

# TAXTICS

July 2004

## *Married Individuals - Income Splitting & Tax Savings*

*inside*

Married couples (including common-law partners) can generally save thousands of dollars in taxes over their lifetimes by ensuring that their incomes are split as evenly as possible amongst each spouse. The savings are as a result of the lower tax rates available at lower levels of income. One or more of the following ideas may help reduce your tax bill.

### **Loans to spouse**

The higher income spouse makes a loan to the lower income spouse at the prescribed rate of interest (July through September 2004, 2%). Provided the lower income spouse can generate a return greater than 2%, the overall tax burden of the couple will fall. The spouses should document the amount advanced and the interest rate by way of a long-term promissory note. It is essential that the interest be paid no later than 30 days after the end of the year.

### **Use of funds**

The higher income spouse could use all of their income to pay for household and personal living expenses while the lower income spouse uses all of their income (maintained in a separate bank account) for

investment and savings purposes. The married couple would achieve a greater after-tax return on their investments.

### **Retirement assets**

The higher income spouse could make contributions to a spousal RSP for the benefit of the lower income spouse. The overall taxes paid during retirement would be lower if retirement incomes are comparable. This could also potentially prevent the claw-back of government benefits. A couple could also ask the government to split their CPP entitlements.

### **Shifting losses**

This planning idea is best explained by way of an example. Mr. A, who has never realized a capital gain or loss in the past, owns 100 shares of Nortel with an accrued loss, whereas Mrs. A has realized capital gains in the year.

Mr. A would sell 100 Nortel shares and Mrs. A would acquire 100 Nortel shares within 30 days thereafter. Provided Mrs. A owns her 100 Nortel shares on the 30<sup>th</sup> day after the original disposition, then the capital loss of

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# *U.S. Vacation Properties – The Changing Environment*



Over the last several years, Canadians have been acquiring personal-use U.S. vacation properties in ever-increasing numbers. One question that should always be considered upon the acquisition of such a property is how to structure ownership. The question is of more than academic interest. The owner of such a property will be exposed to Canadian capital gains tax in the event the property is sold or gifted to a person other than his or her spouse. Canadian capital gains tax will also arise upon death (with the possibility of some limited spousal deferral) if the property is still owned at that time. As if this in itself is not enough, the owner will also be exposed to U.S. capital gains tax upon sale of the property (although this tax would normally reduce or even eliminate any Canadian capital gains tax payable on the sale). The taxpayer will also be faced with U.S. gift tax in the event the property is gifted during his or her lifetime and U.S. estate tax upon death. Proper planning can avoid double taxation but even the best planning cannot anticipate all the possibilities.

In the early 1980's, the most common planning technique was to acquire the property in a single-purpose Canadian company. The major problem faced by owners at that time was the fact that death would give rise to capital gains tax in Canada and estate tax in the U.S. with no opportunity to offset one tax against the other. Similar concerns arose for gifts of the real estate during the lifetime of the owner. Use of a Canadian company, at least arguably, would shield the Canadian owner from exposure to U.S. gift or estate tax and would therefore avoid double-taxation. Although both U.S. and Canadian capital gains tax would arise upon a sale of the property, Canadian taxpayers could claim a foreign tax credit for the U.S. capital gains tax and thereby avoid double taxation. U.S. tax advisors were (and perhaps remain) less optimistic than Canadian advisors about the effectiveness of this type of planning. One Canadian concern did arise with the use of a Canadian corporation. Would the company be viewed as conferring a benefit on the shareholders if the shareholders were allowed to use the property rent-free? Fortunately, the Canadian tax authorities agreed as early as 1980 not to assess a benefit as long as certain guidelines were followed.

Subsequent case law provided further assurances that taxable benefits would not arise if the shareholders carefully planned the acquisition and continued to pay attention to detail. Three major developments have taken place over the last decade that suggest this type of planning should be reconsidered (but not necessarily abandoned) for future acquisitions.

The first significant event occurred in 1995 when the treaty between Canada and the U.S. was renegotiated. Canadian individuals could now claim a foreign tax credit for U.S. estate tax arising on death (but still could not claim a credit for gift tax). This reduced, or in some cases even eliminated, the double taxation that previously existed on death where the U.S. property was owned personally. In addition, estate tax exemption limits for Canadians were increased in some cases. This somewhat reduced the need for using Canadian companies as part of the planning.

At the same time, personal capital gains tax rates declined in both countries to the point where these rates are now considerably lower than U.S. corporate rates of tax. The higher of the two personal rates is the Canadian rate of approximately 23%. However, this is still significantly lower than the U.S. corporate rate which can be as high as 40% when state tax rates are taken into account. A real penalty is therefore imposed on corporate ownership of U.S. real estate at the time the real property is sold if the property is sold at a gain.

Lastly, the Canada Revenue Agency announced on June 23, 2004, that it was revoking its policy regarding corporate ownership of personal use property. The administrative policy will continue to be applied to those arrangements currently in place. Does this mean that future corporate acquisitions of U.S. property will necessarily give rise to taxable benefits thereby further reducing the attractiveness of corporate ownership? Not necessarily. Remember that there is Canadian case law on the taxpayer's side. What we do know is that the decision to discontinue the administrative policy does add some uncertainty and some reason for concern. What we don't know is whether this change in policy signals a renewed interest on the part of the authorities in reviewing the Canadian tax consequences for shareholders of Canadian corporations owning U.S. personal-use vacation properties.

Does this mean the end of corporate ownership for future purchases of U.S. vacation properties? No, but it does mean that arriving at a decision will be that much more difficult. It also means, because of all the variables and uncertainty involved, that there will be a greater risk of making what proves to be, with the benefit of hindsight, the wrong choice.

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# *They're watching – Be aware of state tax issues when selling to U.S. customers*

In recent years, state taxing authorities have become more aggressive in arriving at ways to increase their tax revenue base in order to overcome decreases in federal funding. To avoid negative public reaction from residents, many states have been actively pursuing foreign corporations doing business in their state for additional tax revenue. These corporations may be subject to state income taxes, sales taxes and/or franchise taxes.

In many cases, companies that are being sought after by state authorities are exempt from U.S. federal taxes since they do not have a permanent establishment in the U.S. based on its tax treaty with Canada. However, states are not bound to follow the treaties entered into by the U.S. federal government. Instead, individual states subject foreign corporations to taxes based on the concept of “nexus”, which refers to the minimum connection required for a state to impose tax. Although the nexus threshold varies from state to state, the requirements to establish nexus are significantly lower than what is required for a company to have a permanent establishment under the tax treaty.

Canadian companies can avoid creating a permanent establishment in the U.S. by soliciting customers through independent agents. Where employees are sent to the U.S. to solicit business, actual orders would be sent back to Canada for processing and approval. In contrast, the concept of nexus covers a greater scope of activities that would not otherwise constitute a permanent establishment, such as: company employees visiting U.S. clients, delivering goods to U.S. clients using own trucks, driving through a particular state in the course of business, and employees soliciting orders regardless of where the contract is concluded.

Depending on where a corporation has nexus, it could be required to compute its state taxable income in a variety of different ways. Some states base a foreign corporation's computation of taxable income on an allocation of its worldwide income. This can increase a Canadian company's vulnerability to certain Canadian-source profits being subject to U.S. taxation. Even where a foreign corporation does not have any taxable income for state tax purposes, it may be subject to a minimum fixed dollar amount for the privilege of doing business in that state.

The states have become more aware of and are monitoring the activity of foreign corporations doing business in their state. There are approximately 22 information sharing agreements between states and the states gather information from the Internal Revenue Service and the United States

Customs Service as well. Once a state is informed of the foreign company's presence, they will typically send out a “nexus” questionnaire. It is recommended that you do not complete the questionnaire without first contacting your accountant. Once the state has determined that a company's operation in a state triggers nexus, the state's department of revenue will write to the foreign corporation demanding payment of current and past-due taxes, plus interest and penalties. The company may potentially be liable for the entire period it has been active in the state.

Most states have voluntary disclosure programs that allow delinquent taxpayers to voluntarily and anonymously come forward and resolve past tax liabilities. Most states will only require repayment of taxes for the previous 3-5 years. In addition, many states will waive penalties, and some may even give a break on interest. Some states also offer a tax amnesty program periodically to allow delinquent taxpayers to come forward and resolve outstanding liabilities. The states tend to offer greater relief from interest and penalties under the amnesty program than they do by way of a voluntary disclosure.

For a Canadian corporation doing business in the U.S., state tax can pose significant risks that may initially go undetected. State and local statutes vary in their application and interpretation, which results in little uniformity between jurisdictions. Canadian corporations should carefully review their U.S. activities to determine whether they have nexus in a particular state – and if so, assess how to minimize the tax exposure.

*Rob Steven, C.A., MAcc*

*Tax Associate, Crawford, Smith & Swallow, LLP*



**ANNOUNCEMENT**

The partners and staff of Crawford, Smith & Swallow Chartered Accountants LLP are pleased to announce the appointment of Chris Bodnar, CA as a tax partner in the Firm.

Chris graduated from Brock University in 1998 receiving an Honours Bachelor of Accounting degree. He has completed the Canadian Institute of Chartered Accountants In-Depth Tax Course.

Chris provides tax advisory services to individual, trust and corporate clients of our Niagara Falls, St. Catharines and Fort Erie offices. His specialized areas of practice include estate planning, corporate reorganizations and U.S. taxation.

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## ***Married Individuals: Income Splitting & Tax Savings cont'd***

Mr. A is added to the cost base of her Nortel shares. By then disposing of her Nortel shares, Mrs. A would be able to recognize a loss and offset her other gains.

The accrued capital losses in the above example could also be transferred directly to one spouse by way of a sale at fair market value. By ensuring that fair value consideration is given, the income attribution rules will not apply.

### **Private business owners**

If one spouse operates a profitable business it may be desirable to split the income of the business between the spouses. This could be accomplished by introducing the other spouse as a shareholder or paying them a reasonable fee for services rendered. Having a spouse as a shareholder would also multiply access to the \$500,000 capital gains deduction on the sale of a business.

### **Testamentary spousal trusts**

Where one or both spouses have accumulated significant assets they may want to establish a testamentary spousal trust

in their wills. The income of the trust would be available to the surviving spouse during his/her lifetime. Income earned will be subject to a lower rate of tax in the trust than if combined with the spouse's existing income. The settlor of the trust would decide in his/her will how the balance of the assets of the spousal trust are to be distributed on the death of the surviving spouse.

It is important to remember that there are non-tax implications to the above planning ideas that should be carefully considered.

*Chris Bodnar, C.A.*

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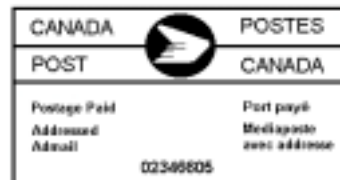
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