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TAX PERSPECTIVES

A QUARTERLY PUBLICATION OF THE TAX SPECIALIST GROUP (TSG)

Introduction

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The View from 37,000 Feet.

Somewhere between Northern Japan and Alaska, traveling at 600 miles an hour, the dawn finds me busily writing this introduction to Tax Perspectives. From here, the world seems a very small place. Borders vanish and the International Date Line we crossed a moment ago registers nothing. Tired but determined I press on.

As the world becomes more and more international, so must we. The addition of Arnold Sherman to our group does just that. He brings a working knowledge and practical experience of the tax systems and business structures of over 60 countries.

Our Asian connection has been strengthened by Thomas Lee and Partners of Hong Kong, a tax specialist firm who can handle tax issues in South East Asia and China. This will have far reaching benefits for the group.

Our long term associate, Graham Smith and Partners of Amsterdam, continues to handle European tax matters for our clients. Stanley Ruchelman of The Ruchelman Law Firm, based in New York, assists on U.S. tax matters.

As a group, we will continue to strengthen our international capability, and from time to time we will profile our associate firms from around the world.

To find out more about our international capabilities, visit our web site at www.taxspecialistgroup.ca.

Paying Yourself With Capital Gains

Kim Moody, CA, TEP

Moody Shikaze Boulet, LLP (Calgary)

In these economic times, capital gains are elusive, yet there is an easy way for business people to create them, and pay themselves at the same time.

Traditionally, owner-managers have taken remuneration either by salary or by dividends. However, with certain structuring, it is possible to withdraw funds from a corporation as a capital gain, instead of a dividend.

There are many reasons why remuneration by capital gains could be beneficial. Firstly, capital gains are taxed at a lower rate than dividends, with the savings ranging from 4% to 9% depending on the province. Secondly, capital gains which are allocated to minor children (possibly via a trust) are not subject to income attribution or to the so-called "kiddie" tax. Therefore, capital gains can be used for income splitting.

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Lastly, if you have capital losses, capital gains may be offset against these losses, allowing the gains to be received tax-free.

For the most part, this tax planning is effective in two basic scenarios:

- For owner-managers with corporations that carry on an active business and have income eligible for the small business deduction.
- For foreign corporations which carry on an active business, especially if they are established in low tax jurisdictions.

The possibility of receiving remuneration as capital gains should be considered for all owner-managers. While the strategy does involve some complexities, and may have some risks associated with it, the benefits, in our view, can substantially outweigh the costs.

Becoming Non-Resident

Allan Cruikshank, CA,

Cruikshank Associates (Montreal)

It is common knowledge that the Canada Customs and Revenue Agency (the "CCRA") takes an aggressive view of who is a Canadian resident. If a person has ties to Canada, then that person may be considered resident, even though they may also have a tax residence in another country.

As an extension of this, persons who become non-residents, but who continue to keep certain ties to Canada, may also be considered resident. Therefore, it is hard to become a non-resident. Right? Wrong!

Several years ago, a special rule was introduced for persons who are residents of countries with which Canada has an international tax treaty. If a person is resident in a treaty country, then that person will be deemed to be a non-resident of Canada. This is best illustrated by an example.

Several years ago, John and Mary bought a condominium in Florida and have been spending more and more time in the U.S. Last year, they applied for a visa to allow them to live in the U.S. on a full year basis. However, John still has a business in Canada in which he is actively involved. While the business has now been passed to his children, they still require his guidance on an on-going basis with important business decisions.

John and Mary know that the tax rates in the U.S. are significantly lower than the tax rates in Canada, provided appropriate planning is carried out. They would like to become non-residents, but are concerned about their ongoing ties to Canada.

Under the Canada-U.S. Treaty, if a person would otherwise be a dual resident (i.e., a resident of Canada and the U.S.), then that person's residency is determined by the so-called tie-breaker test. Under this test, the person will be deemed to be resident where they have a permanent home available. However, if they have a permanent home available in both countries (or in neither country), then they are considered to be resident where they have their centre of vital interests.

If John and Mary cease to have a permanent home available to them in Canada (which may include a property owned or rented), then they will be categorically considered U.S. residents under the tie-breaker test. However, if they retain a home in Canada (which could include a seasonal residence such as a cottage), then one must consider their centre of vital interests. This is basically a measure of their economic and social relationships with the U.S., as compared to their relationships with Canada. While this is quite subjective, there is a substantial risk that they could be considered Canadian resident under this test.

Until recently, there was always the worry that Canada could consider John and Mary to be ongoing Canadian residents, even though they would be considered U.S. residents under the Canada-U.S. Treaty. There is also the issue of time spent in Canada. For example, if John spends over 183 days in Canada, then he would be deemed to be Canadian resident.

A change to Canadian law now overrides these concerns. If resident in the U.S. under the Canada-U.S. Treaty, then John and Mary are deemed non-residents of Canada regardless of their ties to Canada or time spent in Canada.

This rule provides for greater certainty in planning a person's residency status. Since Canada has international tax treaties with over 50 countries in the world (Hong Kong and Taiwan being the main exceptions), extensive use can be made of this planning. In other words, becoming a non-resident is a more feasible strategy than ever before.

In considering such a strategy, it is important to obtain qualified professional advice on issues related to leaving Canada, and the tax position in the country to which the person is going. Depending on the assets involved, this may be relatively simple, or extremely complex. These considerations include departure tax on leaving Canada (deemed capital gains on assets which have appreciated), how to deal with retirement plans, and the tax position of ongoing Canadian investments and businesses. Of course, advice must also be obtained in the country to which the person is going, and this advice must be coordinated with the Canadian structuring, in order to maximize the international opportunities.

REASONABLE EXPECTATION OF PROFIT
THE DEMISE – WHAT'S NEXT?

Michael Cadesky, FCA, TEP

Cadesky and Associates (Toronto)

In the mid-1990s, the Canada Customs and Revenue Agency (the "CCRA") discovered a weapon previously seldom used. It was a weapon of devastation to taxpayers, particularly individuals who purchased syndicated investments. In one sweep, the CCRA could disallow the tax deductions claimed by an entire investment syndicate, simply on the basis that it had failed to objectively establish that it could be profitable.

Having met with initial success, a theory developed in the CCRA that most syndicated investments were never designed to make a profit. Instead, they were clever arrangements designed to synthesize tax losses, without regard to the normal rules of business economics. While the CCRA would go through certain motions to demonstrate that they had objectively considered all of the facts, we have substantial evidence to indicate the opposite - in many cases the information provided by taxpayers to justify the investment's viability was simply ignored. Standardized responses on a mass-mailing basis were very much the order of the day from the CCRA.

Fortunately, the Supreme Court has put a stop to this. According to the Supreme Court, the reasonable expectation of profit test is only relevant where personal use is involved. Even then, it is necessary to carefully examine whether the project has economic viability.

How will the CCRA react to this decision, and what are the longer term implications?

While the CCRA must clearly be unhappy about the Supreme Court's decision, it is unlikely that we will see legislative changes as a result. There are already a number of tests in the Income Tax Act to govern expense deductibility, and these should be sufficient in and of themselves. Furthermore, sensitive areas, such as deducting losses created by claiming depreciation, already have rules which limit the deductions available.

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It is our prediction that the CCRA will have to live with the Supreme Court's decision, and readjust their thinking on syndicated investments. Instead of being able to deny deductibility outright, based on general grounds, any attack will now have to be based on technical merit. This means that syndicated investments which are bona fide, and well constructed from a technical perspective, should yield tax deductions which are allowable. This may very well give rise to the rebirth of syndicated investments, as a means to own and finance real estate investments and business projects.

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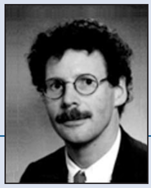

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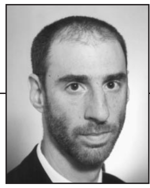

Howard L. Wasserman, CA, CFP, TEP

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When an individual passes away, a final return must be prepared by April 30 following the year of death or six months after death, whichever is later. In that terminal return, the deceased taxpayer is able to claim donations made in the year and those included in the Will (subject to the restrictions discussed below).

The amount of donations that can be claimed in the terminal return is limited to 100% of the income reflected in that return. If there are excess donations, they can be used in the immediately preceding tax year. The donation credit can be of significant tax savings.

As stated above, there are two types of donations available in the year of death: those actually made and those gifted by Will. For those gifted by Will, it was CCRA's position that the charity must be named and the amount specified. This made it difficult to get a donation credit when a taxpayer's Will stated that a certain amount could be given to any charity at the trustee's discretion or that any money left over after specific bequests or payments should be donated to charity. In both of these situations, there was some uncertainty as to either the amount or the charity itself.

CCRA has now developed some new policies as stated in their Technical Interpretation 2001-0090205. One of the new policies is that, where the Will states that a specific amount in total is available for charities, and a list of charities is given, a donation credit will be allowed in the terminal return, even though the trustee or executor has the discretion as to how much each charity will get.

Another new approach from CCRA concerns charities not specifically named. Where the Will states that a trustee is to make a donation without identifying the charity, the donation could still be used as a credit in the terminal return. As long as the Will states that there should be a donation of either a specific property, a specific amount, or a percentage of the residue of the individual's estate, then the donation would be available as a tax credit.

The above policies are a significant change from CCRA's previous policy. This changes the way individuals might formulate their Wills. In the past, professionals advised clients to name specific charities and give specific amounts. This was often difficult for individuals, since they did not always know the size of their estate. Therefore, whenever Wills are revised or new ones are made, this should be kept in mind.

PROFILE – ARNOLD SHERMAN CA, TEP

Based in Calgary, Arnold Sherman has one of the most extensive private tax libraries in Canada, if not the world. As a consulting editor and advisory board member for the International Bureau of Fiscal Documentation (IBFD), Amsterdam, he reviews publications of the IBFD and has a complete set of their materials dating back several decades. The wall-to-wall coverage of tax journals in his office reflect Arnold's interests and expertise – knowledge of international taxation in over 60 countries. Arnold also teaches at the IBFD's affiliate, the International Tax Academy.

Originally from England, Arnold is a fellow of the Institute of Chartered Accountants of England and Wales. He also holds similar memberships in Canada, Cyprus and Israel, and is a member of the Chartered Institute of Taxation (U.K.) and the Society of Trust and Estate Practitioners.

ONTARIO RESEARCH EMPLOYEE STOCK OPTION CREDIT

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"The Ontario Research Employee Stock Option Credit ("ORESO") is an Ontario tax incentive to reduce Ontario personal income tax. It applies to income and capital gains of employees arising from stock option benefits and capital gains on the sale of shares."

The Ontario Research Employee Stock Option Credit ("ORESO") is an Ontario tax incentive to reduce Ontario personal income tax. It applies to income and capital gains of employees arising from stock option benefits and capital gains on the sale of shares.

Eligible employees can receive a refund of their Ontario personal income tax on up to $100,000 of taxable income each year. There is no lifetime limit to the amount of taxable stock option benefits and taxable capital gains that qualify for this incentive. However, this incentive only applies to stock options that are granted after December 21, 2000.

For a taxpayer to be eligible for this incentive, he/she must be an eligible employee; the employer must qualify as an eligible employer; the stock option agreement must meet certain criteria; and certain forms must be filed by both the employee and employer within specific time frames.

The employee must first pay the Ontario tax on the filing of a personal income tax return, and subsequently file an application with the Ministry of Finance (Ontario) for a refund.

Eligible Employee

To be eligible for the ORESO tax incentive, an individual must meet the following criteria:

- Be an Ontario resident on December 31 of the year in which the eligible stock option was granted, and the year in which the income is taxable;
- Be eligible to claim the 50% stock option deduction;
- Not be a specified shareholder of the corporation (i.e., not own more than 10% of any class of shares of the corporation);
- Spend at least 30% of his/her time in eligible SR&ED work;
- Be employed by the employer for at least six months (including at least part of the year in which the stock option was granted); and
- Be a full-time or permanent part-time employee.

Eligible Employers

The employer must also meet certain criteria. An employer is an eligible employer for the ORESO tax incentive if the following criteria are met:

- the employer is a corporation;
- the employer carries on business and undertakes R&D through a permanent establishment in Ontario; and
- the employer incurs eligible R&D expenditures in Ontario of $25 million or 10% of its total revenue, whichever is less, in the taxation year prior to the year in which the stock option was granted.

The employer is required to complete certain paperwork, both in the year that the option is granted and when it is exercised. The employee must also submit a host of forms to the Ministry of Finance (Ontario). However, if everything checks out, the tax savings will make it more than worthwhile.

INCORPORATION FOR PROFESSIONAL PARTNERSHIPS - SOME NEW IDEAS

Hugh Woolley, CA
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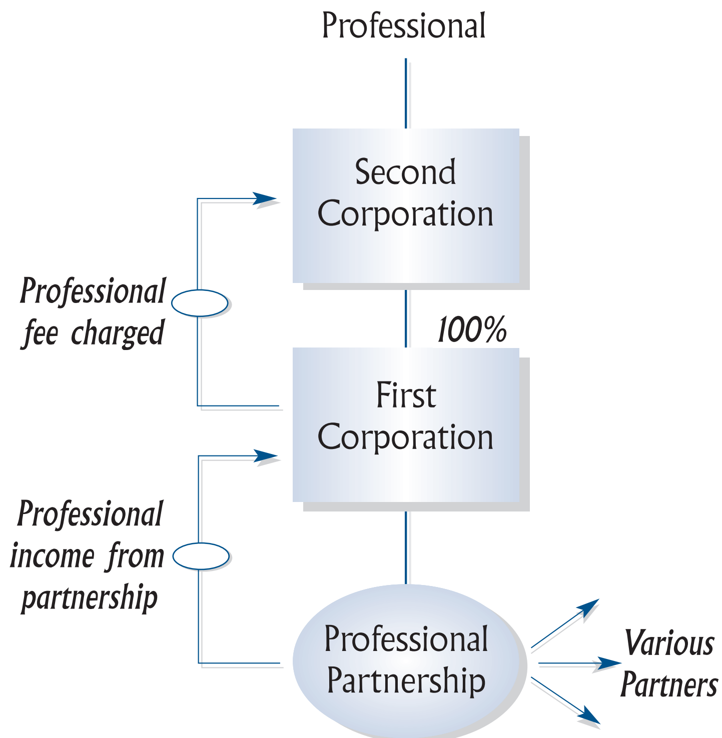
For decades, individual professionals practicing through large partnerships have struggled to achieve more tax efficient structures. Solutions have included the use of management companies and management limited partnerships. Rules requiring partners to share the $200,000 small business deduction have generally made incorporation impractical from an income tax perspective if a firm has more than 4 or 5 partners.

In some circumstances, incorporation of an individual's partnership interest can be beneficial. For example, Alberta partners of law firms with offices in Ontario, B.C. and Quebec have frequently chosen to use incorporation as a method of converting multi-jurisdictional business income into Alberta employment income. The income is paid out as salary. A side benefit of such an incorporation is the ability to claim home office expenses which are statutorily denied to individuals unless the home is used to regularly meet with clients. As no business income is left in the corporation, the lack of any small business deduction is not an issue.

Individuals with a higher tolerance for risk, who are members of large professional partnerships, have attempted to access the full $200,000 small business deduction with the use of a "stacked structure". This involves having the partnership interest owned by one corporation which is in turn owned by a second



corporation. The business income of the first corporation is paid to the second corporation as a fee for the services of the professional who is an employee of the second corporation. As the two corporations are associated, there is an exemption from the application of the personal services business rules.

Such structures are not without risk. Aside from various anti-avoidance rules, there is a concern that the reasonableness of the inter-corporate fee could be challenged. Also, such structures frequently present GST and PST issues, especially with health professionals.

But a recent series of advance tax rulings issued by the Canada Customs and Revenue Agency (the "CCRA"), may provide an opportunity for some firms to reorganize their affairs to enable all of their partners to enjoy the full $200,000 small business deduction. The general circumstances involved in these rulings are:

1. The existing professional partnership is incorporated and the partnership's business is carried on by this new operating corporation. This restructuring can usually occur on a tax-deferred basis. It may be beneficial to undertake this restructuring at the start of

the fiscal year to mitigate negative adjusted cost base issues and the loss of the 1995 reserve.

2. Each individual professional sets up a new consulting corporation which contracts to provide its services to the main operating corporation.

3. Each consulting corporation must carry on its own business which usually involves paying its own dues, insurance, professional development, travel and promotion expenses.

The CCRA has ruled that the individual consulting corporations will not be considered personal services businesses. This is provided the existing partnership is reorganized for various non-tax benefits such as: reduced professional liability, discretion over types of expenses and investments, greater flexibility and control over working hours and ease of entry and exit from the business.

Although the CCRA has issued advanced tax rulings on several of these reorganizations, some concerns still exist. The new operating corporations will wish to deduct the fees paid to the individual consulting corporations, but this is subject to general reasonableness limitations. Where the fee is based on hours worked, which is common in medical partnerships, the reasonableness of the fee should not be an issue. On the other hand, professional firms (such as some lawyers and accountants) that remunerate their principals based on a variety of factors, including prior marketing success, may have some risk regarding deductibility of the inter-corporate fees.

Also, all advance tax rulings are based on existing legislation. If a professional firm undertakes a complex reorganization and the Department of Finance changes the law, the firm could be stuck in a structure that may be worse than its current arrangements.

Overall, this is an extremely positive development that is long overdue. The stance taken by the CCRA in these rulings is reminiscent of their position enabling multiple small business deductions to be claimed by co-ventures of the same joint venture. However, it would have been preferable for the Department of Finance to simply scrap the "specified partnership rules" rather than force taxpayers to undertake these complex reorganizations.

IN BRIEF

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FIE/NRT Rules Released

On October 11, 2002, the revised legislation for foreign investment entities ("FIE") and non-resident trusts ("NRT") was released, effective for taxation years beginning after 2002.

Most of the rules are similar to those that were issued in the two previous draft releases. However, one significant change was in the FIE area. There is no longer the requirement to use a mark-to-market regime, except for very specific circumstances. The revised draft's default method is an income imputation regime. In other words, the prescribed rate of return is multiplied by the designated cost of the investments.

For those entities that have become FIEs, a determination will have to be made as to the fair market value of assets on January 1, 2003. If the asset has gone up in value, then that fair market value is to be used. However, if the asset has gone down in value from its original cost, then it is the cost amount that must be used. The valuation of the assets and determination of the FIE income could be a significant burden on those Canadian residents who have a number of non-resident investments and/or joint ventures.

The NRT rules contain the same harsh and unreasonable provisions of the previous drafts. However, there are still planning opportunities, especially, for new immigrants and non-residents.

Third-Party Civil Penalties

Recently, the CCRA updated their plan for administering the third-party civil penalty provisions. The CCRA has created a special committee to help ensure that the penalties are applied consistently in accordance with their Information Circular. They have stated that any field auditor who encounters a situation where these penalties may apply must consult a senior audit manager in their tax services office before considering a third-party penalty audit. The tax services office must then contact the penalty review committee's technical support group for authorization to start an audit. In other words, the auditor must get approval from this head office committee in order to just start.

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After the audit has been completed, the committee must then review the facts before endorsing or rejecting the auditor's recommendation.

At this point, there have been only two cases of civil penalties being applied. However, it is likely that we will see more of these penalties as the CCRA auditors gain familiarity with the third-party civil penalty rules. The CCRA has stated that they will pay close attention to the civil penalty rule in those situations where a gross negligence penalty has been applied.

Deductibility of Fines & Penalties

Based on the Supreme Court decision of 65302 British Columbia, the CCRA has amended its Interpretation Bulletin on the deductibility of fines and penalties (IT-104R3). In the past, it was the CCRA's position that fines and penalties are not normally deductible. That has now changed

In its revised IT, it states the following:

- The deduction of a fine or penalty cannot be disallowed solely on the basis that its allowance is contrary to public policy.
- To be deductible, a fine or penalty must be incurred for the purpose of gaining or producing income from a business or property.
- The fine or penalty does not have to be unavoidable in order to be deductible.

In establishing whether a fine or penalty was incurred for the purpose of gaining or producing income, the taxpayer must only establish that there was an income-earning purpose for the act or omission giving rise to the fine or penalty. As well, the taxpayer does not have to attempt to prevent the act or omission that resulted in the fine or penalty. Any fines or penalties incurred with the acquisition of assets should be included in the asset's capital cost. So save those parking tickets, they may be tax deductible.

Valuing Charitable Gifts of Securities

In a recent newsletter, the CCRA stated that in determining the value of securities that were donated, the donation date is the date on which the transfer of ownership occurs. This, they say, is a question of fact. The CCRA's position is that, generally speaking, the charity takes ownership of a share when it has the right to receive dividends declared or amounts on the corporation's liquidation, and the charity has the right to exercise the vote attached to the share. This can be of crucial importance when the value of the security has changed between the time that the donor has made a commitment to give these shares and the time that the actual transfer of ownership occurs.

It is important to note, though,that when securities are left to a charity by Will, it is the CCRA's position that their value is determined immediately before the donor's death and not when the property is actually received by the charity. This again is a significant point as there have been many instances in the past two years where share prices have dropped significantly between the time of death and the actual gifting of the securities.

TSG TAX PERSPECTIVES

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