TAX PERSPECTIVES

A quarterly publication by the Partners and staff of Cadesky and Associates, Chartered Accountants/Tax Specialists

COMPUTER SOFTWARE SHELTERS UNDER ATTACK

by Howard Berglas, CA

Reducing taxes through the use of tax shelters has become more and more difficult over the years. Recent legislative changes and more vigilant scrutiny of tax shelters by Revenue Canada have now led to all out war. In addition, the multitude of reassessments has most certainly led to a decline in the appetite of the average Canadian to get involved.

First it was real estate. Now during the past few months, we have witnessed a concerted attack on computer software tax shelters!

The objective of the attack is to generally deny all of the deductions claimed, using the following arguments:

- There was no reasonable expectation of profit.
- The software was grossly overvalued.
- Deductions cannot exceed income from the software.
- The software was acquired with a contingent liability.
- The assets acquired were not software but copyrights.

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WHAT IS AN ESTATE PLAN?

by Grace Chou, CA

What is an estate plan? When do you need one and what can it do for you? In this article, we will review these questions and provide some guidelines.

To understand what an estate plan is and what it does, we should start with defining the objectives. Typically, the first objective is to transfer assets to the next generation in the most effective manner. Preserving family harmony may be a crucial consideration, because nothing is more ineffective than having an estate tied up in litigation. There may be a business involved as well as other assets, so selecting which property goes where is important in order to enable a smooth transition.

Minimization of taxes on the transfer is also a key aspect to the plan. Along with this, assess the insurance needs to protect the estate from erosion by taxes, inflation and lack of liquidity.

Now that we have the general objectives defined, let's see what the process involves. In order to design the appropriate estate plan, we need an understanding of the family situation and the assets involved. An estate freeze, a family trust, life insurance and wills are all important tools in constructing an effective estate plan.

An estate freeze will allow assets to be frozen at their value today. This will limit the capital gains tax to that on hand. But without further planning, the capital gains remain until the deemed disposition at death or the death of the surviving spouse, the event that triggers the gains. With appropriate planning, these gains can be reduced and possibly even eliminated.

A family trust allows assets to be held in trust for the next generation without giving up control or absolute

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WHAT'S INSIDE

New Faces in the Office

Effective October 1, Jonathan Richler and Christina Tari joined us as Principals and will consult on various tax matters. Coming from legal backgrounds, they will practice as Richler and Tari, Tax Lawyers.

Jonathan L. Richler, LLB
Richler and Tari Tax Lawyers

Jonathan Richler has been practicing tax law for over 10 years. He has been active with the Canadian Tax Foundation, and is an editor of the Taxation of Real Estate in Canada service.

A. Christina Tari, LLB, LLM
Richler and Tari Tax Lawyers

Christina Tari's background is in tax litigation, having practiced with the Department of Justice representing Revenue Canada's side of the issue for the past 9 years. She is the author of a book on tax litigation, a university lecturer, and holds a Masters Degree in Tax Law.

Foreign Reporting Rules
Changed Again

by Michael Cadesky, FCA

Canada's foreign reporting rules were passed into law in April 1997. However, before the forms were even released, the rules have changed yet again. The most significant points are summarized below.

Personal Reporting Deferred

The information return for foreign investment assets has been postponed to next year, pending study. Quite possibly it will never re-emerge.

This rule sparked the greatest controversy, because it would have applied to such a wide range of people and investments.

The other information reporting rules will come into effect.

Extension of first filing deadline

The due date for other information returns that were to be filed on April 30, 1997 (to report transfers or loans to non-resident trusts, and distributions from non-resident trusts) have been extended by one year to April 30, 1998. The deadline for filing information returns for foreign affiliates (a foreign corporation in which you and related people own 10% or more) has been extended to June 30, 1998. Although the deadline has been extended, the reporting will still apply to the 1996 year as originally proposed. Thus the 1996 and 1997 forms will both be due at the same time, April 30 or June 30, 1998.

Exception for first year residents

Individuals will be exempt from the foreign reporting requirements for the year in which they first become Canadian residents.

Penalties Still Heavy

Where the failure to file an information return is deliberate or the circumstances constitute gross negligence, the penalty in most situations will now be $500 per month, for up to 24 months ($12,000 maximum) plus 5% of the cost of certain foreign property where the failure to file exceeds two years. A much reduced penalty will apply for inadvertent errors: $25 per day to a maximum of $2,500.

Due diligence exception

Where a taxpayer can show that due diligence was exercised in attempting to obtain the required information, penalties for omissions will not apply. The government has recognized that some taxpayers will not be able to obtain all the required information from foreign affiliates and non-resident trusts, especially where they exert minimal influence.

Fortunately, the rules will now apply in more limited situations, and not to the public at large. But if you are unsure of how the rules may affect you, don't wait until the last minute. Get professional assistance now.

Transfer Pricing
Canada Gets Serious

by Howard Wasserman, CA

Over the past 10 years, there's been a lot of talk about transfer pricing, arm's length standards, fair market value, OECD models and so on. Aside from very large corporations, nobody really paid much attention. A required form, introduced several years ago (form T106) still failed to get people to take this matter seriously.

This is all about to change.

Effective January 1, 1998, non-arm's length transactions with foreign persons will have to be documented, indicating how the pricing was arrived at. Legislation will now require "accurate and complete" documentation and will call for an enormous amount of detail. The documentation standard is almost impossible to achieve, and must be done contemporaneously or within 60 days of year-end. Otherwise a 10% penalty can be applied to any income adjustment Revenue Canada may make.

Fortunately, there is a minimum threshold ($1,000,000 of non-arm's length sales per year) beneath which the detailed rules do not apply.

We predict that transfer pricing will be the hottest tax issue as we enter the next millennium.

Reasonable Expectation of Profit
Strike one up for the good guys

by Grace Chow, CA

Imagine making an investment of a purely commercial nature. You make money, and you pay tax. Sounds fair. What if it doesn't make money? You should be able to get tax relief. Well, it's not always that easy.

Our client made an investment in a condominium project in 1986 and took possession in 1989 (the peak of the market). By the time she had sold it, her $1,000 down investment turned into a $54,000 realized loss. It nearly wiped her out.

Then the tax department came along two years later, saying that the whole thing was a tax motivated scheme.

The Tax Court would have no part of this. The judge believed that our client purchased the condominium to sell it at a profit, not to rent it. This made the condominium inventory of a business, and her losses were deductible on sale of the condominium.

While, in our view, justice finally prevailed, it did so at an enormous emotional and financial cost. Moreover, Revenue Canada is still considering whether they will appeal the decision.

Meanwhile, strike up one for the good guys.

The New Revenue Agency
No Nonsense Tax Administration

by Howard Berglas, CA

Revenue Canada recently announced that it is proceeding with a plan to create a National Revenue Agency to replace Revenue Canada. The new Agency will be headed by a committee of external persons selected from various sources. While the Revenue Minister will still have ultimate authority, the Agency will have much more autonomy than Revenue Canada. It will probably be more like the Internal Revenue Service in the United States, which for most of us means only one thing - it will be tougher.

A recent Revenue Canada study, in some ways a report card, was released last April. It outlines Revenue Canada's audit approaches and where it will be boosting its efforts. The report is well written, concise, and makes interesting reading. We ordered 200 copies for distribution to our clients and associates. We have about 40 left, so if you would like a copy, call us quickly.

Setting up Offshore

Which Country is the Best?

by Michael Cadesky, FCA

Asking which country is the best tax haven, is a bit like asking which country has the best restaurants. It is difficult to find Swiss fondue in Singapore, or Irish pub fare in Barbados. And while all of these countries are tax havens for certain purposes, the country most favourable to you will most certainly depend on your individual facts and needs.

As you start to explore the offshore world, you will very quickly find that there are dozens of jurisdictions which all claim to be the best tax havens, the most secret, the most confidential, and the most efficient. In general, none of these claims mean much for legitimate Canadian tax planning. Secrecy is irrelevant unless you are planning to commit outright tax evasion, confidentiality is "a given" in dealing with anyone reputable, and a pure tax haven is not always what you want.

The Canadian tax system discriminates greatly between countries with which Canada has a tax treaty and those with which it does not. In general, Canada has treaties with most non-tax haven countries, but not with pure tax havens. If you need a tax treaty country, this limits the selection to the 50 or so countries, which range geographically from Iceland to New Zealand, and alphabetically from Argentina to Zimbabwe. Conspicuously absent from the list are pure tax haven jurisdictions (including the Channel Islands, the Isle of Man, Bermuda, the Cayman Islands and much of the Caribbean, Gibraltar, Liechtenstein and Monaco), as well as Hong Kong and Taiwan. However, treaties could be a possibility with Hong Kong and Taiwan sooner than some people think.

Determining the appropriate jurisdiction to set up within, or to move to, will depend on whether an international tax treaty is required or not. If not, then any tax haven jurisdiction will be suitable. Otherwise, a more refined evaluation is necessary to determine the most suitable place.

Here is a summary of the key attributes of a few countries where we commonly set up arrangements:

United Kingdom

Contrary to popular belief, we place the United Kingdom at the top of the list for people with capital gains tax problems or lots of investment income. People who are not domiciled in the U.K., but live there and are resident there, are only taxable on income earned in the U.K. and monies brought into the U.K. Therefore, foreign income and capital gains escape tax, and the U.K. has an excellent tax treaty network. However, the new labour government is talking about putting a stop to this "nonsense".

United States

With the right planning, it is possible to leave Canada, move to the U.S., live there for part of the year and not actually be resident there. Therefore, foreign income would not be subject to tax there. Also, the U.S. basically does not tax RRSPs or RRIFs. Therefore, people retiring to the U.S. can get a major break on withdrawals.

Switzerland/Ireland

Switzerland has always been a useful country for international tax planning. Recently though, because the Canada-Swiss Treaty has been re-negotiated, it has become even more interesting. The advantages are mainly in setting up businesses operating from Switzerland, where the corporate tax rate can be as low as 8%, with only 5% more tax on bringing the money back to Canada. One added benefit over other places; the Swiss international treaty network is fully available.

Ireland can also be a useful place to earn certain business profits, at an overall rate of 10%. However, there are limitations on the types of activities permitted to enjoy this low tax rate.

Barbados/Cyprus

These countries have special incentives to attract international business. In addition to being tax treaty countries, they offer a very low corporate tax rate on offshore business profits and no withholding taxes. (Barbados 2-1/2%, Cyprus 4-1/4%.) The only disadvantage is that their tax treaties with Canada apply only in a very limited way.

New Zealand/ Singapore/ Netherlands/Barbados

For individuals, these countries can be useful for capital gains tax planning. In the right circumstances, capital gains are not taxed, which allows residents in these countries to realize such gains free of tax. Their international tax treaties with Canada can prevent Canadian capital gains tax.

This is a quick summary of some of the world's more useful jurisdictions for international tax planning. Most people will find the list to be very surprising, and this reinforces the point that international tax planning is not so much a matter of finding the lowest tax rate jurisdiction, but one of careful strategic planning and pinpoint precision.

Computer Software Shelters
Under Attack

by Howard Berglas, CA

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Revenue Canada's disdain for computer software tax shelters seems to stem from their experience with auditing certain ventures that border on being fraudulent. In particular, we have heard of one tax shelter in which a quick flip of software was made to an offshore entity at a price that was over 30 times the price paid by that entity just a few months earlier!! Needless to say, the offshore entity was resident in a tax haven, so its enormous profit went untaxed.

Most software tax shelters were structured so that the investor was only required to come up with cash of approximately 30% of the cost of the software, with the balance payable, by way of notes, ten to twenty years later. Revenue Canada believes that in many cases the balance will never be payable.

Here's the way Revenue Canada sees it: (See below)

Investment in software:	
Cash	$3,000
Note	$7,000
Total	**$10,000**

Tax savings over the first two years (53%)	$5,300
Cash outlay	$3,000
Return	**$2,300**

From Revenue's perspective, this is enough to conclude that the deals are all purely tax motivated. Then out marches the reasonable expectation of profit test. Where the investor can show that the main motivation for the investment was to earn a profit, and this expectation was reasonable, there should be no problem. After all, the Federal Court of Appeal in *Tonn*, deciding in favour of the taxpayer, cited, with approval, the following comments made in *Nichol v. Queen*:

"Mr. Nichol made what might, in retrospect, be seen as an error in judgement but it was a matter of business judgement and it was not one so patently unreasonable as to entitle this Court or the Minister of National Revenue to substitute its or his judgement for it, or penalize him for having made a judgement call that, with the benefit of 20/20 hindsight, that Monday morning quarterbacks always have, I or the Minister of National Revenue might not make today."

However, where the underlying business integrity of the deal is called into question, be prepared for a rough ride.

We have been engaged by over 300 investors in various computer software tax shelters to represent them in their fight against Revenue Canada. We will update you as the events unfold. Meanwhile, if you own a computer software tax shelter, you are almost certainly going to be reassessed. Unfortunately, as with real estate tax shelters, the good, the bad, and the ugly all get tarred and feathered with the same brush.

Taxation of Social Security Benefits

by Howard Berglas, CA

Over the past few years, the taxation of social security benefits under the Canada-US Convention has changed not once, but twice. To clarify the new rules, we have produced this table.

	1996	After 1996
Canadian residents receiving US social security benefits	25.5% non-refundable US withholding tax not taxable in Canada and no tax credit available	25.5% US withholding tax until protocol ratified, after which no withholding tax 85% of income subject to tax in Canada and Canada to refund or credit US withholding tax
US residents or citizens receiving OAS, CPP and QPP benefits	not taxable in the US 25% Canadian withholding tax	taxable in the US no Canadian withholding tax after protocol ratified

Registered Education Savings Plan ("RESP's")

Every Home Should Have One

by Howard Wasserman, CA

The February 1997 Federal Budget introduced a number of favourable changes to RESP's. They are well worth considering, to fund a child's university education in a tax-effective way.

What is a RESP

A RESP is a plan whereby an individual (usually a parent or grandparent) makes contributions towards a fund for a minor's university education. The beneficiaries of the RESP can receive these contributions, plus the income accumulated on the contributions, upon being admitted to a post-secondary institution.

RESP's provide two tax advantages; tax deferral and income-splitting.

Contributions

Unlike RRSP's, contributions to a RESP are unfortunately not tax deductible. However, the capital is not taxable upon withdrawal. The income earned by the RESP is not taxed until it is withdrawn by the student (hence the tax deferral). Since most students have little or no income and can take a tax credit for tuition fees, the taxes on the income withdrawals can be very small (hence the income-splitting).

From January 1997, the annual limit on contributions to RESP's has been increased from $2,000 to $4,000 per child. Therefore, if a couple has three children, they could contribute up to $12,000 each year to an RESP. However, there is a total contribution limit of $42,000 per beneficiary.

Withdrawal of Capital & Income

In the past, if no child in the family attended post-secondary education, the income earned on the contributions was lost. Because of this, many people were reluctant to contribute to an RESP.

To address this concern, if all intended beneficiaries do not pursue higher education by age 21, and the plan has been running for at least ten years, a contributor resident in Canada can withdraw the income from the plan as well as the capital. However, it will be taxable, together with a 20% additional tax. In certain cases, the income can be transferred to an RRSP, thereby avoiding the penalty tax.

Conclusion

RESP's have become more attractive as a consequence of the above changes. Take note that such plans accumulate income without tax. But there are many types of RESP's and one should make a detailed review of the plans that exist before investing. Since there are very few simple and effective ways to income split with minor children, we suspect RESP's will become more popular now that they are more user-friendly.

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What is an Estate Plan?

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ownership. The family trust can be discretionary and the decision as to whom to pass on the asset to can come at a later date.

There are many different types of life insurance products. Understanding each is important in choosing the ones that best suit your needs. Coordination with a life insurance agent is necessary in designing a comprehensive estate plan.

Finally, a proper will should be drawn up. The will should be revised periodically.

If you have substantial assets, planning for your estate may be the most important tax and financial planning you ever do.

Canada's Budget Surplus/ Dangerous Politics

by Michael Cadesky, FCA

The Canadian budget is heading for the black. Yes, there is the scepter of a surplus. This is politically dangerous, yes dangerous we believe, if not accompanied by lower tax rates.

In the past 10 years, Canadians withstood high tax rates, a bogus attempt at income tax reform, and the unpopular GST, to reluctantly do their part to reduce the federal deficit. While other countries were lowering tax rates, we actually raised ours.

The battle of the deficit has been won not by the politicians or large corporate Canada, but by the typical Canadian individual. There will be a tax revolt the likes of which have never before been seen, if the spoils of victory are not shared with the people.