

# Newsletter

Fall 2007

## CHANGES TO THE CANADA – US INCOME TAX TREATY

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After almost 10 years of negotiation, on September 21, 2007, Canada's Minister of Finance and the US Secretary of the Treasury signed the long-awaited Fifth Protocol to the Canada-US Income Tax Convention (the "Treaty"). Unless otherwise noted, the changes will become effective on the later of January 1, 2008 or the date that the governments of both countries ratify the agreement.

The information that follows is meant as a brief summary of the more significant changes in the Protocol. If you may be affected by the new Protocol or are undertaking planning that maybe affected by the Protocol, we recommend you contact your tax advisor.

### Elimination of withholding tax on interest

The current rate of withholding tax on interest paid to a US resident is 10%. The withholding will be eliminated for interest paid to unrelated non-resident

lenders. For interest paid to related non-resident lenders, the maximum withholding rate will be reduced to 7% for the first calendar year the exemption becomes effective, will further reduce to 4% for the following year and is eliminated in the third and subsequent years.

### Limited Liability Companies (LLCs) and Other Hybrid Entities

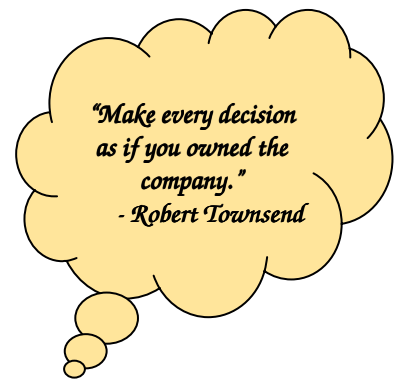
Flow-through or hybrid companies such as the LLC are popular entities used in the US to carry on business. The Protocol addresses a problem under the current Treaty which denies treaty benefits to these types of entities. Income earned by a resident of the US through a hybrid entity, such as an LLC, will be treated by Canada as having been earned directly by the resident of the US. For example, where a US investor carries on business in Canada through an LLC, payments made to the LLC such as dividends, interest and royalties will now be eligible for a reduced rate of withholding tax under the Treaty.

### Denial of Treaty Benefits for Certain Hybrid Entities

The Protocol also contains rules to deny treaty benefits to certain other hybrid entities often used in cross-border planning and financing structures. In

### Inside this issue:

<b>Changes to the Canada— US Income Tax Treaty</b>	<b>1-2</b>
<b>Strong Canadian Dollar— Caution Buying US Assets</b>	<b>3</b>
<b>Some Things to do Before December 31</b>	<b>4</b>



### Special points of interest:

- **Personal tax instalments:**
  - December 15, 2007
  - March 15, 2008
  - June 15, 2008

## CHANGES TO THE CANADA – US INCOME TAX TREATY (CONT'D)

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particular, the changes may impact the popularity of Canadian entities known as ULCs (unlimited liability companies) as a vehicle for a US person to invest in Canada. Fortunately, these rules are not effective until 2010, at the earliest, which will allow time to review the impact of these changes and plan accordingly.

### Service Providers and Permanent Establishment

In general, a service provider who is resident in one country and provides services in the other country is only subject to income tax in the other country to the extent services are provided through a permanent establishment or fixed base in the other country. The Protocol provides for a deemed permanent establishment if the services are performed by an enterprise that is present in the other country for 183 days or more in aggregate in a 12-month period and more than 50% of the gross revenues of the enterprise are derived from those services. There is also a deeming provision for services provided for 183 days or more in a 12-month period with respect to the same or connected projects.

These new measures are likely to have a significant effect on consultants providing services on both sides of the border. The changes will be generally effective for the third year of a taxpayer that ends after the Protocol comes into force.

### Taxpayer Migration – Avoiding Double Tax

An individual leaving Canada is deemed to dispose of certain capital properties and is subject to Canadian tax at that time on the gains that arise. In the US, taxation occurs when the property is actually sold and is based on the original cost. The Protocol provides that an individual may also elect to be taxable in the US as if the assets were sold at the time of leaving

Canada. This change will help ensure that Canadians emigrating to the US will not be subject to double tax. The changes will apply to emigrations that took place after September 17, 2000.

### Pension Contributions

It is becoming more common for employees to live in one country and work in the other or to move from one country to the other on a short-term work assignment. To accommodate the movement of employees between Canada and the US, the Protocol will permit commuters or short-term assignees to deduct contributions made to their home country pension or retirement plan. For example, a Canadian working in the US could continue to pay into a Canadian retirement plan and deduct the contributions for US tax purposes.

### Employee Stock Options

The Protocol clarifies the sourcing of employee stock option benefits for employees who are granted stock options while working in one country and then go to work for the same or a related employer in the other country. At present, the Treaty provides no specific rules for apportioning the stock option benefits between Canada and the US, which may lead to double taxation. The Protocol provides that the stock option benefit will be apportioned or sourced based on the location of the individual's principal place of employment during the time between the granting of the option and its exercise (or the disposition of the share).



## STRONG CANADIAN DOLLAR – CAUTION BUYING US ASSETS

Author: Hugh Faloon CA, CFP, TEP, Partner, Ginsberg Gluzman Fage & Levitz, LLP, Chartered Accountants



The Canadian dollar is strong, and you're heading down south for the holiday season. The real estate prices in Florida are down. Please, do not buy any real estate in the US before you speak with your accountant! Also, make sure your accountant understands US income tax and US estate tax.

If the value of your US assets, including the Florida property, exceeds \$60,000 US, your estate will be subject to US estate tax - up to 46% of the value of the US assets - even if the assets did not increase in value.

The US estate tax exemption for 2007 and 2008 for an American citizen or resident is \$2,000,000. Canadian residents are entitled to a share of the \$2,000,000 exemption, based on their fraction of the value of their US-based assets, divided by their worldwide assets.

In some cases, proper family planning can solve the US estate tax cost. If the value of the US real estate is around \$120,000 US, and you are sharing it with your spouse or family, the property ownership could be divided between your spouse and/or family members to multiply the US estate tax exemption. Each family member must pay their share of the cost of the property for this simple plan to work. The IRS

could ask the estate to prove each person actually paid for their share of the property; and, if there is no proof, we have heard that the IRS will assume the first person to die paid for the property.

If the value of the US property is well in excess of the US estate tax exemption, one of the current planning methods is to purchase the property in a Canadian trust. This is a strategy that may be useful where the size of the investment justifies the cost of setting up the trust.

Also, please do not rent your US real estate without speaking with your accountant as other significant issues may arise.

Other US assets you may consider purchasing are US stocks. Did you know you have to track the cost of the stocks in Canadian dollars? Did you know dividends from US companies are taxed as regular income in Canada; meaning, in BC, the maximum tax rate is 43.7%. The maximum tax rate on Canadian public company dividends is 18.4%. The tax on the capital gains on the sale of US stocks is no different than Canadian public company shares.

Consider also that the value of the US stocks held in your personal account may be included in the US asset base for US estate tax.

If you are thinking of investing in a US business, beware—the taxation of US corporations is very different than in Canada. Investing in the incorrect corporate structure could result in double taxation. What's good for US residents is not necessarily good for Canadian residents.

## SOME THINGS TO DO BEFORE DECEMBER 31

Author: **Hugh Faloon CA, CFP, TEP, Partner, Ginsberg Gluzman Fage & Levitz, LLP, Chartered Accountants**

- Make your \$2,500 contribution to your RESP to get the \$500 government grant.
- Pay your December 15 personal tax instalment.
- Make your donations to maximize your tax credits. Donations greater than \$200 equal a tax credit at the top marginal personal income tax rate.
- If you have high taxable capital gains and no capital loss carry forward, consider selling stocks in a loss position that you and/or your investment advisor no longer consider to be a good investment to realize losses with which to offset the gains. The higher Canadian dollar may have created accrued losses on your US based stocks.
- To earn the maximum 2008 RRSP contribution of \$20,000, you need to have earned income of at least \$111,111. Earned income includes salaries, self-employed and rental income, but is reduced by self-employed and rental losses. For planning purposes, remember that your annual addition to your RRSP contribution room is 18% of your "earned income".
- Businesses with December 31 year ends should buy and put in use assets required in the New Year in December to accelerate tax depreciation.



### Caution Regarding Capital Losses

- If you sell stocks/shares to a related company or spouse, the loss is denied until the stock is sold by your spouse or related company.
- The loss is denied if you, your spouse and/or related company repurchases the same stocks/shares within 30 days of the initial sale. If you wanted to, you could buy the same shares after 30 days.
- DO NOT transfer your personal stocks in loss positions to your or your spouse's RRSP or RRIF account to make your RRSP contribution. You are throwing away the loss. Sell the stocks and use the cash to make your RRSP contribution.



KNV is proud to announce the addition of Lyn Perry, as an Associate and Melissa Coulthard as an Accounting Technician, to our professional services team in Kelowna. Lyn and Melissa will be joining Alix Larsen, a Manager in our Kelowna office, and look forward to serving the corporate and personal tax planning and accounting needs of our Okanagan clientele.

In January of 2008 they will be joined by Aaron Dodsworth as a Senior Accountant.



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