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Take Advantage of the Downturn: Revisit Your Estate Plan

The recession that we're currently facing is creating challenges for all of us. For the business owner, business may have slowed, and the value of their corporation may have declined. For individuals with investment portfolios, they have also experienced adversity as investment prices have fallen.

Despite these conditions, the current environment is a positive one for two key tax planning ideas. First, in the last edition of the *Tax Factor* (and a subsequent *BDO Tax Alert*), we pointed out that now is the perfect time to consider splitting income with family members using prescribed rate loans due to unprecedented interest rate reductions. It is now possible to lend money to a family member with interest at 1%, and the loaned funds can be used by a family member to buy income producing property without income attribution.

The second key tax planning opportunity now available is to either establish an estate plan, or revisit the estate planning that you established in the past. In a nutshell, it may be possible to freeze the value of your estate at current levels so that the value recovery that will come will accrue to other members of your family. The key tool that makes this work is an "estate freeze".

What is an estate freeze?

When an individual dies, they are deemed to dispose of most of their assets for tax purposes at their fair market value (subject to a rollover to a spouse or, in the case of farm property, to a child). For capital property, this means that all accrued capital gains will be taxed. If you own depreciable property such as a rental property, depreciation that you claimed in the past will be included in your income assuming that the current fair market value of the property exceeds its original cost.

For most individuals, the tax arising on these deemed dispositions will represent a significant tax cost on death. Consequently, one of the main goals of estate planning is to minimize these taxes where possible. Also, once you've minimized the tax bill, the next step is to try to defer the tax payment for as long as possible. An estate freeze can help on both fronts.

An estate freeze is a process where you take steps to ensure that the future growth of your estate accumulates in the hands of your intended beneficiaries. By freezing the value of your estate, you will effectively lock in the tax that will arise on your death (subject to changes in tax rates in the future). Consequently, an effective estate freeze will allow you to pre-determine the taxes that will arise on your death so that you can ensure that cash will be available to pay that tax (for example, by taking out sufficient life insurance).



There are many ways to accomplish an estate freeze. One common method is to transfer the assets you want to freeze to a corporation. By taking back fixed value shares (usually preferred shares), this transfer can be accomplished on a tax-deferred basis using special rollover provisions in our income tax rules. Your beneficiaries can then subscribe for the growth shares (usually common shares) of the company. At the time of the estate freeze, the value of these common shares would be nominal, as the value of the property you are freezing has been incorporated into the value of your preferred shares. However, as the assets in the company grow in value, the value of the common shares will also grow. You can continue to control the assets in the company by ensuring that you can outvote the common shareholders. Control can also be achieved through the use of a family trust.

If you already have an incorporated business where you hold the common shares, there are two main estate freeze alternatives. First, you can use a holding company freeze by simply transferring the shares of your corporation to another corporation, as we just discussed, in exchange for preferred shares. Alternatively, you can reorganize the share capital of your existing corporation to accomplish the freeze. Under this scenario, you would transfer your common shares back to your corporation in exchange for preferred shares. Your beneficiaries could then subscribe for new common shares.

Although there would be a number of factors to discuss with your BDO advisor, a holding company freeze can provide additional benefits that are well suited for the current economic environment. If your business corporation has funds that are not currently needed in the business, these funds can be paid by the business corporation to a holding company on a tax-free basis. This will help ensure that the funds will be isolated from future business risks that may arise in the business corporation without a tax cost. It may even be possible to take this planning one step further by borrowing to pay a larger dividend to the holding company and loaning the funds back to the business corporation on a secured basis to pay off this loan.

Before undertaking an estate freeze, you should carefully consider whether you will have enough assets to live on without the future growth of the frozen assets. It is possible to structure the freeze so that you can reclaim future growth, but this will usually undo the value provided by the freeze.

What if I'm not sure whether a full estate freeze makes sense?

If you are unsure whether now is the right time to freeze the value of your assets, keep in mind that there are other options, such as:

- **Do a partial estate freeze** – Under this option, once the value of the assets has been frozen (as an interest in preferred shares), you can subscribe for some of the new common shares along with other family members. This will ensure that you participate in future growth while still deferring tax on some of the growth. In the future, once you are satisfied that you have accumulated enough value based on the preferred shares and your new common shares, you can freeze again to exchange your common shares for additional preferred shares.
- **Freeze the value of common shares later if necessary** – If you do discover that you need additional wealth later, it may be possible to freeze the common shares held by your family and then all of you can subscribe for new common shares, so that you can participate in growth accruing after this freeze.
- **Thaw the freeze** – Provided that a family trust is used to hold the common shares for your family, it may be possible to undo a freeze in the future by naming you or your spouse as a beneficiary of the trust.

How does an estate freeze reduce or eliminate tax?

As we have just discussed, an estate freeze allows you to lock in the value of your investments, which in turn means that the capital gain on death that you will face will also be locked-in at current levels. This means that future growth will accrue for the benefit of other, younger family members. A tax deferral will be achieved if they continue to hold the common shares after your death.

When deciding on whether an estate freeze makes sense, there is one key issue to consider: will your family continue to hold the property in question, or will they sell it when you pass away? If your family will sell the property, then this will reduce or eliminate the tax deferral benefit.

However, even if the property in question will be sold, it is important to remember that an estate freeze will allow you to multiply a key tax reduction tool — the capital gains exemption. If the shares

of your corporation are shares of a qualified small business corporation or are qualified farm property, you can shelter up to \$750,000 of gains (\$375,000 of taxable capital gains) from tax by claiming the exemption. Each member of your family can be eligible provided that they realize appreciation as a shareholder.

Does an estate freeze provide other benefits?

In addition to the tax deferral benefit and the ability to multiply the capital gains exemption, an estate freeze can provide other benefits, such as:

- **Income splitting** – If you already have a corporation and you want to split income with other family members, a common first step is to freeze the value of the corporation so that family members can buy common shares at an affordable price using their own money.
- **Probate tax planning** – Where probate fees are an issue, freezing the value of a corporation will also lock in the probate tax on death. In Ontario, transferring assets to a corporation can also ensure that probate tax will not be payable at all with proper will planning.

I like the idea of an estate freeze, but I don't want my family members to hold shares of my corporation right now. Is there an alternative?

Yes there is. One common concern for most business or portfolio owners is losing control over the property that they want to freeze. Another issue is that the current owner may like the concept of transferring future asset appreciation to the next generation in general, but they are not ready to decide now on who specifically should get this future growth. A discretionary family trust is a tool you can use to deal with both issues.

The main advantage of a trust is that it allows you to separate the control and management of an asset from its ownership. This fact makes trusts a powerful tool. How is this accomplished? It all stems from the legal arrangement involved in setting up a trust and the tax rules that apply to them. A trust is a legal relationship between three different parties. First, there's the settlor of the trust. This is the person who sets up the trust and contributes assets to it. The settlor also sets out instructions on how the assets are to

be used or managed and who will benefit from them. These instructions are set out in the trust agreement. Next, the person (or group of persons) the individual appoints to control and manage the assets in the trust is known as the trustee(s). Finally, there's the person, or group of persons, who will benefit from the assets owned by the trust. They are known as the beneficiaries. Most family trusts are discretionary, which means that the trustee can decide at a later date who will benefit from the trust capital and income.

When you combine the legal and tax aspects, a family trust essentially allows you to set aside property for a group of beneficiaries under the care of a trustee and you can decide later who gets the property. In the context of an estate freeze, it will be this family trust that buys the common shares after you have received preferred shares in exchange for your property. Future appreciation will accrue to the beneficiaries as a group, and not to you. Once you are ready, you can transfer the common shares from the trust to the beneficiaries without triggering a tax liability.

There is a catch to this planning — a family trust will be deemed to dispose of its property after 21 years. Therefore, you will need to keep this in mind when you set up the trust, and the key question will be whether you'll be ready within 21 years to split up the common shares and transfer them to your beneficiaries on a tax-deferred basis.

I have already frozen my estate and set up a family trust. However, the value of my company is now lower. Is there anything I can do?

If you have already done an estate freeze, there is usually no reason why you can't freeze again. Many refer to this as a "refreeze". Although we won't go through the details of how you can accomplish a refreeze, what it effectively allows you to do is replace the estate freeze preferred shares you now hold with new preferred shares that are worth the current reduced value of the corporation. It may also be necessary to take back the common shares your beneficiaries hold, and issue new shares to them. The specific steps will vary, and you can discuss this with your BDO advisor. One key point when refreezing is to have documented reasons why the value of the corporation has declined in the form of a valuation.

An estate refreeze can produce a number of benefits that include:

- **Increase/accelerate access to the capital gains exemption** – Under the original freeze, any value recovery on a go forward basis will generally accrue to the preferred shares until the value of the company reaches the redemption value of those shares. If you refreeze, the value recovery after the refreeze should accrue to the common shares owned by family members. This will increase the gain that will qualify for the capital gains exemption, and will allow an earlier exemption claim if the shares are sold.
- **Tax liability on death can be locked-in again at a lower amount** – Once you have frozen your holdings at the current lower value, this will mean that the gain that will be taxable on death will be lower.

- **Defer the 21-year rule for trusts** – As part of your refreeze, you can wind up the family trust that you used for the original freeze, and set up a new family trust. The new trust won't have a deemed disposition of its property until 21 years after the date of the refreeze. Even if the value of the corporation has increased, a second freeze with a new trust can provide a longer tax deferral on future growth.

Although tax planning may not be at the top of your mind under the current economic conditions, this is an excellent time to set up or update your estate plan. Please keep in mind that we have discussed the issues involved in general terms, and specific tax advice is needed. Your BDO advisor is ready to help you with every step along the way.

US Foreign Bank Account Reporting – The US Treasury Expands Their Reach

The US has some of the most complicated filing requirements in the world. Canadian businesses who carry on business in the US have to pay particular attention to these requirements in order to avoid substantial penalties for failure to file. A recent change to the instructions to a US Treasury financial reporting form may require certain Canadian residents and Canadian corporations to disclose the existence of their Canadian financial accounts.

The filing is Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR). The US Treasury requires a US person to file a FBAR to report any financial interest in, or signature or other authority over, foreign financial accounts, such as Canadian bank accounts, in which the aggregate value of these financial accounts exceeds \$10,000 US at any time during the calendar year. The form is completed on a calendar year basis and is due on June 30th — therefore the filing deadline for 2008 is June 30, 2009.

The change, which applies to all FBAR filings made after 2008 (and therefore would apply to the 2008 calendar year), is with respect to who has to file a FBAR. Previously, a FBAR had to be filed by a US person, which is defined as a citizen or resident of the US, a US domestic partnership, a US domestic corporation, or a US domestic estate or trust.

Effective for filings made after 2008, the US Treasury has expanded who has to file a FBAR to include “a person in and doing business in the United States”. This could include a Canadian individual or corporation who is conducting business in the US, even if the individual or corporation is not subject to US Federal tax on its business activities because they do not have a permanent establishment in the US. The penalties for not filing when required are substantial.

If you or your corporation is conducting business in the US, talk to your BDO advisor about whether you need to file a FBAR.



A Good Tax Reason to Renovate your Home...



In an effort to stimulate the economy and, in particular, the housing sector, the federal government introduced the Home Renovation Tax Credit (HRTC) in the 2009 federal budget. This temporary tax credit allows individuals to claim a 15% non-refundable tax credit for eligible expenditures made in respect of eligible dwellings. This article explains what this means to you and how you can take advantage of this newly proposed credit.

How Much is the HRTC Worth?

The HRTC applies to eligible renovation expenditures between \$1,000 and \$10,000, resulting in a maximum federal tax credit of \$1,350 $[(\$10,000 - \$1,000) \times 15\%]$. To date, none of the provinces, with the exception of Québec, have decided to offer a similar credit.

When am I eligible to claim the HRTC?

The HRTC will be based on eligible expenditures for work performed or goods acquired after January 27, 2009, and before February 1, 2010. If you are contemplating renovations to your home, now would be a good time to get this underway.

Expenditures incurred pursuant to an agreement that was entered into before January 28, 2009, will not qualify for the HRTC. Therefore, even if the work was performed after January 28, 2009, but was based on an agreement entered into before that time, those expenditures will not qualify for the HRTC.

What types of expenses are eligible for the HRTC?

To qualify for the HRTC, expenditures must be incurred in respect of renovations or alterations of an eligible dwelling that are of an “enduring nature” and are “integral to the dwelling itself”. Eligible expenditures include building materials, fixtures, equipment rentals, permits, labour and professional services. Examples of eligible expenditures include, but are not limited to:

- Renovations to a kitchen, bathroom or basement;
- New carpeting or flooring;
- Building an addition, garage, deck, garden/storage shed, fence;
- Re-shingling a roof;
- Installing a new furnace, woodstove, boiler, fireplace, water softener or water heater;

- A new driveway or resurfacing a driveway;
- Painting of the interior or exterior of a house;
- Window coverings directly attached to the window frame and whose removal would alter the nature of the dwelling;
- Laying new sod;
- Swimming pools (permanent — in ground and above ground); and
- Fixtures (including lights and fans).

Expenditures related to routine repairs and maintenance would not be considered eligible expenditures. Examples of these types of expenditures include:

- Purchasing of furniture, appliances, and audio and visual electronics;
- Purchasing of tools;
- Cleaning carpets;
- House cleaning;
- Maintenance contracts (e.g. furnace cleaning, snow removal, lawn care, and pool cleaning); and
- Financing costs.

What is an eligible dwelling and who can claim the credit?

In order to claim the HRTC, expenditures must relate to an eligible dwelling, which is either your or your family member’s principal residence. A principal residence is a housing unit owned and ordinarily inhabited by you, your spouse or common-law partner, or your children in the year. What this means is that your house or another property such as a cottage are both an eligible dwelling for purposes of this credit. If you earn business or rental income from part of your principal residence (i.e. you rent out your basement or another portion of your home) you will only be allowed to claim the credit for expenditures made for the personal use areas of the residence — not the areas that are rented out.

The HRTC is limited to one per family. As a result, family members will be subject to a single limit based on their pooled expenditures. A family is considered to include you, your spouse or common-law partner and children who are under 18 years of age. To the extent that you are unable to utilize the entire HRTC, the unused portion may be used by other family members. In

circumstances, where two or more families share ownership of an eligible dwelling, each family will be entitled to claim its own HRTC, as if the family owned the dwelling alone.

If you live in a condominium or co-operative housing corporation your share of eligible expenditures incurred in respect of common areas will also qualify for the HRTC.

How do I claim the HRTC?

You will claim the HRTC on your 2009 personal tax return, even for eligible expenses incurred in January 2010. You should maintain copies of all documentation that supports your claim — you do not have to file this with your tax return but you will have to produce it if a tax auditor wants to verify your claim. Agreements, invoices, and receipts which clearly identify the type and quantity of goods purchased or services provided are examples of what the CRA considers to be

acceptable documentation. The CRA specifically states that documentation must include:

- information that clearly identifies the vendor/contractor, their business address and, if applicable, their GST/HST registration number;
- a description of the goods and the date when the goods were purchased;
- the date when the goods were delivered (keep your delivery slip as proof) and/or when the work or services were performed;
- a description of the work performed including the address where the work was performed;
- the amount of the invoice; and
- proof of payment. Receipts or invoices must indicate paid in full or be accompanied by other proof of payment, such as a credit card slip or cancelled cheque.

If you need more information on the HRTC or have any questions regarding your eligibility to claim the credit, contact your BDO advisor.

... Also Good News for Those in the Home Renovation Industry

As we just discussed in the previous article, the Home Renovation Tax Credit (HRTC) for individual taxpayers who renovate their homes was introduced in an effort to stimulate the economy and, in particular, sales in the home renovation industry.

For those in the home renovation industry, there are some important things you must remember about this credit. To begin with, it is a temporary tax credit that only applies to expenditures for work performed or goods acquired after January 27, 2009 and before February 1, 2010. As well, the credit is only applicable to certain expenditures and does not apply to routine repairs and maintenance.

And finally, in order for an individual to claim the credit, eligible expenditures must be supported by sufficient documentation. As a result, it is important to make sure that any invoices that you issue or contracts that you enter into include a sufficient amount of detail.

The HRTC can benefit both you and your customers. If you have not done so already, you may want to refer to the HRTC in your marketing materials and advertising.

If you need more information on the HRTC or assistance in preparing any marketing materials that discuss the HRTC, contact your BDO advisor.



Recent BDO Tax Publications

The following new BDO Tax publications are now available:

- 2009 BDO Budget Reports – Federal, British Columbia, Alberta, Manitoba, Ontario, Québec and Prince Edward Island
- Tax Alert – Income Splitting Just Became More Attractive

As well, the following BDO Tax publications have been updated:

- Fast Facts – Failure To Pay Tax Instalments Can Be Costly
- Tax Bulletins – Automobile Expenses and Recordkeeping, U.S. Tax Issues for Canadians and Tax Consequences for U.S. Persons in Canada

To obtain a copy of any of the above publications, contact your BDO advisor or visit the BDO Library area of www.bdo.ca



Employee Stock Benefits and Capital Losses Don't Mix

With stock market declines in the current troubled economy, investors are definitely feeling the negative effects on their stock portfolios. Stock based compensation may also be leaving employees in a bad situation, not only from an investment perspective but also from a tax perspective. In particular, employees who have purchased shares through an employee share purchase plan (ESPP) or who have exercised employee stock options, and who are still holding their shares, may be impacted by an unfavourable tax consequence due to the significant market declines.

When shares are purchased, stock based compensation will generally result in a benefit to the employee that is taxed as employment income, to make up the difference between the value of stock acquired and how much the employee actually paid. But later declines in the share price can lead to capital losses when shares are sold. Unfortunately, our tax system does not allow the benefits to be offset by the capital losses. This issue isn't new. In fact, its impact was quite significant in the early part of this decade when there were significant stock market declines, particularly in the technology sector. With the economy currently in turmoil, the issue is likely significant again. To get a better understanding of the issue, let's take a look at the tax treatment of stock based compensation in more detail.

The Tax Treatment

Employee Share Purchase Plans

Employee share purchase plans allow employees to use their after-tax earnings to purchase shares of their employer, often at a discount. Or, the employer may match funds that the employee uses to buy stock. Under either variation, the employee will be required to report a benefit — the difference between the amount paid and the fair market value of the shares at the purchase date — as employment income. These plans normally require employees to hold the shares purchased for a specified period of time before they are able to sell. Or, employees may not actually be given the share certificates until a specific time in the future. Where the value of the shares declines before a sale can be arranged, the eventual sale of those shares will result in a capital loss, which

can't be applied to reduce the employment income benefit.

Stock Options

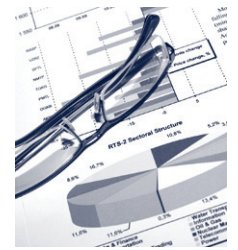
Where an employee is granted stock options by a public company, a benefit will arise when the options are exercised to purchase the shares. The benefit will be the difference between the exercise price and the fair market value of the shares at the time the shares are exercised and it will be treated as employment income at that time. If the employee does not immediately sell the shares and the share value declines, a capital loss will arise when the shares are later sold. Again, the capital loss can't be used to reduce the benefit.

A favourable tax rule does allow employees to claim a 50% deduction against the employment income benefit from stock options, where certain conditions are met. As a result, the amount of tax paid on the benefit may be the same as the amount paid on a capital gain — but the benefit is still treated as employment income.

Note that in certain cases, the employment income benefit may not be taxed until the shares are sold. This applies to the shares of Canadian-controlled private corporations and certain public companies where specific conditions are met. However, this does not change the tax consequences as described. Although, the benefit is not taxed until the shares are sold, the benefit will still be considered employment income and capital losses realized can't be used to reduce this income.

What You Need to Consider

From the point in time that the shares are purchased under a stock compensation plan, it is the government's policy that the tax consequences will be similar to those of other stock market investors. They believe that once you purchase the shares, you are in fact accepting the market risk if you choose to hold the shares. This is the same as for other investors who purchase share investments using their regular employment income in hopes of earning a return on their investment, while accepting the risk that the share price may decline. Where a capital loss arises, it can't be used to offset income other than capital gains. Unfortunately for many individuals who hold shares of their employer through an ESPP



or from exercising employee stock options, these shareholdings may be their only capital property and they may not realize capital gains on other investments. Therefore, it is important to consider the tax consequences when making investment decisions.

With stock options, if you are not ready to sell your shares, consider holding the options as long as you can — until you are ready to sell. If the options are expiring and you need to exercise them, consider selling the shares immediately after you exercise the options to avoid capital losses. However, if you don't want to sell all of your shares immediately, consider selling at least a sufficient number of shares for proceeds to cover the tax liability on your employment benefit. Then consider your remaining holdings as an investment that could result in either a capital gain or capital loss.

If you are a member of your employer's ESPP, it may not be possible to avoid having an employment income benefit and a capital loss

when the market is declining and your plan requires you to hold the shares for a specified period after you purchase them, or the shares will not be distributed to you until later. If you find yourself in this position, your decision will ultimately be an investment decision. Hold on to the shares if you think that their value will increase, or sell the shares and realize the capital loss. If you have realized capital gains on other investments or have the future potential to do so, you can use your capital losses to offset the capital gains on those investments.

There are a number of factors to consider when it comes to your investment portfolio — including the uncertainties of when to buy and sell — particularly in a tumultuous market. It is always important to keep in mind the tax consequences of your investment decisions, as they can have an impact on your cash situation as well as your investment return. If you have questions concerning the tax treatment of your stock based compensation, contact your BDO advisor.

Coming Soon BDO Tax Bulletins — Ontario Harmonized Sales Tax

In its most recent budget, the Ontario government announced that it will harmonize the provincial sales tax (PST) with the federal GST on July 1, 2010. As a result the combined tax rate will be 13% (5% federal and 8% Ontario). Ontario's share of the new harmonized tax will be collected by the Canada Revenue Agency. The change to a harmonized sales tax will affect businesses both small and large, and individual taxpayers.

The Ontario government has stated that additional details will follow in the coming months to help taxpayers and businesses prepare for the proposed changes. As well, you can look forward to the release of two separate BDO Tax Bulletins which will discuss the impact that the harmonized sales tax will have on businesses and public service bodies.



This is a publication of BDO Dunwoody LLP on developments in the area of taxation. This material is general in nature and should not be relied upon to replace the requirement for specific professional advice. The information in this document is current as of April 30th, 2009.

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