◆ Any unused contribution room from the previous year will be added to the contribution room for the current year.

To illustrate the rules, consider the following example (indexing has been ignored). In 2009 you'll be allowed to contribute up to \$5,000. So, if you only contribute \$2,000 in 2009, that will mean that you can carry forward the remaining \$3,000 of contribution room to 2010, giving you 2010 contribution room of \$8,000 (the annual limit for 2010 of \$5,000 plus the \$3,000 carried forward). Next, let's say you withdraw \$1,000 in 2010 (and you don't make a contribution during the year). This will give you contribution room in 2011 of \$14,000 (being the annual limit for 2011 of \$5,000, plus the \$8,000 carried forward from 2010 and the \$1,000 you withdrew in 2010).

### How will I know what my TFSA contribution room will be?

Although calculating the TFSA contribution room may seem complicated, there is good news. The CRA has said it will track TFSA room in the same sort of way that it currently tracks RRSP contribution room. So, although the TFSA is not subject to tax, we anticipate that you will report TFSA contributions and withdrawals as part of your personal tax return and the CRA will report your TFSA contribution room on your notice of assessment.

### What if I overcontribute to a TFSA?

TFSA overcontributions will be subject to a 1% penalty tax per month in the same way as RRSP overcontributions. However, in the case of the TFSA, there will not be a \$2,000 margin for error which is available for RRSP overcontributions—the first dollar of TFSA overcontributions will be penalized. So, you will have to track your TFSA limit and carefully compare it to the contributions you make. We would also anticipate that the CRA will track TFSA overcontributions.

### What kind of investments can I hold in my TFSA?

A TFSA will generally be permitted to hold the same investments as an RRSP, including mutual funds, publicly traded securities, GICs, bonds, and certain shares of small business corporations. The specific investments available to you could also be governed by the terms of your TFSA agreement with your financial institution.

### Can I gift or loan funds to a spouse or other family members to make TFSA contributions?

Yes. Generally, if you make an interest-free loan or gift funds to a spouse to invest, the income on the investment will be attributed to you and taxed in your hands. In the case of funds used by your spouse to make a TFSA contribution, there will be no taxable income, and therefore, the attribution rules will not be a concern. The same will be true where you make an interest-free loan or a gift to an adult child so that they can invest in a TFSA. Lending or gifting money to family members to buy a TFSA will become an important personal tax planning consideration.

### I'm putting money aside for my next car. If I use a TFSA next year, will that mean I can't use a new plan later to save for a house?

No. As discussed earlier, your TFSA contribution room will include amounts withdrawn in a previous year from any of your TFSAs. Therefore, if you fully use your TFSA room over the first two years, and collapse your TFSA when it is worth \$12,000, you'll be able to put that \$12,000 back into a new TFSA in a subsequent year when you begin to save for your house (plus the annual TFSA contribution room that accumulates by then). So, you will be able to use a TFSA repeatedly over the course of your lifetime to save for different purposes.

### How will a TFSA be handled on death or marital breakdown?

A TFSA will become an ordinary investment account on death. Income earned to the time of death will be tax-free, but earnings after death while your assets are held by your legal representative will be taxable.

In the case of a surviving spouse, it will be possible to transfer a TFSA to the spouse without affecting the spouse's TFSA contribution room. This can be accomplished by simply naming the spouse as the successor account holder as part of the plan. Alternatively, the assets of a deceased individual's TFSA can be transferred to a TFSA held by the surviving spouse.

The same sort of rules will apply on marital breakdown. That is, if TFSA property is transferred between spouses on marriage breakdown, it will again be eligible for TFSA

treatment in the hands of the transferee without affecting their TFSA room.

### What happens if I emigrate from Canada?

If you become a non-resident of Canada, you will be allowed to maintain your TFSA, and you will not be taxed on any earnings in the account or on withdrawals in Canada. However, you will not be allowed to contribute, and no contribution room will accrue for any year throughout which you are a non-resident. In addition, any withdrawals made while you were a non-resident will not be added back to your contribution room.

### I'm a U.S. citizen living in Canada. Should I make a TFSA contribution?

The main issue that has to be considered here is that U.S. citizens and other "U.S. persons" such as green card holders are subject to U.S. tax on their worldwide income. Under the current Canada-U.S. Tax Treaty, U.S. persons in Canada can elect to defer income earned in certain plans such as an RRSP, registered retirement income fund or a deferred profit sharing plan for U.S. tax purposes until it is withdrawn. This is because current income in these plans is exempt from tax in Canada and each plan was "operated exclusively to provide pension, retirement or employee benefits". As TFSA contributions and withdrawals are in no way linked to employment or retirement, it currently appears that treaty relief will not apply to TFSAs. This would mean that TFSAs will be treated as an ordinary investment account for a U.S. person and therefore, TFSA earnings would be part of a U.S. person's taxable income for U.S. purposes. If you're a U.S. person, the best advice would be to consult with your BDO advisor before purchasing a TFSA.

### Should I borrow to make a TFSA contribution?

Probably not. In the case of an RRSP, it has been suggested that borrowing money for an RRSP contribution and paying non-deductible interest for a few months can make sense if you borrow just before the RRSP contribution deadline and you will pay off the loan quickly. This is because a last minute RRSP contribution will provide a tax reduction now that you wouldn't otherwise get until next year. In the case of a TFSA contribution, it will not generate a tax deduction and any interest paid will also be non-deductible.

In the case of a terminally ill individual with a spouse, it could make sense to borrow money to make a TFSA contribution, as the TFSA account can be transferred to the surviving spouse while TFSA room can not. The surviving spouse can pay off the loan with other funds that arise after death or even simply collapse the TFSA (as the withdrawal will be added to the surviving spouse's TFSA room for future years).

### **I have RRSP contribution room and I still owe money on a recent home purchase. Should I invest in a TFSA, make an RRSP contribution or pay off my mortgage?**

This is definitely the most difficult question to answer as there was never a “one size fits all” answer on the RRSP contribution vs. mortgage repayment issue. So, the answer will vary even more once TFSAs are added to the mix. That said, there are a number of observations that can be made:

- ◆ If you make an RRSP contribution, this will, for most employed individuals, create a tax refund that you can use to pay down your mortgage. Many financial advisors suggest this approach as you are making progress toward both paying off your mortgage and saving for your retirement. A TFSA contribution will not produce a tax refund.
- ◆ The issue of whether an RRSP or TFSA is better for you will really depend on what your marginal income tax rate is now and what it will be in retirement. For example, if you are in a high bracket now, and will be in a lower bracket later, RRSP contributions effectively move income that would be taxed at a high rate now into a lower tax bracket later. This produces both a tax deferral and a tax saving.
- ◆ Where an individual is in a lower tax bracket now, and expects to be in the same lower tax bracket later on retirement, a TFSA might make more sense than an RRSP, as the use of an RRSP could put the individual into a higher bracket in retirement while a deduction arises now at a low marginal rate. Also, having lower income in retirement allows you to keep more of your government benefits that are income-tested such as Old Age Security, Guaranteed Income Supplements, GST credits and other benefits/credits.

- ◆ When comparing a TFSA contribution to making a mortgage repayment, your mortgage is really just another TFSA. That is, any non-deductible interest that you don't have to pay due to the mortgage repayment is effectively tax-free income earned with a fairly good return on your money. Therefore, in terms of limiting risk, many individuals will concentrate on repaying their mortgage first, especially since the accumulated TFSA room should still be there when you finish paying off your mortgage. If your investment rate of return is less than the mortgage rate, then paying down your mortgage will definitely be more beneficial.
- ◆ If you have funds now, but you may need them again later, using a TFSA temporarily could make sense. Contributing money to an RRSP now and withdrawing it soon after is usually a not a good idea. Although the income and deduction may offset each other (i.e. if the contribution and withdrawal fall within the same year), this eliminates RRSP room. If you're in this situation, a better plan could be to put the money into a TFSA and then later contribute the funds to an RRSP once you're sure you won't need the money until retirement (assuming of course using an RRSP makes sense for you in general).
- ◆ Finally, many financial advisors recommend that individuals keep a reserve fund for a rainy day. The TFSA is perfectly suited to this as your reserve fund will not be taxed, and if you do have to draw on it, then you can put the money back later when financial resources permit.

*The TFSA will become an important part of Canadian personal tax planning as TFSA room begins to accumulate next year. If you have any questions on these proposed rules, contact your BDO advisor.*

## **Recent Changes Impacting Your U.S. Work Assignment**

Many Canadians enjoy living and working in the U.S., some moving permanently while others choose ultimately to return and make their home in Canada. If you are considering going on a work assignment to the U.S., there are many factors to consider, one of which are the implications such a move will have on your tax situation.

In this article, we examine some of the tax implications that you need to consider when thinking about a work assignment in the U.S. We will focus in particular on tax issues that have been impacted by recent changes to the Canada-U.S. Tax Treaty (“Treaty”) as contained in the Fifth Protocol (“Protocol”) to the Treaty.

### **Deemed Dispositions on Ceasing Canadian Residency**

When you leave on assignment to the U.S., generally you will cease to be a resident of Canada. There are a number of tax consequences that arise when you cease your Canadian residency.

If you own assets with a fair market value of more than \$25,000, you will have to report the details of these assets (with the exception of personal-use properties individually valued at less than \$10,000) to the Canada Revenue Agency (CRA) on Form T1161. This form is due by the date you would normally file your tax return for the year of departure.

You will be deemed to dispose of properties you owned at that time for proceeds equal to the fair market value of the assets on the date of departure. There are some exceptions to this rule as the deemed disposition rules will not apply to real property situated in Canada, capital property used in a business carried on by you through a permanent establishment in Canada, employee stock options and pension rights such as registered pension plans, registered retirement savings plans and deferred profit sharing plans. If you have been resident in Canada for 60 months or less during the ten year period prior to ceasing residency in Canada, any property you owned when you became a resident of Canada or inherited while resident of Canada will not be subject to the deemed disposition rules. As well, if you return to Canada, you can elect to unwind the deemed disposition on the assets you still own at that time.

Therefore, in the year of departure, you will be taxed on any accrued gains on the deemed dispositions. The CRA will allow you the option of deferring payment of the tax liability on any particular property if you post security with them. The tax will then be due when the property is actually sold, or the security is returned if the deemed disposition is unwound when you return to Canada. Security is not required on the first \$100,000 of capital gains from the deemed dispositions and there will be no interest charged on the tax due between the date of departure and the date of disposition.

If you dispose of property subject to the deemed disposition rules while resident of the U.S., you will be subject to tax in the U.S. on any capital gains as determined under their domestic tax rules. In the U.S., as individuals are taxed on gains realized on most properties based on their original cost, you may face double taxation as a result of the deemed departure disposition for Canadian purposes and on a subsequent sale of the asset for U.S. purposes. To avoid this problem, Canadian emigrants historically sold their investments prior to taking up U.S. residency and then reacquired them in order to get a step-up in the cost basis of their assets.

Under the current Treaty, an individual who has deemed dispositions upon his or her departure from Canada can elect to have a deemed disposition in the U.S. as if the properties were sold and repurchased for fair market value at that time. Foreign tax credits would then be claimed in order to minimize double taxation. However, this treaty provision is only available to individuals who were subject to U.S. tax before the time they ceased to be residents of Canada (e.g. U.S. citizens on the date of departure).

The Protocol contains a change first announced in 2000. To alleviate the potential double tax problem, the Protocol extends the current Treaty election to all individuals subject to deemed dispositions. Specifically, you can elect to be deemed to have sold and repurchased a property at an amount equal to its fair market value at the time immediately before becoming a non-resident of Canada to get the step-up in cost so that you would only be subject to U.S. tax on post-emigration

gains. The time requirement to make the election in the tax return for the year of departure has also been removed and it appears that this election can be made on a property-by-property basis. It is important to remember that you may still face double taxation even with this election as you will be taxed in the U.S. and there may be federal or state foreign tax credit limitations. It should be noted that this change does not apply to assets held within an RRSP and certain other indirect holdings. Therefore, specific pre-emigration planning is still required to minimize U.S. tax exposure on these assets. This change applies to properties that are deemed to have been disposed of after September 17, 2000, the date this measure was first announced.

### Employee Stock Options

The use of stock options as a form of remuneration for employees has become very common and the taxation of these options can be complicated. If you have stock options granted to you prior to ceasing Canadian residency and moving to the U.S., when you exercise the stock options, you will need to determine how your stock options will be treated under both Canadian and U.S. tax rules.

The taxation of these options can be complicated, especially in the situation where you are granted stock options while living and working in Canada and then move to the U.S. to work. Generally, under both Canadian and U.S. domestic rules, you will have a taxable benefit at the time you exercise the options equal to the value of the stock at the time of exercise minus the exercise price and the amount (if any) you paid to acquire the option. However, Canada and the U.S. have different rules for determining whether the option benefits relate to employment services performed in Canada or the U.S. Historically, these cross-border situations resulted in the double taxation of the benefits, with both countries asserting their right to tax the same income which is considered to be Canadian-source under Canadian domestic tax rules and U.S.-source under U.S. domestic tax rules.

As mentioned earlier, if you hold stock options at the time you cease to be a Canadian resident, there are no tax consequences at the time of departure. However, as a non-resident of Canada, you will still remain liable for Canadian tax on the option benefit realized when you exercise the options to the extent the benefits are considered to relate to employment services performed in Canada. As a U.S. resident, the full amount of the option would be subject to tax as well—a foreign tax credit can be claimed on your U.S. return for Canadian tax paid on the same stock option benefit, but only to the extent that the U.S. considers the benefit to be Canadian sourced income.

This problem is best illustrated by an example. Assume an employee of a Canadian company is granted a stock option on January 1, 2009 that only vests three years later on December 31, 2011 (i.e. the date after which the stock

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option can be exercised), and the grant of the option relates to employment services performed in Canada. On January 1, 2010, the employee is moved from the company's Canadian head office to its U.S. subsidiary. On December 31, 2011 (the date the option vests), the employee exercises the stock option, giving rise to an income inclusion. For Canadian tax purposes, the stock option benefit will be considered taxable in Canada as Canadian source income. For U.S. tax purposes, though, the stock option benefit is sourced based on workdays between the grant date and the vesting date three years later. Assuming the employee's workdays were spent in Canada while a Canadian resident and in the U.S. while a U.S. resident, one-third of the benefit is considered Canadian source and two-thirds is considered U.S. source income. As a U.S. resident, the stock option will be fully taxable in the U.S. While the U.S. would allow a foreign tax credit to be claimed for Canadian taxes payable on the portion of the benefit relating to Canadian workdays, the U.S. would not allow a foreign tax credit on the two-thirds of the benefit that the U.S. considers to be U.S. sourced income. As a result, the benefit relating to the U.S. workdays during the grant to vesting period, in this case two-thirds of the benefit, would be subject to tax in both countries with no foreign tax credit relief.

Until recently, the Treaty has been silent on the sourcing of stock options, leaving Canada and the U.S. with no clear direction as to which country has the first right of taxation in situations where both countries assert their right to tax the same income. The Protocol, however, attempts to address this issue. As part of an exchange of diplomatic notes, as opposed to a treaty change, a new test will apply to determine which country can tax the option benefit. Under the Treaty, the stock option benefit will generally be considered to have been earned in a country to the extent that the individual's principal place of employment was in that country during the time between the granting of the option and its exercise.

To revisit our example from earlier, under the Protocol, the taxation of the stock option benefit will be prorated by both Canada and the U.S.—one-third of the resulting benefit will be deemed to have been derived in the Canada and two-thirds will be deemed to have been derived in the U.S. With this change, Canada will now only tax one-third of the income so that this income will no longer be subject to double taxation as illustrated earlier where Canada would tax 100% of the benefit.

Note that you do not have to use the Treaty and can source the stock option benefit according to the domestic rules in Canada or the U.S. or both countries if that would be more advantageous for you. However, this can only be done if

you are not invoking any other provision of the Treaty in that particular country. This change will apply for taxation years that begin after the calendar year in which the Protocol enters into force. As the Protocol was still not ratified by both countries in 2007, the earliest date that the rule can be effective is January 1, 2009.

### Canadian Employer's Pension Plan

In many short-term assignments to the U.S., individuals continue to contribute to their Canadian employer's pension plan during the time they are working and resident in the U.S. Under the current rules, however, if this applies to your situation, generally you would not be allowed a deduction on your U.S. tax return for contributions made to your Canadian employer's pension plan.

Changes under the Protocol will allow, subject to a number of conditions and limitations, a deduction for pension contributions to Canadian plans for U.S. tax purposes. In order for you to be able to deduct your Canadian retirement plan contributions on your U.S. tax return, the following conditions must be met:

- ◆ you must provide "taxable" services in the U.S.,
- ◆ you must have been a member of the Canadian plan (or substituted plan) immediately before performing services in the U.S.,
- ◆ you must not have been resident in the U.S. immediately prior to performing "covered" services in the U.S.,
- ◆ you have not worked in the U.S. for the same employer (or a related employer) for more than 5 years of the 10 years prior to the current tax year,
- ◆ contributions and benefits must be attributable to the period of U.S. employment, and
- ◆ there is no "double-counting" of contributions or service for benefits under any other company plan.

The deduction you will get for U.S. tax purposes will be limited to your Canadian RRSP contribution limit, and the amount deducted will reduce your RRSP room for future years. This change will apply for taxation years that begin after the calendar year in which the Protocol enters into force. As the Protocol was still not ratified by both countries in 2007, the earliest date that the rule can be effective is January 1, 2009.

*If you are planning on moving to the U.S. on a short-term work assignment, there are many tax consequences to consider before leaving Canada—a few of which has been highlighted above. If you have questions, contact your BDO advisor to discuss your specific situation.*