TAX PERSPECTIVES

A QUARTERLY PUBLICATION OF THE TAX SPECIALIST GROUP (TSG)

Introduction

Michael Cadesky FCA, FTIHK, TEP

Cadesky and Associates

This Fall edition of *Tax Perspectives* focuses on year-end planning.

Given the decline in the stock market, which has followed unprecedented gains in recent years, tax planning for capital losses is clearly a top strategy this year. This and 11 other year-end tax-planning strategies are discussed by Kim Moody.

Getting a ruling from CCRA on a tax shelter is not a hassle-free guarantee, writes A. Christina Tari.

Michael Cadesky outlines the tax changes to foreign trusts that will come into effect in 2002. Strategies to be implemented by year-end must be devised now.

Jonathan Richler discusses a new alternative to a will—the alter ego trust.

Our two-part article on e-commerce concludes by looking at how offshore profits are taxed when ultimately distributed. In the theme of "show me the money," Grace Chow shows that the bottom line is what's left after tax.

Gary Bateman discusses year-end tax planning and SR & ED tax credits.

Just in time for the holiday season, CCRA has revised its position on taxable benefits, including Christmas gifts.

Finally, wondering about the latest word on interest deductibilty? Begin by reading Howard Berglas's "In Brief."

Notwithstanding the focus of this issue, we would be remiss not to state the obvious: tax planning is a year-round, not just a year-end, exercise.

Year-end tax-planning considerations

Kim G.C. Moody CA, TEP

Moody Finningley Shikaze

As we approach December 31, 2001, it's time to think about year-end tax planning for yourself and your family. This article summarizes some of the best tax-planning strategies that we recommend for individuals.

1. Ensure that all charitable donations are made by December 31; otherwise, they will apply for 2002. If you donate publicly listed shares to a charity, only 25% of any capital gain on hand is taxable (usually 50% of a capital gain is taxable). This can reduce the cost of the gift by 10% or so (assuming a large gain and a small cost base). Donate the shares that have the largest percentage gains.

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2. Consider shifting income to 2002. Tax rates are continuing to drop across the country. Deferring income to next year may save tax. For example, why not take a Christmas bonus in January?
3. To receive the tax benefits of certain expenditures for 2001, ensure that they're paid by December 31. These include medical expenses, union dues, investment counsel fees, investment management fees, alimony and maintenance payments, child-care expenses, moving expenses, political contributions, and tuition fees.
4. If you have loaned money to your spouse to bypass the normal income attribution rules, pay the interest on this loan no later than January 30, 2002 to ensure non-attribution of the income.
5. Ensure that RRSP contributions for the 2001 taxation year are made no later than March 1, 2002. The sooner that contributions are made, the sooner the tax-free compounding effect will kick in.
6. If you have capital losses in your investment portfolio and had capital gains in 1998, 1999, or 2000, realizing these losses this year makes more sense than ever. Do this before December 31, 2001. If capital losses exceed current capital gains, these losses can be carried back to any of the last three years in order to recover taxes paid on capital gains for those years. Even though capital gains are only 50% taxable now, you can apply the losses at the rate in effect on the gains previously reported (for example, 75% before March 2000). But be aware of the "superficial loss" rules, which will deny the loss if the same security is reacquired within 30 days. In addition, losses triggered by transferring securities to a self-directed RRSP are deemed nil. Seek professional advice on your loss utilization strategy.
7. If you are a shareholder of a private corporation carrying on an active business, consider reorganizing your shareholdings with a view to income splitting with family members. Income splitting can be accomplished by paying dividends to family members on their shareholdings. But beware of the "kiddie tax" rules, which prevent income splitting with minors through dividend payments. Consider payments to minors through corporate capital gains. This strategy can easily save you $10,000 in tax per child.
8. Other income-splitting strategies with minors do not involve the "kiddie tax." Consider paying interest to children, having children realize capital gains, or paying them reasonable salaries. Some strategies can be effectively carried out with an inter vivos trust. Again, so as to avoid unintended results, consider certain attribution rules.
9. New legislation allows for the deferral of certain stock option benefits realized by exercising stock options of a publicly traded company. However, the election to defer benefits for the 2001 taxation year must be made in prescribed form no later than January 15, 2002.
10. If you disposed of "eligible small business corporation shares" and realized a large capital gain, certain tax-deferral strategies may be available if you reinvest. If you acquire replacement shares of another eligible small business corporation by March 1, 2002 or within 120 days after the sale of the former shares (if later than March 1), you may defer or roll over part or all of the gain on the sale of the original shares. Before undertaking this deferral strategy, you and your tax adviser should carefully review the complex rules that apply.
11. If your employer provides you with a vehicle and you are subject to the automotive taxable benefits rules for the personal-use portion of its operating costs, ensure that the amount of the benefit is repaid to your employer by February 14, 2002. By doing so you will avoid being taxed on the benefit for the 2001 taxation year.
12. Be the recipient of a seasonal gift from your employer (tax-free up to $500) and/or an award for merit (also tax-free up to $500). For some of us, it is more fun to give than to receive. Take a deduction as an employer for tax-free employee gifts and awards within these guidelines—and feel good about it. (See "A Christmas gift from CCRA," elsewhere in this issue.)

This list of tax-planning strategies is not exhaustive, but it should provoke thought and help minimize your overall 2001 tax liability. Any member of the Tax Specialist Group would be pleased to assist in reviewing your 2001 tax affairs.

CCRA issues warning: Tax rulings not a guarantee

A. Christina Tari

Richler and Tari, Tax Lawyers

As tax professionals, we attend the annual Canadian Tax Foundation conference with interest to hear the CCRA's current initiatives and positions. This year attention was focused on tax shelters, which are "all" the focus of examination under the Tax Avoidance Program, according to the head of the Compliance Programs Branch, Bill Baker. This program raised $581 million through reassessments issued in the 2000-1 fiscal year.

During the "roundtable" at the conclusion of the conference, attention was drawn to a CCRA press release of August 14, 2001. In this short release, CCRA alerts investors to the risks of investing in certain tax shelter arrangements, warning that there are caveats to advance income tax rulings. The Rulings Directorate, as a policy, will not rule on issues such as the existence of a business, reasonable expectation of profit, and the fair market value of a property or service. The government advises investors to be aware "that advance rulings do not necessarily guarantee proposed deductions."

What is clear from this release is that Tax Avoidance auditors will continue to audit and will deny deductions in relation to a wide range of tax shelters on the grounds that a business did not exist, that there was no reasonable expectation of profit, or that the property or service was overvalued, irrespective of a ruling. While these are not new positions for Tax Avoidance auditors to take, what is news is the government's express warning that rulings will not provide comfort on these issues.

Taxpayers can expect to see increased numbers of "tax avoidance" reassessments as CCRA continues its policy of attacking tax shelters. The best defence is for a group of investors to retain tax professionals with experience in negotiating and litigating tax shelter cases. Group representation offers investors economies of scale that individual representation cannot—an important consideration given the Crown's seemingly bottomless pockets and relentless pursuit.

The government advises investors to be aware "that advance rulings do not necessarily guarantee proposed deductions."

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Did you know?

The Tax Specialist Group member firms support their fellow accounting professionals. We act as a tax resource to over 200 accounting firms, providing assistance to them and their clients, and we offer a monthly tax update seminar series for accountants by invitation.

Changes to Canadian taxation of offshore trusts

Michael Cadesky FCA, FTIHK, TEP

Cadesky and Associates

New or recent immigrants to Canada may continue to use offshore trusts and obtain a 60-month tax exemption. In addition, trusts established by persons who never become resident, either by will or during their lifetime, will be tax-free indefinitely.

Offshore trusts have long been a tax-planning vehicle of choice for affluent clients. So in February 1999, when the Canadian government announced major changes to the taxation of offshore trusts, a shudder ran deep among tax advisers. And while somewhat modified and delayed by one to two years, the amendments maintain their original focus—to eliminate aggressive offshore tax planning by Canadians.

The new legislation will now apply starting in 2002, which, for those fleet of foot, gives some room for tax planning.

NEW IMMIGRANTS AND IN-BOUND TRUSTS

It is well-established policy that new immigrants to Canada are given a five-year tax exemption, through the use of an appropriately structured offshore trust. Furthermore, offshore trusts established by non-residents of Canada for Canadian beneficiaries are not subject to Canadian tax at all. Canadian residents may receive distributions of capital from such offshore trusts tax-free.

The original February 1999 proposals indicated that all distributions, whether income or capital, would be taxable to Canadian-resident beneficiaries. Fortunately, this proposal has been scrapped. Capital distributions from trusts will continue to be tax-free.

New or recent immigrants to Canada may continue to use offshore trusts and obtain a 60-month tax exemption. In addition, trusts established by persons who never become resident, either by will or during their lifetime, will be tax-free indefinitely.

Former residents now living outside Canada may set up a tax-exempt offshore trust to benefit Canadian family members after 60 months of non-residency (18 months if set up by will on death).

OUTBOUND TRUSTS DIRECTLY TARGETED

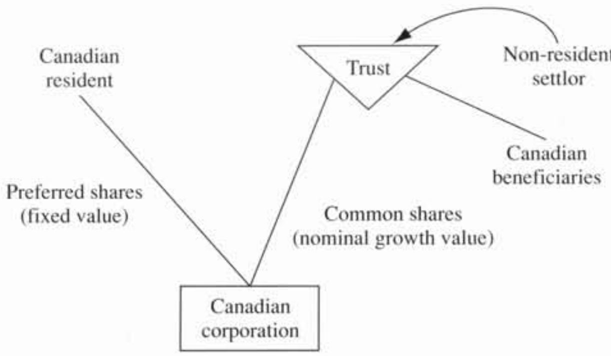
The draft legislation has far-reaching anti-avoidance rules to deter Canadian residents from establishing offshore trusts. Under current rules, a non-resident trust is subject to Canadian tax only if two conditions are met:

1. it received property from a person who has been a Canadian resident for at least 60 months, and
2. it has a Canadian-resident beneficiary.

Considerable intellectual energy has been spent by tax planners on structuring arrangements where one or both of these two conditions were not met.

One approach was to structure indirect arrangements where no Canadian-resident person could be viewed as having transferred property to the trust (see the accompanying figure). For example, an estate freeze could be structured whereby a non-resident purchased common shares of a company after the freeze and then contributed the shares to a non-resident trust. The trust arguably had not received property from a Canadian-resident person and, therefore, was not taxable.

This type of plan is now the focus of specific legislation. The intent is to deem the Canadian resident who is behind the scheme to have transferred property to the trust. Consequently, all non-resident trusts established by Canadian residents, in-



cluding those settled by non-residents who have some indirect connection with a Canadian-resident individual or company, must be carefully reviewed.

The second popular approach was to establish a non-resident trust with no Canadian-resident beneficiaries. In some cases, the trust would allow for unspecified beneficiaries to be added at a future date. Although an amendment in 1998 targeted this approach, some structures still managed to avoid taxation.

The new legislation, after 2001, will deem a trust to which a Canadian resident has transferred property to be a Canadian-resident trust, whether or not there are Canadian-resident beneficiaries. Therefore, if a Canadian resident establishes a trust with no Canadian beneficiaries, the trust will nevertheless be deemed to be Canadian-resident, and subject to Canadian tax.

The policy rationale for this approach is that Canadians have demonstrated an affinity for using of non-resident trusts to avoid Canadian taxation. If income is left in an offshore trust created somehow by a Canadian, it may well be earmarked for a fellow Canadian. Better to tax it than to leave the matter in doubt. However, if the income is actually paid out to non-resident beneficiaries, then, subject to certain limitations, it may escape Canadian taxation. The beneficiaries may of course pay tax on receiving this income, depending on the laws in force where they live.

TRANSITIONAL PLANNING

For trusts caught in the transition from the old rules to the new, there are important transitional rules to be aware of. Property will be revalued to its fair market value on December 31, 2001, provided that the trust was not taxable under the existing rules and the property is not taxable Canadian property.

GREATER ENFORCEMENT

Two very important enforcement tools have been added by the new legislation. First, any Canadian who has contributed property to an offshore trust will be jointly and severally liable for the trust's tax, together with the trust and its beneficiaries (to the extent of distributions received). This allows for collection of tax from any Canadian resident who has participated in some way in the creation of the trust.

The second enforcement tool is expanded information reporting. Under previous rules, a Canadian who participated in the establishment of an offshore trust might have been able to avoid information reporting. Under the new legislation, the reporting rules have been broadened. In addition, if an entity other than a traditional trust has been used, such as a foundation, information reporting is still required.

It is very clear from the thrust of the legislation that the Canadian government is looking to make the tax system watertight in the area of offshore trusts, except where planning is specifically sanctioned (such as for immigrants and trusts established by non-residents of Canada).

The new rules are applicable to 2002 and subsequent years. All existing structures should be reviewed in advance of this.

A number of articles on this topic are available on our Web site.

MEMBER PROFILE

Howard Berglas

Howard Berglas is a partner and a founding member of Cadesky and Associates in Toronto. He is known for his approachable manner, his negotiation skills, and his wide repertoire of tax-planning techniques.

Howard has written and lectured extensively, for organizations including the Society of Trust and Estate Practitioners (STEP) and the Canadian Tax Foundation. His areas of expertise span tax disputes, owner-manager issues, tax shelter syndications, and international tax planning.

Alter ego trusts: A new estate-planning strategy

Jonathan L. Richler MA, LLB, TEP

Richler and Tari, Tax Lawyers

There will be a large number of situations where the alter ego trust (and its close cousin, the joint partner trust) is a useful estate-planning strategy.

Estate planners have been provided with a new tax planning tool—the alter ego trust. This vehicle offers significant benefits for those who wish to avoid probate fees or the public disclosure associated with the probate process. In Ontario, probate fees are 1.5% of the gross estate (0.5% on the first $50,000). For example, on a $5 million estate, probate fees are approximately $75,000—not exactly an incidental cost. The new rules are likely to boost interest in inter vivos trusts, such as alter ego trusts, as an alternative to wills.

An alter ego trust is a trust created by an individual age 65 or over in which the individual (the settlor) is entitled to receive all of the income that arises before death and no other person may receive income or capital before that time. Accordingly, the settlor has complete enjoyment of the trust assets during his or her lifetime. In the trust deed, the settlor can designate alternate beneficiaries who will receive the income and/or capital of the trust assets following the settlor's death. This allows for estate planning through inter vivos trusts in much the same way as through wills.

Unlike other trusts, in which a transfer of assets to the trust can trigger a gain for income tax purposes, a transfer of assets to an alter ego trust is tax-free. This feature, combined with the client's ability to maintain full control of the trust assets during his or her lifetime and to pass them on to beneficiaries of choice, while avoiding probate fees on death, makes the alter ego trust an attractive estate-planning option.

The settlor continues to be taxed on all of the income and capital gains arising from the trust during his or her lifetime. On the settlor's death, the trust is deemed to sell its assets at fair market value (which is identical to what occurs on the death of an individual). A variation of the alter ego trust, the joint partner trust, allows the settlor and his or her spouse to share in the plan. Tax is postponed until the spouse's death.

There are other potential issues to be addressed with alter ego trusts. For example, where real estate is proposed to be transferred, land transfer tax consequences need to be considered. Also, where appreciating assets are held in the trust, the tax liability in certain cases could be greater than it would have been if the individual had retained the assets. The taxes paid by the deceased in the year of death on his or her terminal return are taxed at the deceased's marginal tax rate, after claiming personal exemptions, whereas any gains held in an alter ego trust will be taxed at the highest tax rate with no personal exemptions.

These caveats aside, there will be a large number of situations where the alter ego trust (and its close cousin, the joint partner trust) is a useful estate-planning strategy. The key is proper planning to ensure that the trust is appropriate for the individual and fits into his or her overall estate plan. The professional costs of setting up the trust (drafting the trust deed) and yearly trust reporting (financial statements and T3 trust tax returns) will be more than justified by the probate savings for estates exceeding $2 million.

A technical paper on alter ego trusts is available on our Web site.

Jonathan Richler is a founder of Richler and Tari, Tax Lawyers. His practice is focused on domestic and international personal and corporate tax planning and implementation. Jonathan often works closely with numbers of the Tax Specialist Group. He can be reached at Richler and Tari, phone 416-498-7090, fax 416-498-5190.

E-commerce within an international environment: Part 2

Grace Chow CA, FCCA, ATIHK, TEP

Cadesky and Associates

In part 1 of this article, we reviewed the issues to consider when structuring an e-commerce-based business within an international environment. In part 2, we review how profits may be withdrawn from these structures.

WEBSITECO OWNED BY CANADIAN PARENT

We will first look at a situation where the parent company is located in Canada. Our typical scenario is illustrated in figure 1. Websiteco earns active business income from selling goods and services to international and Canadian customers who order over the Internet. Under this business structure, consider the following:

- Is the income of Websiteco truly active income or can it be deemed to be foreign accrual property income (FAPI)? If FAPI, Websiteco's income will be taxable to Canco as earned by Websiteco.
- How is the income taxed when it's distributed to Canco?
- What are Canco's reporting requirements?

Foreign accrual property income

The income of Websiteco will be considered FAPI if

1. Websiteco earns income from property or
2. Websiteco is deemed to carry on a non-active business.

Income from an active business (such as the sale of property or the provision of services) generally is not income from property. Royalty income (such as income based on usage), however, is income from property. In the e-commerce world, it is not always simple to distinguish royalty income from income from an active business. It is important, then, to analyze the nature of Websiteco's income. Strangely, Websiteco can be deemed to be carrying on a non-active business when it makes sales of goods produced in a country other than the one where Websiteco is located to a related Canadian company. There is, however, an exception to this rule if more than 90% of the gross revenue of Websiteco is derived from sales to arm's-length parties.

Repatriating income to Canada

Assuming that Websiteco earns income from an active business, we must now consider the tax implications of bringing the earned income back to Canada. This will depend on whether Websiteco is resident in a treaty or a non-treaty country.

Websiteco in a treaty country If Websiteco is resident in and carries on business in a country with which Canada has a tax treaty, Websiteco's income from an active business may be repatriated to Canco without tax. (See figure 2.)

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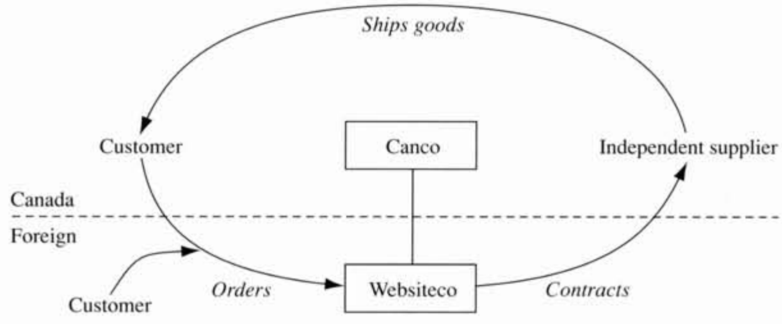
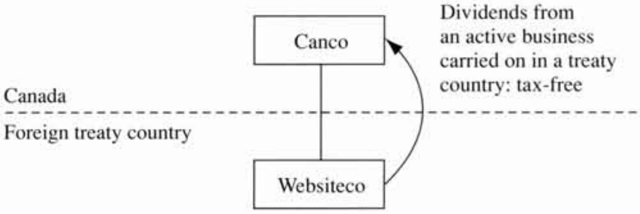
If Websiteco is resident in and carries on business in a country with which Canada has a tax treaty, its income from an active business may be repatriated to Canada without tax.

Figure 1



Recall from part 1 of this article that the Web site itself is not considered a permanent establishment. To have a permanent establishment in a treaty country, there must be an office where income-generating activities occur.

Figure 2

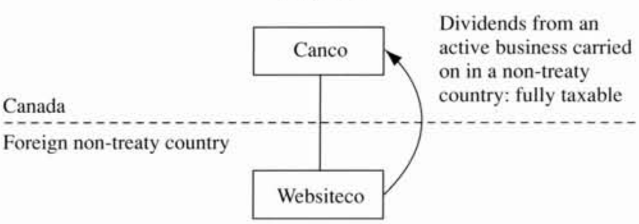


The income earned from the business carried on in the treaty country may be subject to tax there. Dividends paid may be subject to withholding tax by the treaty country. No relief is given by Canada for these taxes, because the dividend itself is not taxable.

Websiteco in a non-treaty country If Websiteco is resident in or carries on business in a non-treaty country, income from an active business will be taxable to Canco when repatriated to Canada. Certain deductions are allowed for foreign income taxes and withholding taxes paid by Websiteco.

If Websiteco is located in a non-treaty country, chances are that this country will be a tax haven. Websiteco will pay little or no tax in that country, nor will it be subject to withholding tax. Therefore, the dividend paid from Websiteco's active business will be fully taxable in Canada. (See figure 3.)

Figure 3



If a non-treaty country is to be used, it will generally be better to own Websiteco through a foreign corporation, as discussed below.

WEBSITECO OWNED BY FOREIGN PARENT

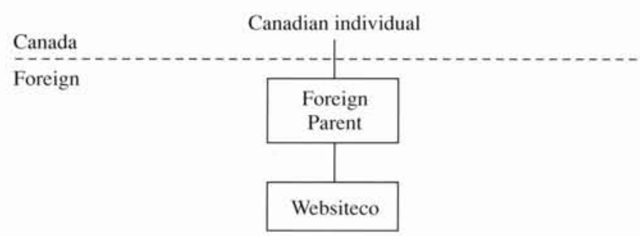
We now consider the business structure in which Websiteco is a wholly owned subsidiary of a foreign corporation. (See figure 4.)

If dividends are paid by Websiteco to Foreign Parent,

If Websiteco is resident in or carries on business in a non-treaty country, income from an active business will be taxable to Canco when repatriated to Canada.

these dividends will not be taxable to the Canadian resident as long as funds are left in Foreign Parent. This is a useful structure for the long-term deferral of taxes.

Figure 4



If funds are taken out of Foreign Parent as dividends, they will be fully taxable. If, however, shares of Foreign Parent are redeemed, this will yield a capital gain taxable at a 50% rate.

REPORTING REQUIREMENTS

Under any of the possible business structures, the Canadian-resident shareholder must file form T1134B in respect of a controlled foreign affiliate. Under the scenarios illustrated in figures 1 to 3, Canco will file in relation to Websiteco. Under the scenario illustrated in figure 4, the Canadian individual shareholder will file in relation to Foreign Parent and Websiteco.

Form T1134B is due 15 months after the year-end of the reporting taxpayer. For example, if Canco has a March 31 year-end, then form T1134B for March 31, 2001 will be due on June 30, 2002.

CONCLUSION

This article has illustrated some of the tax issues on repatriating income from an e-commerce offshore company. Interested readers can visit our Web site for more information.

SR & ED and year-end planning

Gary L. Bateman P ENG, MBA, CA

Bateman MacKay

It is important for tax and business reasons to always conduct a certain level of year-end planning and review. Claims filed under the scientific research and experimental development (SR & ED) provisions of the Income Tax Act are no different. This article, like SR & ED, is divided into technical and financial areas.

TECHNICAL AREA

From the technical point of view, the most important consideration is to compile completed activity descriptions. However, time sheets, contractors' statements of work, and prototype information are also worth reviewing for material to document research projects.

Activity descriptions

In most companies, activity descriptions must be drawn from the technical staff. Ideally, the activity descriptions should be written in real time, as the activities occur. It is difficult to write comprehensive descriptions at or after the end of the year. Both the technical achievement sought and the technical uncertainty involved should be written at the beginning of the activity. Research steps can be written at the end of the activity, in the past tense, to show what actually occurred. A review at the end of the year and at the end of the activity will ensure that the technical staff remember these considerations. A further goal of a year-end review is to look for activities that logically should have occurred but that have not yet been documented.

Time sheets

It is important that the technical staff prepare ongoing time sheets. A year-end review of time sheets from all researchers is an essential part of the research expenditure documentation. A research file supported with time sheets will successfully withstand CCRA review.

There are two aspects to the time sheet: its existence and its reasonable completion. Existence should be reviewed as a clerical function, either throughout the year or at year-end, but reasonable completion should be reviewed by a senior person who knows what has happened and what should have happened in the research department. Additional SR & ED activities may be discovered from this review.

Contractors

It is common for corporations to engage third-party contractors to assist with the research endeavour. Before year-end, it is important to find either the statement of work or the legal contract with the subcontractor to prove its relationship to the research activity. It is critical to ensure that the corporation has the right to exploit the results of the work from the contractor, and that the contractor will not make a claim for SR & ED on its own behalf for the same money.

Prototypes

To remove technological uncertainty, prototypes are often constructed during the R & D process. Materials are often destroyed and discarded as the prototype takes shape. Most corporations know the cost of the final prototype, but the essential cost is that of the materials destroyed and discarded throughout the year. At year-end, it is still possible to recreate these costs. Later, it is often impossible.

> Year-end planning means current, real-time involvement in the SR & ED documentation system. This will result in an optimal claim and fewer concerns when CCRA reviews the tax credit request.

FINANCIAL AREA

From the financial point of view, there are several considerations in a year-end review. These include the 180-day payment rule, the accrual of government assistance, and salary planning for specified shareholders.

Payables

If an R & D expenditure has been accrued as a payable during the fiscal year, the amount must be paid within 180 days after year-end for the corporation to obtain the investment tax credit for that taxation year. The amount is eligible for the deduction, but not the investment tax credit if it fails this test. A year-end

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A Christmas gift from CCRA

Michael Cadesky

Cadesky and Associates

A new and much more liberal policy will apply to employee gifts starting in 2001.

Previously, an employee could receive one tax-free gift of under $100 per year, as long as the employer did not deduct it. Now, up to two gifts may be received tax-free annually, with a total value of up to $500, and the employer may take a tax deduction. The gifts must not be in cash (or near-cash such as gift certificates or gold nuggets).

A similar policy will apply to employee merit awards. Thus, in combination, an employee could receive up to $1,000 in goods tax-free annually.

We caution that we have not seen a written version of this policy. With luck, the warm reception this announcement received will not cause CCRA to rethink its position.

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review of amounts that may fail this test would obviously be of benefit.

Receivables

The corporation may be eligible to receive government assistance under, for example, the Industrial Research Assistance Program (IRAP). It is essential that amounts expected to be received are netted against expenditures for the year in which the expenditures are made. A year-end look at receivables under the program will verify that this calculation is correct.

Specified shareholders

A significant planning opportunity is available for Canadian-controlled private corporations (CCPCs) with specified shareholders who are involved in the research program. To take advantage of this opportunity requires a look at salary levels before year-end.

Specified shareholders are those who own more than 10% of the stock of the corporation. The amount of the research deduction available for such employees is limited to five times the maximum pensionable earnings under the Canada Pension Plan for that year. In 2001, this amount is $38,300. Therefore, a specified shareholder involved 100% in the research program could have a salary of almost $200,000 and have this amount fully eligible for research deductions and investment tax credits. As a result, it is important to ensure that the employee is paid sufficiently to take advantage of this provision.

A critical part of this plan is to remember that bonuses are not eligible for SR & ED. Further, the proxy calculation for a specified shareholder is limited to the least of three calculations: 75% of total wages, 2½ times the yearly maximum pension earnings, and the actual research apportionment of the salary. This calculation also leaves out any bonuses received by this individual.

Therefore, the salary levels of CCPC shareholders should be carefully considered. The standard policy of receiving a small salary and a large bonus when money is available should no longer be followed.

Taxable income level

The SR & ED rate is reduced from 35% to 20% and is not refundable if taxable income exceeds $200,000 in the prior year. This can happen unwittingly for three main reasons:

1. The salary of a related shareholder is not paid within 180 days of year-end, and is therefore not allowed as a deduction until the year in which it is paid.
2. Taxable income is set just below $200,000, and a small income adjustment (for example, disallowed entertainment) pushes income over $200,000.
3. The taxable income of associated corporations is not taken into account.

Subject to the comments on bonuses and eligibility for SR & ED, the time to set the bonus level is at year-end. At the same time, it is a good idea to make plans for payment of the bonus so that this is not overlooked.

CONCLUSION

Year-end planning means current, real-time involvement in the SR & ED documentation system. This will result in an optimal claim and fewer concerns when CCRA reviews the tax credit request.

In brief

NEWS OF IMPORTANT TAX DEVELOPMENTS

Howard Berglas

Cadesky and Associates

Of supreme interest!

It is not often that the Supreme Court of Canada chooses to hear cases involving income tax. So it's not surprising that when it does, it draws the attention of tax practitioners, the CCRA, and the Departments of Justice and Finance.

Two cases were recently heard by the Supreme Court, both involving the deductibility of interest.

In *Singleton v. Canada*, Singleton, a lawyer, used equity he had in a law firm to purchase a house. On the same day, he refinanced the equity in the law firm with borrowed money, withdrew the money, and bought the house. He claimed the interest as a deduction.

The issue before the court was whether the borrowed money was "used for the purpose of earning income from a business."

The court, in a 5:2 majority decision, rejected the Crown's argument to consider the "true purpose" and the "economic reality" of the series of transactions, which could lead to the conclusion that the purpose of the borrowing was personal.

Instead, the court focused on the interest deductibility provisions of the Act, which in its view require that the direct use of the borrowed funds be for the purpose of earning income from a business or property. Singleton clearly directed the borrowed money toward an investment in the partnership. Everything else was irrelevant and therefore he was entitled to a deduction.

In *Ludco Enterprises v. Canada*, the Ludmer family sought to deduct interest paid on borrowed money that was used to purchase shares in foreign corporations. The investments were carefully structured to avoid having to report the income earned by the foreign corporations until it was distributed. During the period in question, the Ludmers received $600,000 in dividends and realized the undistributed income as a large capital gain. They incurred $6 million in interest costs, which they sought to deduct.

The Crown argued that the Ludmers should not be entitled to deduct the interest paid, because they did not reasonably expect to earn income, other than capital gains, while holding the investment. The Crown believed that, since the primary purpose of borrowing to make this investment was to create deductions that exceeded the income expected, the interest deductions should be denied.

The court reaffirmed a well-established principle that it is not the purpose of the borrowing itself that is relevant, but rather the *use* of the borrowed money. Clearly, the borrowed money was used to buy shares of a foreign corporation. The court noted that the purpose need not be the only or primary purpose, but merely one purpose. Since the investment paid dividends that were subject to tax, the Ludmers had, as a purpose, the earning of income. Finally, the court made it very clear that, for the purposes of the interest deductibility provisions, "income" is not "net income" or "profit" but "gross income," and therefore, "absent a sham, window dressing or similar vitiating circumstances," courts should not be concerned with the amount of income earned or expected to be earned.

These decisions clarify the rules concerning interest deductibility. In the next issue, we'll review some strategies on how to make your mortgage tax-deductible.

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The court reaffirmed a well-established principle that it is not the purpose of the borrowing itself that is relevant, but rather the use of the borrowed money.

Ontario simplifies corporate tax filings

Starting in 2002, corporations will be allowed to make quarterly instalments instead of monthly instalments, if their Ontario taxes payable in the current or prior year are less than $10,000. Corporations do not have to make any instalments if their tax liability is under $2,000.

Corporations filing Ontario corporate tax returns will no longer have to file a copy of their federal T2 for taxation years ending after 2000.

Exemptions from source deductions

Employers have been required to withhold tax on payments made to RRSPs unless a waiver was obtained. Amendments will provide relief for employees and their employers from an unnecessary paper burden on payments made to RRSPs. Under the new rules, employers will not be required to withhold if they believe, on reasonable grounds, that the payments to an RRSP are deductible as an RRSP premium or as an eligible retiring allowance.

US estate tax update

Major changes have been enacted to the US estate tax, which may eventually lead to its complete repeal in 2010 (unless the repeal is repealed).

These changes, however, may provide little benefit to Canadian residents who own US situs assets, since no change has been made to the basic credit that exempts only the first US$60,000 of value from estate tax. US citizens or residents will see their basic credit exempt the first $1 million of value in 2002, increasing in stages to $3.5 million in 2009.

Fortunately, the Canada-US tax treaty may provide relief to Canadians who have a high proportion of their total assets in US assets. The treaty allows them to claim a credit prorated to the credit allowed US citizens and residents. For example, a Canadian who dies in 2002 owning a condo in the United States valued at US$400,000 and who has non-US situs assets valued at US$1.6 million will have one-fifth of the US$1 million exemption, or US$200,000, not subject to US estate tax.

It is unclear whether non-US residents/citizens who own US situs property will benefit from the repeal of estate taxes in 2010. The general consensus is that they will, but the repeal itself is uncertain. It is probably as important as ever for Canadians who own US property to arrange their affairs so as to minimize their exposure.

Rectification: Correcting your mistakes

The Supreme Court of Canada has decided not to hear an appeal of a decision of the Ontario Court of Appeal in *Juliar*. That court held that a rectification order may permit a corporate transaction to be altered from inception to reflect the true intention of the parties. Shares were transferred to a holding company for a note. A rectification order was granted so as to replace the note with shares so that the transaction would not result in immediate taxation. This was held to be the intention of the parties.

Making mistakes and then correcting them should not be considered a new approach to tax planning. But if you made a genuine error that created a tax problem, first try fixing the error, which could in turn fix the problem.

TSG TAX PERSPECTIVES

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