



UNDERSTANDING THE FINANCIAL LANDSCAPE

## TO OUR VALUED CLIENTS:

We are writing regarding recent changes the U.S. government has made to its tax laws and enforcement practices with potentially significant affect on U.S. taxpayers (referred to as U.S. Persons) holding certain Canadian investments. If you think you may be affected, we encourage you to seek professional U.S. tax advice.

As we begin 2012 all of us at ScotiaMcLeod would like to take this opportunity to wish you and your family all the best for the coming year.

## Important Information about Recent Changes in U.S. Tax Legislation and Enforcement

Adam Salahudeen – *Director, Taxation Advisory Services*

### ARE YOU A U.S. PERSON?

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U.S. Persons include U.S. residents, U.S. citizens (even those residing in Canada who are Canadian residents for Canadian tax purposes), U.S. green card holders, and others with a substantial connection to the U.S.

The U.S. imposes tax on taxpayers' worldwide income, regardless of where they live. As a result, U.S. Persons have annual U.S. income tax filing and reporting requirements regardless of their country of residence or how little time they spend in the U.S., even if they have no U.S. tax liability to pay.

For the most part, U.S. Persons are aware of their U.S. status and their duty to file a yearly tax return and other tax documents with the U.S. government. However, because the rules surrounding U.S. citizenship, including the application of these rules to the children of U.S. Persons, are complex, you should consult a professional U.S. tax specialist to determine if you may be considered to be a U.S. Person for U.S. tax purposes. If you do not have your own U.S. tax advisor, your Advisor can introduce you to an independent U.S. tax professional upon request.

### RECENT CHANGES IN U.S. TAX LEGISLATION

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#### **Treatment of Passive Foreign Investment Corporations, including Canadian Mutual Funds**

Recent changes to U.S. tax legislation require U.S. Persons who are holders of "Passive Foreign Investment Corporations" (referred to as PFICs) to file an annual report containing information required by the U.S. Internal Revenue Service (IRS). These changes also impose additional U.S. taxes on PFICs held in a tax year. Canadian mutual funds are caught by these revised PFIC rules.

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These U.S. tax changes are a result of the IRS taking the position that a Canadian mutual fund should, going forward, be classified as a corporation rather than a trust for U.S. tax purposes, despite the fact that many Canadian mutual funds are classified as trusts for Canadian tax purposes. This change has potentially significant U.S. tax implications for the U.S. Person who is a holder of a Canadian mutual fund.

In previous years, U.S. Persons only had a U.S. reporting obligation with respect to PFICs if they were reporting a distribution (dividends, etc.) from a PFIC, sold shares of a PFIC, or were making certain elections in respect of the PFIC. This new reporting obligation can arise solely from holding a Canadian mutual fund.

PFICs are subject to a punitive tax regime with associated tax liability that exceeds the tax liability associated with a mutual fund holding in Canada. Amongst other things, distributed income and capital gains could be taxed as ordinary income (rather than investment income) at the highest federal marginal tax rate (rather than the preferential tax treatment that may apply to investment income), and unrealized gains could attract a non-deductible penalty interest charge. These PFIC rules could apply to a U.S. Person even if the PFIC is held in a Canadian registered (tax-deferred) plan, such as a Registered Retirement Savings Plan.

Given the above noted potential U.S. tax consequences for U.S. Persons, careful consideration of these new rules should be factored into the analysis of whether a Canadian mutual fund is a desirable investment from a U.S. tax perspective for an individual who is a U.S. Person. Once you have consulted with a U.S. tax

specialist, your Advisor would be pleased to discuss with you any changes you may wish to make regarding your current investments.

## **OTHER NEW U.S. TAX REPORTING REQUIREMENTS**

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As of the 2011 tax year, U.S. Persons who have foreign (including Canadian) accounts and assets with a combined value exceeding US\$50,000 are required to disclose certain information about these accounts on an information return to be filed with their U.S. individual income tax return. This requirement is in addition to the previous requirement to file a Report of Foreign Bank and Financial Account (FBAR) to report financial interests in accounts in a foreign country where the combined value is more than \$10,000. Failing to file the required reports can result in punitive U.S. tax and penalties.

## **THESE NEW U.S. TAX INITIATIVES ARE COMPLEX AND FLUID**

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Recently, U.S. officials publicly acknowledged that certain of these changes to U.S. tax laws and enforcement practices may have had unintended consequences for some U.S. Persons who are residents of Canada. The U.S. government has signalled an intention to consider these consequences through possible further legislative change. As the scope of the potential for future legislative redress is unknown at this time, U.S. Persons will need to continue to monitor the situation with their professional U.S. tax advisors.

If you have any questions about this letter or related matters, please contact your Advisor directly.

# 2012 Market Outlook

Paul Danesi, CIM, – *Director, Portfolio Advisory Group*

**W**e bid adieu to 2011, leaving behind what was a good year for the fixed income market and a far more challenging one for equities.

In the near term, market sentiment will continue to be driven by the ongoing European debt and banking crisis. We are committed to the view European politicians and regulators will ultimately put forth a credible solution to deal with these issues. Nevertheless, the damage has been done and austerity measures in the region will ensure global economic growth slows further in 2012. Weakness in developed economies will be offset by comparatively stronger growth in emerging markets arguing for the continued need for global diversification.

## BONDS THE CLEAR WINNER

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Canadian bonds were a clear winner in 2011. As of November 30th, the DEX Universe Total Return Index gained nearly 8%, while the DEX Long Canada Total Return Index posted an impressive 16.1% return! Provincial and municipal bonds outperformed corporates. The long end of the curve benefited from generally weaker growth expectations in Canada, and “operation twist”, a move by the U.S. Federal Reserve to drive down long-term interest rates and reinvigorate their economy.

Looking ahead, the current low rate environment offers little value in the mid-to-long end of the curve and we recommend investors remain short duration at this time. From a sector weighting perspective, investors should be underweight Canadas and overweight provincials, municipals and corporates. The recent narrowing of high yield spreads leaves us at a point of indifference on these credits. With the Canadian dollar expected to outperform most major currencies over the coming year, we recommend Canadian investors remain in Canadian dollars for their fixed income holdings.

## TOUGH YEAR FOR STOCKS

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Major equity benchmarks around the globe were deep in the red, although losses varied widely from region to region. On a relative basis, the U.S. has been an outperformer. In fact, the Dow Jones Industrial Average eked out a modest gain in Canadian dollar terms. Barring a major December rally, the TSX Composite will finish the year with a loss. We look for equities to provide investors with better returns in 2012.

## A FUNDAMENTAL DISCONNECT

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There is a large disconnect between underlying business fundamentals and equity market performance driven by fears of a euro break-up. Recent data points show the U.S. economy is proving more resilient than originally thought, and barring another global credit crunch, should avoid recession in 2012. Corporate balance sheets are in good shape with record cash and cash flows; no credit crisis here. Profit margins and corporate earnings are at record levels reflecting extensive cost cutting and a general reluctance to invest. This is reflected in the pace of job growth, which will further delay a recovery in the U.S. housing market. Business spending in Canada has been more robust. Nevertheless, Scotia Economics forecasts Canadian GDP growth will slow in 2012 as increasing consumer caution and softer export sales keep the Canadian economy in the slow lane.

## EQUITIES LIKELY TO BE RANGE-BOUND

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Equity markets are likely to remain range-bound with the occasional cyclical rally within what appears to be a secular bear market for stocks. Sub-par economic growth in developed markets argues for diversification that emphasizes faster growing emerging markets. Domestically the current environment favors quality growth stocks while persistently low bond yields will

continue to lead income-oriented investors into defensive, dividend-paying stocks.

While valuations of utility and telecommunication stocks appear stretched by historical standards, this new paradigm - higher prices/lower yields - is a reflection of investors' quest for yield. We recommend clients continue to hold these shares. U.S. telecommunications giants AT&T (T) and Verizon Communications (VZ) offer compelling yields at current levels.

## STAY NIMBLE

The past decade has rewarded investors who were selective in their stock picking and recognized the need for occasional profit taking. We encourage investors to remain nimble.

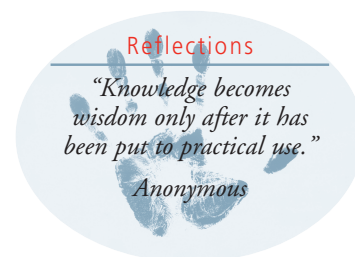
Intermittent rallies will be led by commodity cyclicals, industrials, small cap and other high-beta stocks. U.S. steel companies, miners including Teck Resources

(TCK.B), First Quantum (FM), and Freeport McMoRan Copper and Gold (FCX), heavy equipment manufacturers and dealers including Finning International (FTT) and Deere & Co. (DE), and "small cap" focused exchange traded funds (ETFs) are likely to exhibit the greatest volatility and could make for good trading vehicles. Gold equities and gold bullion should also perform well in this environment.

Thematically, we like emerging market consumer plays such as Nike (NKE), McDonald's (MCD), Yum Brands! (YUM), Coach (COH), and Diageo (DEO). We also favour software companies such as Open Text (OTC) and Oracle (ORCL) from a capital spending perspective. Software is productivity enhancing and offers companies a high return on investment.

Clients should speak with their ScotiaMcLeod advisor to determine appropriate asset allocation strategies and security selection.

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