The ScotiaMcLeod Wealth Planning Series

Tax Handbook for Investors

ScotiaMcLeod™

Building Relationships for Life

ScotiaMcLeod's Tax Handbook for Investors

You worked hard to earn your money and in turn, you want to see as much of it as possible work for you.

Building your wealth requires a careful look at your overall financial picture, particularly your own personal circumstances and the tax implications of your investments. By structuring the right mix of investments for your portfolio you can pay less tax and ensure you are receiving optimal returns.

The first step towards developing an effective investment plan is knowing how much tax you are paying and how much tax you pay on each type of income you may receive. This sounds obvious, but the truth is, many Canadians are not sure what their marginal tax rate is.

This guide is designed to show you how much tax you are paying as well as provide you with some tips on how to reduce the amount of tax that you do pay.

While this publication outlines important tax information and tax saving ideas for individual investors, it is important to consult with a professional tax advisor for guidance before utilizing these strategies. A professional tax advisor will take your personal circumstances into account in determining appropriate recommendations, which will enable you and your ScotiaMcLeod Investment Executive to develop your investment strategy.

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ScotiaMcLeod's Wealth Planning Services

Building and preserving wealth demands specialized financial advice. ScotiaMcLeod has established a full range of advisory services encompassing tax, estate and retirement planning. Our Wealth Planning Series of educational booklets has been developed to assist investors in all their individual planning needs. Ask your Investment Executive about other Wealth Planning publications.

How Much Tax Do You Pay?

The Taxation of Investment Income

When selecting investments for your portfolio, it is important to know that different types of income are taxed differently. This could have a significant impact on your after-tax returns. Interest income is taxed at the highest rate while capital gains and dividends are taxed at lower rates.

While it is after-tax income that is important when evaluating an investment, tax implications should not be the sole criteria for judging an investment. Other factors such as risk, liquidity, opportunity for appreciation and your overall goals and objectives should also be considered.

Your after-tax investment income will be dependent upon a few factors—other income sources, deductions available and your marginal tax rate.

What is a Marginal Tax Rate?

This is the rate of tax applied to each additional dollar of income you earn. In calculating your taxable income, the income you earn from investments is added to your income from all other sources. As a result, each additional dollar of investment income is taxed at the highest rate applicable to your total income.

Calculating After-Tax Income

To determine your after-tax income, you start by adding up your income from all sources. Then you subtract any deductions that you are eligible for. This amount is your taxable income. Multiply this number by the appropriate federal tax rate and subtract any credits that are available (i.e. basic personal amount). Then apply the provincial tax and calculate any surtaxes that may be applicable.

Interest Income

Interest income is fully taxable on a yearly basis at applicable combined tax rates whether or not you actually receive the income. For example, there are certain investments (GICs, strip coupons or CSBs) where you may earn interest but not receive it. These amounts must still be reported on your tax return as interest earned. Note however, that in the case of investments with terms that are one year or less, the income is reported in the year received (eg. T-Bills). Where possible, structure your T-bill purchases so that the maturity date is after the year end. This will effectively defer tax for another year.

Dividend Income

Dividends received from taxable Canadian corporations are taxed at a lower rate than interest income. This is due to the fact that dividends are eligible for a dividend tax credit which recognizes that the corporation has already paid tax on the income that is being distributed to shareholders. However, dividends received from foreign corporations are not eligible for this tax credit and are therefore taxed in the same manner as interest income.

To calculate the tax payable on a dividend you must multiply (gross up) the actual dividend received by 25%. Tax is then calculated on this amount at the applicable Federal rate. The dividend tax credit of 13.33% of the grossed up dividend reduces the amount of federal tax. For provincial calculations, the dividen tax credit varies by province. Then, take the resulting amount and apply the appropriate surtaxes and provincial tax rates. You can elect to include all of your spouse's dividend income from taxable Canadian corporations in your income if this will increase your married credit. Additionally, individuals can receive approximately $28,000 of dividend income tax free if they have no other income ($14,000 in Quebec, Saskatchewan and Manitoba).

Capital Gains

The following information relates only to non-depreciable assets.

Capital gains result when you sell an asset for more than you paid for it. Any expenses that you incurred to purchase the asset or to sell the asset would further reduce the amount of the gain or alternatively, increase the amount of the loss.

It is your net capital gains that are taxed in a particular year. Net capital gains are equal to your total capital gains less any capital losses within the same year. One-half (50%) of the net capital gain is referred to as the taxable capital gain. It is this amount that is taxable at appropriate federal and provincial rates.

A capital loss would occur when the proceeds (less expenses) are less than what you paid for the asset. Net capital losses are eligible to be carried back three years and applied against gains or carried forward indefinitely to be applied against gains in a future year. As a general rule of thumb, interest bearing vehicles should be purchased within an RRSP while dividend and capital gain producing vehicles should be purchased outside registered plans to take advantage of the tax treatment of dividends and capital gains.

The following example compares how a taxpayer in the top tax-bracket in Ontario would be taxed on a $100 dividend, interest and capital gain in 2001.

	Dividend	**Interest**	**Capital Gain**
Cash Payment	$100.00	$100.00	$100.00
Dividend gross-up	25.00		
Non-taxable portion			50.00
Taxable income	$125.00	$100.00	$50.00
Federal tax @ 29%	36.25	29.00	14.50
Dividend tax credit @ 13.33%	(16.67)	–	–
Basic federal tax	19.58	29.00	14.50
Ontario provincial tax[1] @ 11.16%	13.95	11.16	5.58
Ontario Dividend tax credit	(6.41)	–	–
Ontario FSHCL[2] @ 56%	4.22	6.25	3.12
Total tax	$31.34	$46.41	23.20
Amount retained after tax	**$68.66**	**$53.59**	**76.80**

[1] Please note, Ontario has moved to a 'tax on income' system from the traditional 'tax on tax' system. This has changed the way you calculate your tax, however the net effect is the same.

[2] Fair Share Health Care Levy is 20% on Ontario Tax greater than $3,561 with an additional FSHCL of 36% on FSHCL over $4,468.

Superficial Losses

A superficial loss occurs when an asset is sold at a loss and reacquired by yourself, your spouse or a corporation controlled by you or your spouse within a period beginning 30 days prior to the sale and ending 30 days after the date of sale. This type of loss is not deductible for tax purposes.

Many people will transfer securities from their taxable account into an RRSP. This transfer is actually a disposition of the asset for tax purposes. This means that a capital gain or loss will occur. If a capital gain occurs, it is taxable. However, if a capital loss occurs, it is denied and cannot be used to offset other capital gains. In this case, it is sometimes recommended to sell the asset, use the cash for the contribution to the RRSP and then repurchase the asset inside the RRSP. If this strategy is followed, the loss will be allowed. It should be noted that this strategy will depend upon your outlook for the security in question.

The Dividend/Interest Tradeoff

It was mentioned earlier that when making investment decisions, you should be concerned with after-tax rates of return. Given that dividends are taxed at a lower rate than interest bearing vehicles, there is an obvious question that arises. What interest rate must I achieve to be indifferent after-tax, relative to receiving interest income?

The calculation required to determine this is simply the amount of money retained after tax from dividend income divided by the amount retained after-tax from interest income.

If we use the prior example, the factor to use for the highest tax rate in Ontario would be:

$$\frac{\text{After-tax dividend}}{\text{After-tax interest}} = \frac{68.66}{53.59} = 1.28$$

This means that at the highest marginal tax rate, you must receive about $128 of interest income for every $100 of dividend income in order to earn the same after-tax return.

Although the answer is straightforward from a calculation perspective, there can be more risk when investing in common or preferred shares than in fixed income investments. However, the lower tax rate, along with the growth potential of common stocks, can often offset these risks for at least a portion of your portfolio. Your Investment Executive can recommend many high-yielding blue chip common and preferred shares that can boost your income without boosting your taxes.

Borrowing to Invest

Borrowing to invest can work to your advantage. Interest payments on loans for investments are tax deductible with certain restrictions.

In the case of debt instruments, interest payments are deductible only up to the rate yielded by the security purchased. For example, if you borrowed funds at 6% to purchase a bond that pays interest at 4%, you are only able to deduct 4% as interest costs. Interest costs incurred to purchase preferred shares are deductible at 1.25 times the rate of the preferred dividend. For example, if the preferred dividend was 4%, interest could be deductible up to 5%. Interest incurred on money borrowed to buy common shares is generally deductible whether or not any dividends are actually received, provided the common shares you purchased with borrowed funds have the potential to produce investment income at some time in the future.

It is important to remember that borrowing can also have a negative outcome if the investment that you purchased with borrowed funds decreases in value. In that event, you may end up owning an investment that is worth less than the loan amount outstanding. Before you borrow to invest, make sure that this strategy is appropriate for your risk profile.

Converting Non-Deductible Debt to Deductible Debt

Since interest is generally tax deductible when you borrow for investment purposes, you should consider converting non-deductible debt into deductible debt. You can do this by using available cash to pay down personal loans and then borrow for investment or business purposes. As well, if you have a portfolio and non-deductible debt, you may want to liquidate enough of your portfolio to pay off the debt and then reborrow to purchase securities. This strategy should always be discussed with your tax advisor before proceeding.

Income Splitting

Income splitting involves dividing income more evenly among family members to reduce the overall tax liability of the family. For example, if $1,000 of income is taxed in the hands of a family member whose marginal tax rate is 20% lower than yours, the saving is $200. Although income splitting is allowed between family members there are provisions in the Income Tax Act called attribution rules which discourage income splitting. In certain circumstances, these rules attribute income back to you, taxing it in your hands even though you did not receive it. Still, there are a few strategies that can be used to legally split income among family members.

Income Splitting with a Spouse

Use a Spousal RRSP

Good retirement planning results in both spouses earning the same amount of income at retirement to take advantage of both individual's lower marginal tax rates. Contributing to a spousal RRSP allows one spouse to split income with the other when funds are removed from the RRSP in the

future. However, individuals should be aware that there will be income attribution on a withdrawal from a spousal RRSP if there has been a contribution to any spousal plan in the year of withdrawal or the previous two years.

Organizing Household Expenses and Investments

If both spouses earn income but one spouse consistently pays tax at a higher rate than the other, consider organizing your household finances so the higher income spouse pays all household expenses. Then, the lower income spouse can invest as much of his or her earnings as possible and a lower amount of tax will be paid on the investment income earned.

Loans to Finance a Business

As business income is not attributable, if one spouse lends money to another for the purpose of earning business income, that income will not be taxed in the hands of the spouse who lent the money.

Salaries to Spouses (or other family members)

For individuals who own their own business, it is possible to pay salaries to family members for their work. The amount paid must be reasonable for the work being done. As a guide, consider what you would pay someone else to perform similar duties. The benefit is that this provides income to lower taxed family members as well as allows them to contribute to their own RRSPs.

CPP/QPP Retirement Pension

CPP and QPP benefits can be split between spouses. It would make sense to split this income with a lower income spouse.

Income on Income

The attribution rules tax income earned on money transferred to a spouse back to the transferring spouse. This income becomes the capital of the transferee spouse for reinvestment purposes.

The income earned on the reinvested capital (income on income) is not attributed back but is instead taxed in the hand of the transferee spouse. However, the income on the original transfer will continue to be taxed each year in the hands of the transferring spouse. Over time, this strategy is a very effective method of transferring capital from a spouse in a high tax bracket to a spouse in a lower tax bracket.

Consider the following example: Mr. Jones is in the top tax bracket so he decides to give Mrs. Jones $100,000 to invest in order to earn income in her hands. Mrs. Jones invests the money and receives a 10% return each year for a ten-year period. The following table shows the effect on Mr. and Mrs. Jones.

Year	Gift	Income taxed to Mr. Jones	Mrs. Jones Capital	Mrs. Jones income
1	100,000	10,000	10,000	nil
2		10,000	21,000	1,000
3		10,000	33,100	2,100
4		10,000	46,410	3,310
5		10,000	61,051	4,641
6		10,000	77,156	6,105
7		10,000	94,872	7,716
8		10,000	114,359	9,487
9		10,000	135,759	11,436
10		10,000	159,375	13,580
				$59,375

After the ten years, Mrs. Jones has accumulated $159,375 of her own capital which is comprised of the $10,000 earned each year on the original gift, plus $59,375 (the total of column four) of income on income. Note that this example assumes that Mr. Jones pays the tax liability on the attributed income from other sources.

Income Splitting with Children

Children 18 years of age or older

Giving monetary gifts to children 18 years of age or older can be done without any income attribution. Remember that once you have gifted the money, it is the child's to do what they want with it. However, this money could be used to allow them to make their maximum RRSP contributions. It also allows them to earn sufficient income to absorb their personal deductions and credits and to pay for certain expenses that you might ordinarily pay out of your own after-tax dollars. This can be an effective way to fund education expenses.

Loaning money to adult children at low or no interest results in attribution back to the individual who loaned the money for interest and dividends received but not capital gains.

Children under the age of 18

There is attribution of income back to a parent on any money lent or gifted to a minor. However, a number of income splitting strategies outlined above work with a minor as well as a spouse. Also, if set up properly, there may be no attribution of capital gains earned by minor children. One such strategy is to invest in stocks or mutual funds that only produce capital gains and pay out very little income. Lastly, a salary could also be paid to a child from a family business but only to the extent that is reasonable given the specific circumstances.

Consider the above ideas but, as with other tax minimization strategies in this booklet, it is recommended that you obtain advice from a qualified tax advisor to ensure they are appropriate for you.

Tax and Retirement Planning

Invest for Your Retirement Today

There is no better tax shelter today than the Registered Retirement Savings Plan (RRSP). The RRSP is the obvious solution to achieve the objectives of reducing tax and maximizing assets for retirement. The benefit is not only a tax deduction for contributions but tax-free growth of these funds within the RRSP until the contributions are withdrawn as income. Annual contributions are limited to the lesser of 18% of your earned income from the prior year and the annual maximums noted below.

Maximum RRSP Contribution Limits

Year	Limits
2000-2003	$13,500
2004	$14,500
2005	$15,500

Pre–Authorized Contribution Plans

Consider the ScotiaMcLeod Pre-Authorized Contribution Plan for your RRSP. This plan enables you to make monthly contributions to your RRSP rather than trying to come up with a lump sum before the deadline each year. Contributing to your RRSP earlier means your contributions earn a tax-deferred return for a longer period of time than if you contribute at the end of the year. The powerful effect of compounding can make a significant difference in the growth of your investments.

Structure Your Investments

If you have investments both inside and outside of your RRSP, it makes sense to treat them as a single portfolio keeping in mind that different types of investment income are taxed in different ways. Consider holding the interest-earning investments inside the RRSP and those generating capital gains and dividends outside where you can benefit from the related lower effective tax rates.

Take Advantage of Unused Contribution Room

The 1996 federal budget eliminated the seven-year carryforward limit of unused RRSP contributions. Now, unused contributions that have accumulated since 1991 may be carried forward indefinitely.

ScotiaMcLeod's parent company, Scotiabank, offers the Catch-Up™ Loan, developed to assist in taking advantage of this opportunity. The Catch-Up™ Loan is available for extended terms at preferential interest rates.

The Pension Adjustment Reversal

For individuals who leave registered pension plans or deferred profit sharing plans before retirement, the 1997 Federal budget introduced the pension adjustment reversal, which will restore lost RRSP contribution room, for employees who leave their company, retroactive to 1996. This pension adjustment reversal will ensure that individuals who receive low termination benefits in relation to the benefits promised under their plan, will have the ability to generate adequate levels of retirement income through additional RRSP contributions.

Planning for Your Retirement Years

In the 1996 Federal Budget, the age at which you must collapse your RRSP was reduced from 71 to 69. Any final year contribution must be made on or before December 31st of that year, not 60 days after the end of the year. Individuals who have RRSP deduction room after age 69 will be able to contribute to a spousal RRSP up until the end of the year in which their spouse turns 69. At the time you must collapse your RRSP, you have four alternatives, all of which have different tax consequences.

Collapse your RRSP

If you simply cash in your entire RRSP, the funds must be included in your income for that year and you will be taxed on these funds as ordinary income at your marginal tax rate. This is generally not a good idea, both from a tax-planning and a retirement income planning point of view.

Purchase an annuity with the funds

Annuities pay a fixed amount at a guaranteed rate of return either until death or for a specified term. These payments are taxed only as you receive them, but in most cases, payments are identical and are fixed for the life of the contract. (Indexed annuities are available but you pay more for this option.)

Transfer Your Funds to a RRIF (Registered Retirement Income Funds)

A RRIF is similar to an RRSP, in that the same type of investments are permitted. However, contributions cannot be made to a RRIF. Like an annuity, payments from a RRIF are taxed as income only as they are paid to you. A RRIF can be more flexible than an annuity as you can vary the amount and timing of your payments as long as you receive the minimum annual withdrawal. RRIFs are attractive due to the fact that the RRIF lasts for your lifetime rather than being depleted by age 90. For more information on the RRIF payment rules, please ask your ScotiaMcLeod Investment Executive.

Combine all three alternatives

Some combination of the three alternatives discussed above is often the best solution to planning for flexible income in retirement years.

Making an Extra Contribution

Those individuals who would have normally been able to contribute to their own RRSPs in their 70th year (but who are prevented fom doing so due to the fact that the RRSP account had to be closed the year before) may want to consider making this otherwise lost contribution in December of their 69th year. Although technically considered an overcontribution (and therefore subject to a 1% penalty) for that month, as of January 1st of the next year, the contribution becomes deductible, which would result in an added tax deduction for that year.

Locked–In Accounts

When money is transferred from a pension plan to an RRSP, it must be transferred to a locked-in account. From an investment perspective, there is no difference between a locked-in account and a regular RRSP. However, a difference does exist as to when and how the money can be received. With a regular (non-locked) RRSP account, you can withdraw money at any point you deem appropriate in any amount that you deem appropriate.

However, with a locked-in account, options for withdrawals are limited to either a life annuity, a Locked-In Retirement Income Fund (LRIF), a Life Income Fund (LIF) or a combination thereof. With a life annuity, the funds in the locked-in plan are used to purchase an annuity from a life insurance company that will pay you a stated sum (depending upon the options that you choose) for your lifetime. A LIF operates in a manner similar to a RRIF in that minimum payments (calculated exactly the same as RRIF minimum payments) must be withdrawn every year. The difference is that there is also a maximum amount of money that can be taken out every year. A LRIF is similar to a LIF but does not have to be converted to an annuity at age 80. Please note that LRIFs are not available in every province. If you have a locked-in account, contact your ScotiaMcLeod Investment Executive for more information.

ScotiaMcLeod specializes in providing retirement planning advice. Your Investment Executive can assist you in determining which combination of these alternatives is best for you.

Other Issues to Consider

Age Credit

Since February 1994, the age credit has been subject to income-testing. The age credit is equal to 16% of the "age amount," which is currently $3,531. This credit translates into a federal tax reduction of about $560 a year for all taxable seniors. In all provinces except Quebec, this credit also reduces provincial taxes, resulting in a combined federal-provincial tax reduction of about $900. The age credit is reduced when an individual's net income exceeds $26,284 and is completely eliminated when net income exceeds $49,824. A taxable senior who has a spouse with little or no income can claim the spouse's unused credit, if the spouse is over 65.

Investment Products with Tax Advantages

In addition to some of the tax saving opportunities described above, many investors look for other products that may provide them with alternative ways to save tax. Although the availability of such products has diminished over the years, there are still some opportunities. The information below is a general outline of products that have some positive tax consequences associated with them. However, as noted above, tax is not the only factor to consider when evaluating a potential investment.

Registered Education Savings Plans

Registered Education Savings Plans (RESPs) are a tax effective way to save for a child's education. Contributions to an RESP are not tax-deductible but are tax sheltered within the plan. The income earned on the contributions is not taxable until paid out to the student, at which time it is taxed in their hands, usually at a very low rate, if at all. In addition, the student beneficiary may claim the tuition fee and education tax credit which will help offset any tax that may be payable. Payments can only be made to designated beneficiaries attending a post-secondary institution full-time.

The 1997 and 1998 Federal Budgets made RESP contributions more attractive by increasing the contribution limits and allowing for the transfer of these funds. In the event that your child does not pursue post-secondary education, you are now able to transfer up to $50,000 of unused RESP income into your or your spouse's RRSP provided, you have unused contribution room and meet certain other requirements. The annual limit on RESP contributions is limited to $4,000 per beneficiary, although the lifetime contribution per beneficiary remains at $42,000.

The government has also provided a grant equal to 20% of the first $2,000 in contributions to an RESP. The Canada Education Savings Grant (CESG) will provide up to $400 per year of additional funding. There are a number of conditions on the CESG that your Investment Executive would be pleased to outline for you.

RESPs can be extremely flexible and offer a range of investments for your contributions. They also allow multiple beneficiary designations. Ask your Investment Executive for details or refer to our *ScotiaMcLeod Registered Education Savings Plan* brochure.

Universal Life – A Powerful Retirement and Estate Planning Tool

Popularized in the early 1980s, Universal Life is the most flexible of all permanent life insurance plans. It separates the insurance and investment components of traditional whole life insurance. The first component of Universal Life, traditional life insurance coverage, provides a lump sum benefit to named beneficiaries upon death of the insured. The second component is the investment portion, or the reserve account which is used to accumulate funds.

In Universal Life, premiums are paid and charges for mortality costs, administration fees and provincial taxes are deducted. After all the costs are taken out, the reserve is credited with interest. How much interest depends on the type of investment account chosen — Daily Interest Savings Accounts, Term Deposit Accounts, and both domestic and foreign equity market Index Accounts. Any accumulation in a Universal Life account grows tax deferred, similar to an RRSP, provided the policy is an exempt policy. For a policy to be considered an exempt policy, and to maintain its tax deferred status, it can only have a certain amount of investment component in relation to the amount of pure insurance. Unlike an RRSP, the death benefit — the sum of any accumulation plus the amount of insurance originally applied for — will flow to the named beneficiaries of the policy tax-free. For individuals with an increasing, but deferred, tax liability, the funding or overfunding of a Universal Life contract is an attractive option. Universal Life is also an effective product which allows for the transfer of assets from one generation to the next in a tax friendly manner.

Overfunding a Universal Life Plan

Paying more than the minimum payment or overfunding a Universal Life Plan can result in significant tax savings. As a life insurance product, any growth that occurs in the reserve account is not taxable (if the policy retains its exempt status) unless the funds are removed from the policy. For instance, if you have a large portfolio of interest earning investments which are currently not tax sheltered, you could consider moving these investments into similar investments in a Universal Life Policy. The advantage is twofold: these investments would continue to grow for your estate and you would no longer be taxed on the interest earned from these investments. In the event of your death, the policy would pay your beneficiaries the original death benefit plus any investments in the reserve account tax-free.

U.S. Investments

Many Canadians diversify their portfolio by investing in the United States, particularly in the equity markets. The following is an overview of some of the tax implications involved and is not, by any means, an exhaustive study. Consult with a qualified tax advisor for more detailed information on how these general guidelines apply to your own circumstances.

Canadians who invest in the United States are subject to both U.S. and Canadian income tax laws on their U.S. source investment income. Some tax relief is provided, in certain situations, by the Canada - U.S. Tax Treaty. U.S. source investment income includes dividend and interest income received from the United States. Generally, this income is subject only to U.S. non-resident withholding tax at the rate of 30%, which is reduced under the Canada - U.S. Tax Treaty to 15% for dividends and 10% for interest. Bank account interest is exempt from non-resident withholding tax as is interest received on other types of investments such as US federal, state and municipal debt obligations and certain US corporate bonds classified under the portfolio interest exemption. These rules are complex however, and must be assessed individually.

Canadians are also subject to U.S. tax on gains realized on the disposition of U.S. real property, but generally are not subject to U.S. tax on the disposition of other non-business assets (for example, securities). Gains on the disposition of U.S. real property interests are reportable on a U.S. (and Canadian) tax return and taxed at graduated tax rates. In addition, the buyer may be required to withhold tax at the rate of 10% of the gross sales proceeds. This withholding tax may be reduced to the seller's maximum tax liability upon application to the IRS prior to the date of disposition. Certain exceptions to this withholding tax do exist.

U.S. non-resident withholding tax on various types of income is as follows:

Interest	10%
Dividends	15%
Periodic pension and annuity payments	15%

Note that state and local tax may be payable in addition to any federal tax.

A Canadian resident is taxed on his or her worldwide income, despite the fact that the same income may have been taxed by another country. Accordingly, investment income received from the United States by an individual resident in Canada is also subject to Canadian tax. The gross amount of the investment income must be included in your income, even though the actual amount received may be less, resulting from the deduction of U.S. non-resident withholding tax. Fifty-percent of U.S. source capital gains must also be included in your income for Canadian income tax purposes. In order to obtain relief from double taxation, the U.S. taxes paid may be deducted within defined limits as a foreign tax credit against your Canadian income tax payable. Where some or all of the U.S. tax is not creditable against your Canadian tax, you may be able to claim a deduction from income for that tax.

Dividends received from U.S. sources do not qualify for the dividend tax credit and this factor should be taken into account when planning your investment strategy. As a result, the effective tax rate on a Canadian dividend is lower than that payable on a dividend of an equal amount from a U.S. corporation.

U.S. Estate Tax

Although Canada no longer has estate duties, Canadian residents may be subject to U.S. estate tax on their property that is situated within the United States. This property includes U.S. real property, U.S. pension plans, shares of U.S. corporations, and certain bonds and debt obligations issued by U.S. persons (excluding debt obligations, the interest on which qualifies as portfolio interest).

It is important to note that the **tax is levied on the fair market value of the property and not just the increase in value**. Therefore, if the property in question has lost value, it is still subject to US estate tax.

How Much U.S. Estate Tax Will I Pay?

U.S. estate tax rates range from 18% on the first $10,000 of U.S. situs assets to 55% on the portion of the estate's taxable assets in excess of U.S. $3,000,000 (See Appendix for U.S. Estate Tax Rates). Under the Canadian/U.S. Income Tax Treaty, Canadian residents are entitled to a pro rated portion of the standard $220,550 U.S. estate tax credit which translates into a pro rated U.S. $675,000 exemption equivalent. This amount is determined by taking the ratio of the U.S. situs property in the decedent's U.S. taxable estate over the decedent's world-wide taxable estate. Under a recently enacted U.S. tax law, the U.S. $675,000 exemption equivalent will gradually rise to U.S. $1,000,000 by the year 2006 (see Appendix).

Non-residents of the U.S. who have surviving spouses, have the opportunity to completely defer U.S. estate taxation on their U.S. situs property by creating a qualified domestic trust ("QDOT") which will qualify for the U.S. marital deduction under certain conditions and restrictions. When the surviving spouse dies, the assets of the trust are included in his/her U.S. taxable estate. Thus, a QDOT results in a deferral, not elimination, of the U.S. estate tax on the property passing to the surviving spouse.

A change to the Canadian/U.S. Income Tax Treaty has created an additional U.S. estate tax planning alternative in addition to the marital trust noted above. In lieu of the U.S. marital deduction, Canadians can now elect an additional spousal credit, equal to the pro rated unified credit the decedent will be allowed, which will be available, subject to certain conditions and restrictions, only on property passing to the surviving spouse. The availability of this credit can be obtained without the necessity of passing property to the spouse by way of a trust vehicle. Thus, for instance, it can apply to outright transfers to a surviving spouse under joint tenancy rules.

Prior to the changes enacted by the Third Protocol to the Canadian/U.S. Income Tax Treaty, there was the probability that double taxation would occur on U.S. assets as U.S. estate tax paid could not be used as a credit on a Canadian tax return against Canadian taxes that would be paid on those same assets. However, a Canadian income tax credit is now allowed for the U.S. estate tax in an amount not in excess of the Canadian deemed capital gains, income and profit taxes which would have otherwise been payable on the decedent's U.S. situs assets, or the decedent's U.S. source income and profits, had Canada been the sole taxing jurisdiction in the year of death.

Another provision further reduces potential exposure for another group of people whose total gross estate does not exceed U.S. $1,200,000. This provision will essentially only tax gains on U.S. real property (real estate or shares of a real estate holding company). This means that if your total net worth is less than the above amount and you held shares in U.S. companies, there would be no taxes due on those shares.

Developing Your Strategy

The information contained in this book is by no means all encompassing and should not be substituted for professional tax advice. Both your tax advisor and your Investment Executive should be consulted before acting on any information contained in this publication.

Appendix: U.S. Estate Tax Rate

Column A	Column B	Column C	Column D
Taxable Amount Over ($)	Taxable Amount Not Over ($)	Tax On Amount in Column A ($)	Tax Rate on Excess Amount A (%)
0	10,000	0	18
10,000	20,000	1,800	20
20,000	40,000	3,800	22
40,000	60,000	8,200	24
60,000	80,000	13,000	26
80,000	100,000	18,200	28
100,000	150,000	23,800	30
150,000	**250,000**	**38,600**	**32**
250,000	500,000	70,800	34
500,000	750,000	155,800	37
750,000	1,000,000	248,300	39
1,000,000	1,250,000	345,800	41
1,250,000	1,500,000	448,300	43
1,500,000	2,000,000	555,800	45
2,000,000	2,500,000	780,000	49
2,500,000	3,000,000	1,025,800	53
3,000,000		1,290,800	55

Yearly U.S. Estate Exemption*

2000 and 2001	675,000
2002 and 2003	700,000
2004	850,000
2005	950,000
After 2005	1,000,000

This table illustrates the asset threshold over which a U.S. resident will be subject to U.S. Estate Tax. For non-residents of the U.S., the exemption must be prorated by the percentage of the individual's estate located in the U.S..

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833 8764-06 04/01

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