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# Perspective



**Sherry Cooper**  
Executive Vice-President and  
Chief Economist, BMO Financial Group.

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## The Eurozone's Real Problem

The eurozone has far more than a debt problem. If this were the only problem, the move toward a tighter fiscal union and deficit reduction, along with ECB support for banks and sovereign debt markets, could be a lasting solution. But competitiveness is the fundamental problem. It gets far too little attention and is far tougher to deal with.

For Canadians, lagging productivity growth has been a structural problem for years, making it tougher to compete with our number-one trading partner, the U.S., where productivity growth has surged and unit labour costs have fallen sharply over the past cycle. Normally, this divergence would be expected to weaken the Canadian-U.S. dollar exchange rate, and undoubtedly it has had that effect to some degree. But the impact of weaker productivity on the loonie has been more than offset by high commodity prices, the negative effects of the U.S. financial excesses, Washington's political problems and by the American trade and budget deficits. Canada's trade balance with the U.S. has deteriorated sharply, which has been the major dampening effect of the U.S. financial crisis and ensuing recession on the Canadian economy.

Canadian business has been far too slow in shifting trade to the rapidly growing emerging economies, posing both a structural and economic problem. Until we build an East-West pipeline from Ft. McMurray to the deep-sea ports of B.C., Canada cannot export oil to China and elsewhere in Asia. Exports of other products such as lumber and coal have picked up significantly, but far too little to offset the diminished net sales to the U.S.

**“The most likely, but painful path, to redress the imbalances is deflating these economies through a protracted period of recession and hardship.”**

For the eurozone, the productivity differences among the 17-member countries are an even bigger problem and, as Ottawa has learned, you cannot legislate productivity. Germany is by far the most productive economy in Europe and the gap has widened with the restructuring of its labour markets over the past decade. Since 2000, unit labour costs in Germany have risen about 20%–40% less than in the other euro countries. That gap has left Germany with a large intra-European trade surplus while most other countries run deficits. Germany is an export juggernaut, not just with the eurozone, but with China and the rest of the world, which has spurred its economic growth and mitigated the rise in its debt and deficit ratios. German employment hit another post-unification high in October, highlighting the massive disconnect between its current prosperity and the suffering in many other eurozone members.

This was no accident on Germany's part. Berlin was well aware that, by adopting the euro, it was almost certain to benefit from a significantly undervalued currency. By abandoning the deutsche mark, Germany locked into fixed exchange rates with the likes of Greece, Portugal, Italy and others. This virtually guaranteed it would have a sustained competitive advantage vis-à-vis the rest of the world, without being accused of manipulating its currency (like China). And, while Germans complain loudly that the cost of supporting the rest of the eurozone is an unreasonable burden, you better believe that burden has been well worth it, or the Germans would have never supported the creation of the eurozone in the first place.

It was no secret to anyone that the currency union would run into these problems sooner or later. It's amazing it took so long to rupture. The solution for the rest of the eurozone is very difficult. Germany could stimulate its economy and thereby increase domestic consumption, wages and prices, which is simply not going to happen. The other countries can engineer a productivity miracle by restructuring their labour markets and reducing the size of government, incentivizing private investment, encouraging foreign direct investment, building new business sectors, retraining workers, improving education and reducing impediments to wage reduction. While all of these actions are needed, many of them are simply unaffordable and would take years to bear fruit.



The most likely, but painful path, to redress the imbalances is deflating these economies through a protracted period of recession and hardship. When Canada engaged in such an effort in the 90s, the global economy was booming, which

shortened the process and mitigated the pain; and, the situation in Canada was never as dire, and our currency's fall cushioned the blow.

Alternatively, Greece or others could leave the eurozone, the ramifications of which are uncertain, but would certainly involve massive devaluation (estimated at about 60% for Greece), which would destroy that proportion of incomes and wealth while the cost of living would surge. In fear of just this, substantial capital flight from Greece has already occurred. Any move away from the euro would require the freezing of bank accounts and other asset sales and default on government debt, which could trigger panic and potential collapse. Greece would be unable to borrow in open markets, requiring assistance from the IMF and triggering huge losses at the ECB, European banks and other investors. Some even expect this would topple the government and cause civil unrest requiring military action. The return to the drachma would create huge bargains for foreign consumers, tourists and businesses, eventually helping to return the economy to normalcy, but the interim price would be steep and could be frightening. Just how much of it would spill over outside Greece is uncertain.

### Bottom Line:

Over the continued period of turbulence, households and investors must become more prudent, reducing their exposure to debt and repairing their balance sheets as net worth has been damaged by the recent decline in asset values, particularly stocks. Shifting from debt-financed consumption to cash-financed business investment will bear fruit in the medium term, but look for sub-par growth and financial uncertainty for much of 2012. This is a good time for consumers to increase savings and reduce risk.

Canada must still work hard to become more competitive, using corporate cash balances to innovate, invest in technology, hire the best talent from the global pool, thereby increasing productivity. In the U.S., corporate productivity was, in large measure, the result of the willful and unprecedented slashing of payrolls, which has a prolonged negative effect on the economy and society. Canadian business doesn't usually respond that way, although some companies might be forced to adopt such measures if they don't create innovative products and services at a faster pace.

# Tax Planning for the Family Farm

The family farm continues to serve an important role in the Canadian economy and as such it receives special status under Canadian tax law. In particular, there are two key tax planning strategies that can be used when transferring a Canadian farm property. The Capital Gains Deduction, which is the subject of this article, is available to shelter up to \$750,000 of capital gains on transfers of *qualified farm property*. The Intergenerational Rollover, which will be discussed in the next issue of Perspective, permits tax-deferred transfers of farm property to other family members. Both strategies can apply to lifetime transfers (i.e. a sale or gift), or to transfers that take place on the death of the owner. The rules surrounding these strategies are very complex and only a general discussion is provided here. As with all tax planning, professional advice is critical to understand the specific implications in your situation.

## Capital Gains Deduction on Qualified Farm Property

A Canadian resident individual has a lifetime Capital Gains Deduction available to shelter up to \$750,000 of capital gains on a *Qualified Farm Property* which is reduced for previous capital gain deduction claims by the individual. Qualifying property includes land used in a Canadian farming business or an interest in a family farm business owned through a corporation or a partnership. Whether a farming activity is considered a *business* is a further consideration, and will depend on the degree of time and effort expended, amongst other criteria.

There are a number of complex rules relating to this deduction. For example, tests for qualification may include whether the owner is engaged in the business of farming on an active and continuous basis, and whether the farming income was greater than income from all other sources for at least two years. Less onerous tests may apply where the farm property was acquired prior to June 18, 1987. In addition, an individual's personal tax situation must be considered as a history of investment expenses resulting in a cumulative net investment loss may restrict access to the Capital Gains Deduction. Alternatively, the application of Alternative Minimum Tax may result from claiming the deduction, thereby reducing its benefit.



Many tax planning strategies are available to obtain optimal benefit from the Capital Gains Deduction. It may be possible to reorganize the ownership of the *Qualified Farm Property* to *multiply* access to the deduction by making it available to other family members in the future. It may also be possible to immediately trigger the use of the deduction without any change in beneficial ownership through a transaction called a *Crystallization*, which would have the benefit of creating an increased tax cost base in the property, thereby reducing a future capital gain. Tax planning for the deduction is often combined with an *Estate Freeze* which transfers future growth to other family members (typically on a tax-deferred basis) and limits the tax liability upon the transferor's death to the accrued gain at the time of the freeze. Sound tax planning advice by professionals who have specific expertise and experience is recommended to explore opportunities to utilize the deduction during one's lifetime, or as part of a tax-efficient estate plan, since the rules are very technical and complex.

For more information regarding the tax planning opportunities involving farm property, please ask your BMO Nesbitt Burns Investment Advisor for a copy of our publication *Tax Planning for the Family Farm*. Your BMO Nesbitt Burns Investment Advisor can also help you to identify your needs and refer you to the appropriate professional(s) for further assistance in your particular situation.

# Develop your own tax efficiency strategy to save taxes in retirement



**M**aking retirement income last a lifetime is the financial objective of all retirees. Common approaches to meeting this challenge include accumulating as big a retirement nest egg as possible (i.e. increasing the income base), scaling back retirement lifestyle expectations (i.e. decreasing expenditure) and even postponing retirement (i.e. a bit of both, by giving retirement savings more time to grow while simultaneously lowering lifetime retirement income need).

A further strategy, which retirees should not ignore, is achieving tax efficiency.

Many retirees who saved diligently during their working years have accumulated a sizable registered retirement savings plan (RRSP), which is required to be converted into a registered retirement income fund (RRIF) latest by the end of the year a person turned 71. In terms of tax planning, traditional thinking favors:

- Converting an RRSP to a RRIF at the last possible moment (age 71),
- Taking out no more than the legal minimum payment amount from the RRIF every year (and if there is a younger spouse or common-law partner, using his / her age to calculate the minimum amount), and
- Tapping into non-registered assets first if additional income is needed.

The rationale is to minimize the amount of withdrawal from the RRIF, thereby delaying taxes. Moreover, keeping assets inside the RRIF as long as possible enables one to take full advantage of the tax-sheltered growth inside the plan.

Retirees should however be aware of the possible effects of a large RRIF on their tax bill. At age 65, Canadian taxpayers are eligible for the age tax credit and the Old Age Security (OAS) benefit, but these government benefits are income-tested, meaning they may be lost if one's income exceeds a certain level. A person 65 years or older with a large RRIF may find that, receiving just the RRIF minimum amount (together with other incomes – CPP/QPP, OAS and other investment income etc.) will propel them into higher tax brackets, in turn resulting in the loss of these tax benefits.

Advance planning to smooth out one's income level over the course of retirement can help avoid these benefit clawbacks. In planning for tax efficiency in retirement, an understanding that maximizing after-tax lifetime income is not always the same as minimizing current year taxes is required. For some people, it may even make sense to keep the size of their RRSP/RRIF in check by:

- Converting an RRSP to RRIF earlier. The added advantage of conversion at age 65 is the ability to take advantage of the pension income tax credit and pension income splitting.
- Taking out more than the required RRIF minimum during years of lower income (e.g. if you are retired but not yet receiving OAS and CPP/QPP).
- Depositing extra RRIF income into a Tax-Free Savings Account (TFSA) to benefit from continued tax-free growth.

Since everyone's circumstances are different, there is no one-size-fits-all solution for achieving tax efficiency in retirement. To develop your very own strategy, please discuss with your BMO Nesbitt Burns investment advisor.

For further information about the BMO Retirement Institute visit us at [www.bmo.com/retirementinstitute](http://www.bmo.com/retirementinstitute)

# US Gift Tax for Canadians

When you decide to make a gift of property, you may not normally think about being subject to tax on the gift as the gift giver. However, if you are a US person (US citizen, US resident or Greencard holder), US gift tax should be a consideration whenever you are contemplating a gift. Even if you are not a US person, but are contemplating a gift of tangible property that is located in the US, you should also take US gift tax into consideration.

The IRS may impose a “gift tax” to the transferor when assets are gifted during a person’s lifetime. The gift tax may apply when assets are transferred (ie. gifted) to another individual or, in some circumstances, to a trust. Based on the value of the gift, gift tax rates range from 18% to 35%.

The good news is that there are exclusions that may reduce or eliminate the US gift tax. A US person has *annual* gift tax exclusions of US\$13,000 per recipient, and US\$139,000 (inflation adjusted amount for 2012) for gifts made to a non-US citizen spouse. In addition to these annual exclusions, a US citizen has a lifetime gift tax exclusion of US\$5,120,000 for gifts made in 2012 (as adjusted for inflation). However since the US gift tax and US estate tax regimes work in tandem, any amount of the *lifetime* gift tax exclusion applied toward gifts reduces the amount that can be used to offset US estate tax upon the individual’s death. Assuming there is no new US tax legislation, the future lifetime gift tax exclusion amount is scheduled to be reduced to US\$1 million and the highest US gift tax rate will increase to 55% on January 1, 2013.

Even if you are not a US person, you will still need to consider US gift tax if you gift tangible property, such as a vacation home that is located in the US. Unlike a *US person*, you would not be eligible for the US\$5,120,000 *lifetime* gift tax exclusion. However, the *annual* gift tax exclusion amounts of US\$13,000 or US\$139,000 (for gifts to a non-US citizen spouse) would apply to you. Gift tax does not apply to Canadians (who are non-US persons) who gift intangible US property (i.e. US securities).

As with any transaction, a Canadian resident would need to consider the Canadian income tax implications that may apply to any transfer of assets. These implications include the potential application of the “attribution rules” or the possible recognition of capital gains or capital loss if assets other than cash are transferred to a family member.

Since gifting is often incorporated in tax and estate planning, it will be important to carefully consider all of the legal and tax consequences that may result from the transfer of assets.

If you are contemplating the transfer of a significant amount of assets where US gift tax may be applicable, your BMO Nesbitt Burns Investment Advisor can refer you to a qualified external tax professional who can provide you with additional guidance in your particular situation.

## Contribution reminder

### RRSP

With the holiday season behind us, it’s now time to turn our attention to the year ahead. What better way to start off the New Year than by making your annual RRSP contribution. If you still haven’t made your 2011 contribution, don’t delay, the deadline is February 29, 2012. If you have already maximized your 2011 contribution, there’s no better time than right now to make your 2012 contribution.

The easiest way to find your RRSP deduction limit is to look it up on the Notice of Assessment that Canada Revenue Agency (CRA) sends back to you after you file your annual income tax return.

If you would like to verify this amount, here’s how to calculate it for yourself:

For 2011, your RRSP contribution amount is based upon your carry forward amount from 2010, plus your current year’s contribution amount which is the lesser of \$22,450 or 18% of 2010 earned income. If you are a member of a Deferred Profit Sharing Plan (DPSP) or Registered Pension Plan (RPP), you must deduct your pension adjustment (and net past service pension adjustment, if any) when calculating your RRSP contribution room.

### TFSA

Canadians age 18 and over\* can contribute \$5,000 annually to a TFSA. Any unused contribution room, dating back to 2009 or the year you turn age 18, carries forward so it can be used in a future year. If you have never contributed to a TFSA and were age 18 or older in 2009, your contribution limit for 2012 will be \$20,000. With the application of the indexation increase of 2.8% for 2012 and rounding the result to the nearest \$500, the TFSA dollar limit for 2012 remains at \$5,000. Unused TFSA contribution room can be carried forward to later years. Your annual TFSA contribution limit is reported on your annual Notice of Assessment from Canada Revenue Agency (CRA).

\*For BMO Nesbitt Burns, TFSA account holders must be the age of majority to open a TFSA – for some jurisdictions (B.C., N.S., N.B., Nfld., Yukon, NorthWest Territories, Nunavut) the age of majority is 19.

# Maturing your RRSP

Canadians must mature their Registered Retirement Savings Plan (RRSP) by December 31st of the year they turn 71.

When you mature your RRSP, you will have the following options:

- Convert to a Registered Retirement Income Fund (RRIF);
- Take a cash payment; or
- Buy an annuity

You may choose one or a combination of the maturity options listed. But a RRIF is the most common and flexible choice at maturity. Converting an RRSP to a RRIF may seem like little more than a name change since the RRIF can hold most of the same investments as an RRSP. Like an RRSP, the assets in the RRIF continue to be tax sheltered until withdrawn. The key difference is that once the RRIF is in place, deposits stop and minimum withdrawals start. A RRIF is very much like an RRSP in reverse. An RRSP is an account designed to help you save for retirement while a RRIF is an account designed to provide annual income in the form of withdrawals from a registered plan during your retirement.

## Here are a few tips to get the most of your RRIF

**Tip: You can transfer assets from an RRSP to a RRIF “in kind”.**

Assets in an RRSP can be transferred to a RRIF without having to pay any income tax. You only pay tax once income is withdrawn from a RRIF. You can also transfer assets “in kind” to a RRIF which means these investments do not have to be sold – and there is no impact to their related interest rate or maturity date.

The comments included in this publication are not intended to be a definitive analysis of tax law or trust and estate law. The comments contained herein are general in nature and professional advice regarding an individual’s particular tax position should be obtained in respect of any person’s specific circumstances.

**Tip: If you are 65 or older, RRIF withdrawals qualify for the \$2,000 Pension Income Tax Credit.**

When it comes time to file your personal tax return, remember that your RRIF withdrawals can qualify for the \$2,000 Pension Income Tax Credit (if you are age 65 or older). This means you are entitled to deduct from your taxes payable, a tax credit on the first \$2,000 of pension income received. You can start taking advantage of this as soon as you turn 65 by transferring \$14,000 from a RRSP to a RRIF and taking out \$2,000 per year from age 65 to 71 (inclusive). Depending on your marginal tax rate, this pension tax credit will reduce or eliminate the incremental tax otherwise owing on the additional \$2,000 of qualifying income annually, to the extent that you are not otherwise taking advantage of this credit with other income.

**Tip: Your minimum withdrawal amount can be calculated based on your spouse’s age.**

If your spouse is younger than you, you may choose to have your minimum withdrawal amount calculated on his/her age. This will result in a minimum withdrawal amount that is lower than if the amount was calculated based on your age.

This is beneficial if you do not need all of your RRIF income right now. Lower payments leave more money invested in your RRIF, resulting in the potential for more tax sheltered growth. The age your RRIF minimum withdrawal amount is based on cannot be changed in subsequent years.



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