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TAX PERSPECTIVES

A QUARTERLY PUBLICATION OF THE TAX SPECIALIST GROUP (TSG)

Introduction

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Cadesky and Associates (Toronto)

With this edition of *Tax Perspectives*, we welcome three new TSG members. Lewis & Company will represent the group in Vancouver and Allan Cruikshank will serve as our representative in Montreal. Steven Peters, who writes in this newsletter about Canada's only hybrid entity—the Nova Scotia unlimited liability company (NSULC)—will represent TSG in Halifax.

This edition of *Tax Perspectives* has a Canada–US focus; a focus that reflects the expertise of TSG member firms as well as the interests of our clients.

Robert Sommer of the Buffalo, New York CPA firm Brock, Schechter & Polakoff, LLP outlines the requirements for filing US tax returns. Steven Peters describes how an NSULC may be useful in structuring Canada–US arrangements.

Kim Moody focuses on interest deductibility and Howard Wasserman has taken over the "In Brief" column from Howard Berglas, who has left the group to pursue other interests.

Finally, Gary Bateman writes about provincial rivalry in attracting R & D activities by offering tax incentives.

Making your mortgage tax-deductible

Kim G C Moody CA, TEP

Moody Shikaze Boulet LLP (Calgary)

On September 28, 2001, the Supreme Court of Canada released its long-awaited decisions in *Ludco* (2001 SCC 62) and *Singleton* (2001 SCC 61). Both cases involved the question of whether interest payments were tax-deductible.

For interest to be an allowable expense, it must meet certain criteria. In general, the amount must be paid or payable pursuant to a legal obligation to pay interest on borrowed money that is used for the purpose of earning income from a business or property. Income from property does not include a capital gain earned from the sale of that property. Therefore, interest on borrowed money used to generate a capital gain will generally not be considered tax-deductible. Such a determination is always a question of fact.

In response to the 1987 *Bronfman Trust* case, the Department of Finance released very detailed proposals for interest deduct-

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Making your mortgage tax-deductible

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ibility in a 1991 technical bill. These proposals, however, have been “on hold” for over 10 years while the Department has continued to study the issue. In the meantime, the treatment of interest deductibility has been in a state of flux. The *Singleton* and *Ludco* decisions move the issue of interest deductibility to the forefront once again.

Mr. Singleton was a partner in a law firm. In 1998, he withdrew $300,000 of equity from the law firm to assist in the purchase of a personal residence. He then borrowed approximately $300,000 from a financial institution and invested the funds back into the law firm to replace the funds taken out. On his tax return, Mr. Singleton deducted the mortgage interest charged on this loan, reasoning that the borrowed money was used to earn income from a business (that is, his law practice). Revenue Canada (now the Canada Customs and Revenue Agency (CCRA)) disagreed with Mr. Singleton’s reasoning and denied the interest expense deduction, saying that the borrowed money was used to finance the purchase of a house. The Supreme Court of Canada disagreed with the CCRA and suggested that it was an error to treat the transactions as one simultaneous transaction. To give effect to the legal relationships, the transactions must be viewed independently. Accordingly, the fact that the money was borrowed in order to allow Mr. Singleton to use his own funds to purchase the house was irrelevant. The court found that, in giving effect to the legal relationships underlying the transactions, it was obvious that the borrowed money was used directly to refinance the capital account in the law firm. This was a direct, eligible use of borrowed money. Accordingly, Mr. Singleton was entitled to deduct the interest expense.

In both *Singleton* and *Ludco*, the Supreme Court of Canada reviewed the four elements that must be present before interest can be deducted. They are:

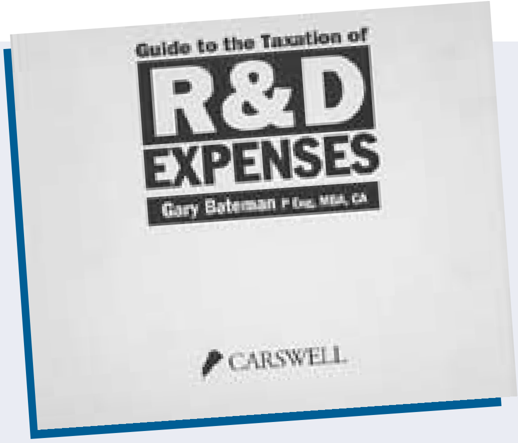
1. the interest must be paid in the year or be payable in respect of the year in which it is to be deducted;
2. the amount must be paid pursuant to a legal obligation to pay interest on borrowed money;
3. the borrowed money must be used for the purpose of earning income from a business or property; and
4. the amount must be reasonable as assessed by reference to the first three requirements.

The court also suggested in *Ludco* that in order to meet these conditions, there must be a “reasonable expectation of income.” The court further reasoned that “income” means income subject to tax and not *net* income.

These decisions clearly indicate that there is scope to plan one’s affairs to make interest deductible, even on a home mortgage. Such planning can replicate that of *Singleton*. All one needs is to have capital employed in an income-earning activity such as a business, a professional partnership, or an investment portfolio. Then, follow these steps:

- Create liquidity by borrowing from the business or the partnership or by liquidating the investments.
- Use the funds to pay off your personal mortgage.
- Borrow using your residence as security (that is, negotiate a new mortgage) and put the funds back into the income-earning activity.

Before entering into such transactions, we encourage you to seek professional tax advice to ensure that such a plan is appropriate for you and consistent with your overall financial planning objectives. TSG representatives welcome the opportunity to determine whether you can make your mortgage tax-deductible.



GUIDE TO THE TAXATION OF R & D EXPENSES

Guide to the Taxation of R & D Expenses is an in-depth handbook of Canada’s R & D rules. In addition to an exhaustive discussion of tax law, the book gives a step-by-step guide to submitting an R & D tax credit claim.

Written by TSG member Gary Bateman, P Eng, MBA, CA, and published by Carswell, this work makes Gary one of Canada’s pre-eminent R & D authorities.

US tax filings

Robert Sommer CPA

Brock, Schechter & Polakoff, LLP (Buffalo, New York)

For a variety of reasons, many Canadians have a keen interest in US tax matters. But keeping track of US tax filing requirements is not an easy matter. This article briefly summarizes the more commonly encountered tax filings, when and why they are required, and their due dates.

US CITIZENS AND US RESIDENT ALIENS

US citizens and US resident aliens must file US income tax returns reporting their worldwide income, regardless of where in the world they actually live. US citizens must comply with this requirement, regardless of whether they hold other citizenships (such as Canadian) and regardless of whether they hold a current US passport. In addition, children of US citizens are automatically US citizens as well, extending the filing requirement to the next generation. For those US citizens living outside the United States who have not complied with the requirement to file tax returns, the IRS has a voluntary disclosure program, and typically seeks six years of tax returns.

A person may be classified as a US resident upon meeting one of two tests: the lawful permanent resident test (otherwise known as the "green card" test) or the substantial presence test. The green card test is straightforward. A person holding a US green card is considered a US resident. The second test—the substantial presence test—requires more explanation. An individual will be

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US citizens and US resident aliens must file US income tax returns reporting their worldwide income, regardless of where in the world they actually live.

MEMBER PROFILES

Dora Mariani

Dora Mariani, CA, CFP, is a tax manager with the TSG member firm Cadesky and Associates in Toronto. She practises in Canadian and international tax matters, with a special emphasis on high net worth individuals, trusts, and executive compensation, where she can use her skills gained as a certified financial planner. Dora is an editor of *Taxation of Real Estate in Canada*, a reporting service published by Carswell. She is a member of the Society of Trust and Estate Practitioners (STEP), the Canadian Tax Foundation, and the International Fiscal Association, as well as the Ontario and Canadian Institutes of Chartered Accountants. Dora's experience includes training with two international accounting firms and a year with a major Canadian financial institution, where she acted as coordinator of personal and trust income tax.

Fred Richardson

Fred Richardson, CGA, is a tax specialist with the TSG member firm of Moody Shikaze Boulet LLP in Calgary. Fred's diverse background in public practice, industry, and three years with CCRA gives him a unique perspective on income tax issues.

Fred has written a number of courses for presentation to chartered accountants in and around the Calgary area, including a detailed analysis of the extremely complex stock option benefit legislation. His areas of expertise include tax and estate planning, owner-manager issues, personal tax issues, and the uses of trusts.

He is a member of the Society of Trust and Estate Practitioners (STEP), the Canadian Tax Foundation, and the Certified General Accountants Association of Canada.

US tax filings

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considered a US resident if he or she spends 183 days or more in the United States in the year. In addition, if the person cannot show a closer connection to another country, then a three-year moving average test can apply. Under this test, days in the current year count as a day, days in the preceding year count as one-third of a day, and days in the second preceding year count as one-sixth of a day. If the person accumulates a total of 183 days under this test, and has 31 days present in the United States in the current year, he or she will be considered a US resident. If, however, by filing Form 8840, one can demonstrate a closer connection to another country, the three-year moving average test will not apply.

All US domestic corporations are required to file US tax returns, reporting their worldwide income. Further, US limited liability companies that elect to be treated as US corporations are also required to file on this basis.

NON-US PERSONS

Non-US persons are required to file US tax returns in certain circumstances where they have US-source income.

In general, there is no requirement to file a US tax return for passive income, as long as the correct amount of withholding tax has been deducted. However, if the amount of withholding tax deducted is incorrect, it is adjusted by filing a US non-resident tax return (Form 1120F for a corporation or Form 1040NR for an individual).

An individual who derives employment income, business income, or gains from the disposal of US real estate must report this income on an individual income tax return (Form 1040NR). A corporation with income effectively connected to a US trade or business, including gains from the sale of US real estate, must report this income on a corporate tax return (Form 1120F).

Where an individual, trust, or corporation derives rental income from US sources, 30% withholding tax will be taken from the gross rental income. Alternatively, these persons may elect to file a tax return reporting the net rental income and pay tax on it at graduated tax rates.

Canadian individuals who are required to file a 1040NR return will need a taxpayer identification number. This takes some time to obtain, and is not a straightforward procedure. Form W-7 is used for this purpose.

Persons who take the position that an international tax treaty (such as the Canada–US treaty) exempts them from US taxation may need to file a treaty-based return position disclosure using Form 8833. There are substantial penalties for not filing this return.

Canadians who own 25% or more of a US corporation and foreign corporations engaged in a trade or business in the United States may be required to file Form 5472.

This article is certainly not a comprehensive list of all US tax filing requirements, but it does outline those more commonly encountered. By paying close attention to the filing requirements, the due dates, and required payment schedules, you will greatly reduce your exposure to interest and penalties, and thus have a happier experience when pursuing US activities.

TAX FILING DATE SUMMARY

Taxpayer or situation	Form to file	Filing dates	Extension
US citizen or resident	1040	4/15 or 6/15 (if out of US on 4/15)	4-month initial extension, second extension on application
Non-resident	1040NR	4/15 (if US salary); 6/15 otherwise	2-month initial extension, second extension on application
Domestic corporation	1120	2½ months after year-end	6-month extension on application
Foreign corporation	1120F	2½ months after year-end (if it has a US office); otherwise, 5½ months after year-end	With a US office, 6 months; otherwise, 3 months
Foreign individual closer connections	8840	With tax return (usually 1040NR)	As per return
Treaty-based disclosure	8833	With tax return (usually 1040NR or 1120F)	As per return
Application for identification number	W-7	Allow plenty of time for processing	N/A
25% foreign ownership	5472	With corporate return 1120 or 1120F	As per return

Provincial R & D incentives

Gary L. Bateman P ENG, MBA, CA

Bateman Mackay (Burlington, Ontario)

The provinces have never managed to agree on a standard R & D incentive. The only thing they seem to agree on is that, if the neighbouring province has an incentive policy, they need one as well. But like other things Canadian, there are exceptions—neither PEI nor Alberta has a separate provincial incentive. Perhaps Alberta's low provincial tax rate is incentive enough.

R & D performers must remember to claim the relevant provincial credit for each of the provinces in which they perform SR & ED. It is also important to know the provincial strategy with regard to refundability and the potential to renounce a provincial credit.

In brief, a provincial tax credit is taxable federally, and reduces the expenditure base on which the federal credit is earned. Therefore, if a provincial tax credit is renounced, the federal credit is increased. This may be important in a loss year if a provincial credit is non-refundable. As can be seen, the failure to claim these provincial credits in an optimal way denies a taxpayer a substantial portion of the benefit.

The table below summarizes the provincial credit rates and options.

Provincial incentives comprise three main groups: (1) refundable tax credits, (2) non-refundable tax credits, and (3) incentive deductions.

Refundable tax credits result in a refund whether or not the entity is taxable, while non-refundable tax credits may be claimed only against a provincial tax liability.

Incentive deductions give a deduction of over 100% of the expenditure as an additional incentive.

TABLE OF TAX INCENTIVES FOR SR & ED BY PROVINCE

Refundable tax credit	Tax credit rate	Expenditure limit	Renounceability	Eligibility notes
British Columbia	10%	First $2 million	Yes	CCPCs only[a]
Yukon	15%	None	No	All corporations[b]
Ontario	10%	First $2 million	Yes	All corporations up to $50 million[c] of taxable capital
Quebec	20%/40%[d]	None	No	Special rules apply; computed on labour only
Nova Scotia	15%	None	Yes	All corporations
Newfoundland	15%	None	No	All corporations

Non-refundable tax credit	Tax credit rate	Expenditure limited	Renounceability	Eligibility notes
British Columbia	10%	If not CCPC, no limit If CCPC, over $2 million	Yes	All corporations
Saskatchewan	15%	None	Yes	All corporations
Manitoba	15%	None	Yes	All corporations
New Brunswick	10%	None	Yes	All corporations

Incentive deductions[e]
Ontario (now suspended)
Quebec (now repealed)

[a] Canadian-controlled private corporations.

[b] Introduced June 30, 2000.

[c] After May 5, 1999, *all* corporations are eligible for the Ontario 10% refundable credit if their taxable capital is less than $50 million. Previously, only CCPCs were eligible for the 35% credit.

[d] 20% on labour payments only by all taxpayers except if (1) paid to a qualified entity by any business 40%, and (2) a qualified small business (SMB) made the labour payments 40%.

[e] The federal government moved to tax the deduction incentives. Both provinces that introduced them—Quebec and Ontario—have since repealed or suspended this incentive. The Ontario superallowance deduction became taxable federally in the February 27, 2001 federal budget.

Nova Scotia unlimited liability companies

Steven Peters CA, CPA

Steven Peters Limited (Halifax)

An NSULC is eligible for the Canadian tax benefits accorded Canadian corporations, such as tax-free reorganizations, the small business deduction, and refundable taxes on investment income.

It is often said that tax is the world of the strange and bizarre. But who would have thought that the failure of Nova Scotia to modernize its corporate legislation would create a US tax-planning opportunity? Nova Scotia is the only province to contain a vestige of archaic English corporate law that allows shareholders to elect to have unlimited liability for corporate debts. This unlimited liability causes a company making this election, a Nova Scotia unlimited liability company (NSULC), to be treated as a "flowthrough" entity for US tax purposes—a disregarded entity if it has only one shareholder and a partnership otherwise. Either way, the US shareholder of the NSULC reports its share of the NSULC's income and expenses directly on its US tax return.

An NSULC is still treated as a corporation for Canadian tax purposes. It is thereby eligible for the Canadian tax benefits accorded Canadian corporations, such as tax-free reorganizations, the small business deduction, and refundable taxes on investment income. This hybrid status—a flowthrough entity for US purposes but a corporation for Canadian purposes—provides a number of advantages, which have made the NSULC one of the most powerful tools in Canada–US cross-border tax planning. Two of these advantages will be discussed in this article, and additional points will be explored in a sequel.

	Ordinary Canadian Corporation	NSULC
	dollars	
Income from Canco	100	100
Corporate tax payable (40%)	40	40
Dividend paid	60	60
Withholding tax payable (15%)	9	9
Net corporate income received by Ms. X	51	51
US income	60	100
US personal tax payable	24	40
Foreign tax credit	(9)	(40)
US tax payable	15	—
After-tax cash	36	51

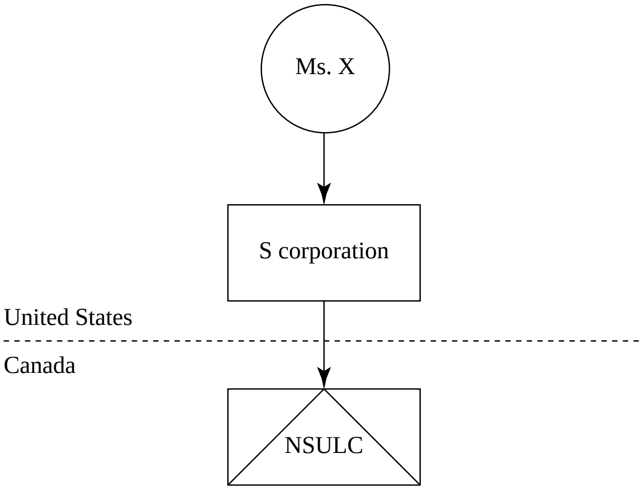
FOREIGN TAX CREDIT

The primary benefit of an NSULC to a US individual investor is that it allows a foreign tax credit on the investor's US tax return for the Canadian corporate income tax of the NSULC, thereby avoiding double taxation.

Let's consider the scenario of Ms. X, a US citizen who intends to carry on a business venture in Canada through a Canadian corporation (Canco). Because it is not Canadian-controlled, Canco will be subject to Canadian corporate income tax at the high rate. We will assume that Ms. X will be subject to US income tax at the highest marginal tax rate. If an ordinary Canadian corporation is used, Ms. X will pay US income tax on dividends received, but will not receive any foreign tax credit for Canco's corporate income tax. As a result, the total tax burden after all profits have been distributed to her will be a rather depressing 64%. In contrast, if Canco is an NSULC, Ms. X's ability to claim a foreign tax credit for Canco's corporate income tax will reduce the total tax burden to approximately 49%—thereby increasing her after-tax income from $36 to $51 for every $100 earned by Canco!

LOSS FLOWTHROUGH

Another potential benefit to Ms. X is that losses of the NSULC may, subject to certain constraints, flow through and be deducted on her US income tax return. This flowthrough is a timing benefit if the NSULC turns around and becomes profitable in the future, or could become a permanent benefit if the NSULC is ultimately wound up at a loss. If an ordinary Canadian corporation had been used, the loss on liquidation would be a capital loss, which may be used by Ms. X only against capital gains.



STRUCTURING TO INSULATE FROM LIABILITY

As noted above, the shareholders of an NSULC have unlimited liability for corporate debts. This liability arises if the NSULC has insufficient assets to meet its obligations on winding up. To protect the shareholders from this liability, a US corporation would normally be interposed between the US shareholder and the NSULC as a holding company. In this scenario, the holding company would be an S corporation, which, like an NSULC, is treated as a flowthrough entity for US tax purposes. The S corporation also serves to reduce the Canadian withholding tax rate on dividends paid by the NSULC from 15% to 5%, increasing the net retention from 51 to 57%. This structure is illustrated above.

Existing corporations can be converted to NSULCs on a rollover basis for Canadian tax puposes. Such conversion can be advantageous in advance of bringing in a new shareholder who is a US taxpayer. However, the conversion will be taxable as a liquidation for US purposes, triggering accrued gains if the corporation already has a US shareholder. This highlights the importance of proper planning at the outset of a business venture.

My technical paper on NSULCs is available on our web site at www.taxspecialistgroup.ca.

In Brief

NEWS OF IMPORTANT TAX DEVELOPMENTS

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Foreign trusts are still foreign

On December 17, 2001, the Department of Finance issued a news release in which it announced a one-year delay in the effective date of all proposals affecting nonresident trusts and foreign investment entities. This means that these rules will now come into effect on *January 1, 2003*. This delay is significant because it means that one has until the end of 2002 to complete any tax planning done in contemplation of the new rules.

It appears that the government received many detailed submissions on the rules and wanted to review them carefully before finalizing the proposed legislation. We anticipate that revised proposals will be released by the spring.

It is important for all individuals with ties to foreign trusts to have their situations reviewed before 2003.

Late-filing subsection 216 tax returns

Non-residents of Canada who receive rent from Canadian properties have the choice of paying 25% withholding tax on their gross rental income or paying tax at regular rates on their net rental income. In many circumstances, tax payable on net income is far less than the 25% withholding tax. In order to pay tax on the net rental income and avoid the 25% withholding, the non-resident should file an NR6 form before the calendar year commences, showing expected net rental income, and then file an income tax return within six months of the year-end. If no NR6 form has been completed, the 25% withholding will apply, but can be claimed back by filing an income tax return within two years of year-end.

It is important to note that if these elective tax returns are not filed on time (within six months or two years, depending on whether an NR6 form was filed), there is currently no mechanism for the CCRA to accept them. This is unfortunate, considering that net income from rental activities may actually be nil. Being liable for 25% withholding tax on gross rents is, therefore, a real hardship.

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It now seems, however, that the CCRA is changing its hard-line position on late-filed returns. The CCRA recently sent letters to various non-residents stating that they had “one opportunity to late-file a return for any previous year.” This means that a non-resident may be able to catch up for all outstanding years.

The CCRA will not accept a late-filed return if there was correspondence between the CCRA and the non-resident that a tax return was required or if actions have commenced against the non-resident to enforce the legislation. In essence, the non-resident must make a voluntary disclosure.

Where a late-filed return is allowed, the government will assess arrears interest on the withholding tax that has not been deducted or withheld, as well as on any amount of income tax that the non-resident owes.

Corporate instalments

In the federal budget of December 10, 2001, the government announced a deferral of corporate tax instalments for small businesses. It proposed to defer the federal income and capital tax instalments for January, February, and March 2002 for at least six months. Therefore, any instalments that would otherwise be due for these months may be deferred, provided that the taxable capital employed in Canada is under $15 million.

Ontario has also announced that corporations that have income and capital tax between $2,000 and $10,000 can now make quarterly, rather than monthly, tax instalments.

Tax rates decline

Although federal tax rates for individuals remain unchanged, provincial rates for 2002 have been dropping in British Columbia, Saskatchewan, and Quebec. Of course, many provinces will have budgets in April or May, and more rate reductions may be in store. The lowest taxing province remains Alberta, where the maximum combined rate for individuals is 39%.

Corporate tax rates are dropping in the prairie provinces for small business, and the tax rates for corporations in the highest bracket are being reduced by 2%. Every bit counts! ●

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Free tax tips

Last month, TSG launched “Tax Tip of the Week,” a free information service that goes to about 1,000 clients and friends of member firms. This free service, written in non-technical language, outlines useful tax-planning ideas and strategies. If you would like to be added to our Tax Tip circulation list, contact any TSG representative. ●