TAX PERSPECTIVES

A QUARTERLY PUBLICATION OF THE TAX SPECIALIST GROUP (TSG)

Introduction

Michael Cadesky, FCA, TEP

Cadesky and Associates (Toronto)

With this edition of Tax Perspectives, we welcome Frostiak & Leslie Chartered Accountants Inc., Winnipeg, to our TSG network. Larry Frostiak is a specialist in estate planning with a strong tax background. He is Chair of the Winnipeg branch of STEP (Society of Trust and Estate Practitioners) and National Treasurer. His partner, Ken Leslie, has a background in business valuations and consulting as well as being a chartered accountant. This brings the number of TSG member firms in Canada to ten.

Around the world, the pace of change is relentless in the tax field. Recently, I consulted on tax reform options for the State of Israel, with particular emphasis in the trust area. Extensive reforms are underway, as the country moves from a territorial basis of taxation to taxing world income.

This edition of Tax Perspectives contains the usual mix of articles, Canadian and international, lighter and more technical, provocative and informative. We welcome your comments.

Did You Know *Tax Perspectives has a circulation of 6,000 and is mailed to over 30 countries.*

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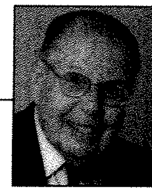
U.S. Attacks Offshore Credit Cards



H. Arnold Sherman, CA, TEP

H. Arnold Sherman Professional Corporation (Calgary)

The United States Internal Revenue Service ("IRS") has been aware for many years that some U.S. taxpayers have been cheating on their taxes by hiding part of their income in banks in the Caribbean and elsewhere. In the year 2000, the IRS found a way to identify many of these tax evaders.

The IRS was particularly interested in the so-called tax advisers, who were promoting ways in which US taxpayers could hide income from the IRS. These tax advisers, mostly based outside the U.S., relied on bank secrecy as a basic element of their promotion. All the jurisdictions used by tax evaders have strict bank secrecy rules, making it a criminal offence for a locally incorporated bank, or bank branch, to provide information about their customers.

Tax evaders who hide money offshore were always concerned about access to their funds. The promoters provided a solution. Funds were deposited offshore in the name of a tax haven corporation (or an offshore trust) set up for this purpose. The tax cheat was given an offshore credit (or debit) card, issued by the bank holding the deposit, in the name of the corporation or trust. Often these cards had very high limits on withdrawals – US$1 million, for example. The bank had no risk, as the amount charged on the credit card could never exceed the deposit.

The IRS had a problem because of the offshore bank secrecy rules. They guessed that between 100,000 and 250,000 U.S. taxpayers were using offshore cards. The solution they devised was to seek U.S. Court orders, requiring credit card companies to make available to the IRS their files concerning offshore credit and debit cards. By 2002, they had the orders they needed.

When petitioning for the Court orders, a consultant to the IRS filed an affidavit estimating the cost of offshore tax evasion as US$70 billion per year.

Most cards issued outside the U.S. are either processed by U.S. based credit card companies, or by offshore subsidiaries of the U.S. companies, so the IRS could get the information, by-passing the offshore banks.

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Employee vs. Independent Contractor

Hugh Woolley, CA

Lewis & Company (Vancouver)

Whether an individual is considered to be an employee or an independent contractor is an important issue for both workers and hirers. From the worker's perspective, the ability to deduct significantly more expenses and to incorporate income without fear of being considered a "personal services business" are the main income tax issues. From the hirer's perspective, the obligation to withhold and remit not only income tax but also EI and CPP are the main tax concerns. Non-tax issues include the obligation to pay benefits, the risk of severance pay and vicarious liability for the worker's actions.

The changing work environment has fundamentally altered the relationships between workers and hirers.

Although this is not a new issue, the changing work environment has fundamentally altered the relationships between workers and hirers. Technology such as the internet, email, cell phones and fax machines has permitted many workers to operate from home on their own schedules. Also small businesses, which account for most of the new jobs, are often reluctant to hire employees due to payroll taxes and various employment rights such as severance pay.

The Income Tax Act provides no guidance on this issue other than to deem officers (and thus directors) to be employees. Accordingly, the matter must be resolved by common law. This question of law must be determined based on the facts of each particular case using guiding factors set down by the courts.

Over the past several years, a large number of cases have been heard on this issue. The 2001 Supreme Court of Canada decision in the *Sagaz Industries* case was the only time the highest court has ever considered this important issue. This case did not significantly alter the existing jurisprudence as set out in the 1947 *Montreal Locomotive* case or the 1987 *Wiebe Door* case. But it did confirm that there was no one universal test. Many different factors (such as level of control, chance of profit or loss and ability to delegate) must be considered and the relative weight of each factor will depend on the facts of the particular case.

Not only is it difficult to draw significant conclusions from any one case, it is also important to view certain decisions in light of special implications. For example, the 2002 Federal Court of Appeal's decision in the *Wolf* case dealt with an American resident engineer working at Canadair. Had the court found Mr. Wolfe to be an employee, the Canada-U.S. Tax Treaty would have permitted Canada to tax his income. Another 2002 Federal Court decision in the *Comeau's Sea Foods* case dealt with EI claims of scallop fishermen. The court agreed with the fishermen's contention that they were contractors rather than employees and thus entitled to certain EI benefits available to self-employed fishermen. Similar facts will probably be faced in the near future by the courts in the context of native fishermen living on reserves who claim they are earning exempt employment income from a fishing corporation resident on a reserve.

The worker should own his own equipment, which, may be no more than a computer and a cell phone.

One trend that is starting to emerge is to give weight to the stated intentions of the parties and the specific actions that support these intentions. As early as 1988, the Tax Court of Canada recognized, in the *Bradford* case dealing with a dental hygienist, the importance of an unequivocal agreement between the parties as to the nature of their relationship. In 2001, the Tax Court ruled in the *Sara Consulting* case that the Supreme Court of Canada's findings in the 1999 *Shell* case have application in this area wherein it was stated, *"this court has never held that the economic realities of a situation can be used to recharacterize a taxpayer's bona fide legal relationships. To the contrary, we have held that, absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases. Recharacterization is only permissible if the label attached by the taxpayer to the particular transaction does not properly reflect its actual legal effect..."* In July 2003, the Tax Court followed similar reasoning in its *1391288 Ontario Limited* decision.

Where a written contract clearly sets out the taxpayer's intention to be considered a contractor, the actions of the parties should be consistent with this contention. The worker should prepare regular invoices on his own letterhead, together with applicable GST charges. The worker should own his own equipment, which, in many instances, may be no more than a computer and a cell phone. Also, the worker should purchase his own supplies and pay his own expenses, should not be on the company's benefit plan or receive holiday pay nor be on the company's telephone or email listings or carry company business cards. The worker should set his own hours and be permitted to subcontract the work, if applicable. The worker should obtain any required licences or permits and carry his own insurance for his own actions.

Non-compete Payments Now Taxable

The Jig is Up, Unfortunately

Kim Moody, CA, TEP

Moody Shikaze Boulet LLP (Calgary)

In the previous issue of Tax Perspectives, we discussed the *Manrell* case and the strategy of tax-free non-compete payments on sale of a business. Legislation is to be introduced to eliminate this unintended benefit.

After October 7, 2003, non-compete payments will be taxable as income or capital gains, depending on the circumstances. An exception will be made for amounts received before 2005 that were paid based on a written arm's length agreement made before October 8, 2003. Note though that these may still require substantiation, especially as to the reasonableness of the amount.

Well, it was great while it lasted.

Bill Daye Recognized

In our last edition, we welcomed Bill Daye and his firm to the Tax Specialist Group. We now recognize him for a distinguished achievement.

Bill was recently made a Fellow of the Institute of Chartered Accountants of Alberta (FCA designation). This is the highest designation awarded to Chartered Accountants.

Bill received his CA designation in 1970. He is a highly respected and dedicated professional, who has devoted his time and talent to benefiting his community, his profession and his firm. While building his own firm, he has still found time for extensive volunteer work with Big Brothers and Sisters of Edmonton, serving as President of the Board and Chair of the Strategic Planning Committee. Professionally, Bill's major leadership role has been in the area of tax specialization. It is indeed notable that Bill was chosen by the CICA to lead the tax specialization initiative as Chair of the CICA Tax Alliance Board. Outside of the tax area, Bill has also served the profession as a long-time investigator for Conduct and Discipline matters with the ICAA, and as a member of the Registration and Member Recognition Committees. His contributions in all of these areas make him a true asset to the profession.

From all the members of TSG, congratulations!

U.S. Attacks Offshore Credit Cards

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It is not illegal for a U.S. taxpayer to have an offshore card that "controls" an offshore bank account, but its existence must be disclosed on the taxpayer's annual tax return. Filing a false U.S. tax return is a felony.

There are some legitimate reasons for a U.S. (or Canadian) taxpayer to have an offshore card, but most are presumably used for doubtful purposes.

The IRS requested all the correspondence in the credit card files, because they knew that the card alone, in the name of an offshore entity, would not help. They hoped that the correspondence would identify the U.S. tax evader. They asked for information on cash withdrawals from ATMs; often a video camera records withdrawals.

The IRS planned to train 1,400 auditors for the project, and were apparently successful in obtaining useful information. However, they must have hit a roadblock, because they added a new wrinkle. They obtained further Court orders, requiring many airlines, hotel chains, department stores and others, such as AOL Time Warner, to give them information about customers paying with offshore cards. Presumably, this was necessary because their information about a particular card did not identify the user. If, for example, there was a record of an airline ticket purchase using the card, the IRS, under a Court order, could obtain the name of the traveler by contacting the airline.

So what are the implications for cheating Canadians? Unconfirmed reports have appeared in the press from time to time that the CCRA is conducting a similar investigation. There has been close cooperation between the CCRA and the IRS for many years. For example, the IRS provides Ottawa with annual information on interest payments made by U.S. banks and financial institutions to taxpayers with Canadian addresses. The CCRA compares this information with Canadian tax returns.

My guess (and it is only a guess) is that the IRS will accumulate information on many Canadian taxpayers through their offshore credit card program. What will they do with it? They can forward it to Ottawa if they wish, since exchange of information is permitted under Article XXVII of the Canada/United States tax treaty. The technical explanation of the treaty (prepared by the U.S. authorities) reads:

"It is contemplated that Article XXVII will be utilized by the competent authorities to exchange information upon request, routinely, and spontaneously."

Canadian taxpayers, who in the past have evaded Canadian tax using an offshore bank with an offshore credit or debit card, would be well advised to consider their position carefully, and to consult their Canadian tax adviser. A voluntary disclosure, before the CCRA begins an investigation, will tend to reduce or eliminate penalties and may avoid the risk of a criminal prosecution for tax evasion.

The Estate Freeze-Old Tools Revisited

Larry Frostiak, CA, CFP, TEP

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In the next ten years or so, there will be a monumental transfer of wealth, as a younger generation gets set to inherit business, real estate and other investment assets.

Of course, the Canada Customs and Revenue Agency (CCRA) will also be anxiously waiting to benefit from the considerable tax windfall, as the transfer of these assets will ultimately trigger a deemed disposition immediately prior to death. This will result in capital gains and tax payable on those gains.

Historically, an "estate freeze" has been an effective tool in limiting and quantifying the tax payable on such appreciating assets. An estate freeze attempts to minimize the tax by ensuring that the value of the taxpayer's estate will not increase after the freeze is implemented. Properly done, the maximum amount of any capital gain arising on death and the resultant tax thereon should be relatively predictable.

Let's review a number of alternative methods of creating an estate freeze.

1. A Simple Sale

At its simplest, a parent could sell an appreciating asset to the intended family member in exchange for a non-interest bearing note, payable on demand. The parent now holds only the note that will not increase in value; the family member now holds the appreciating asset.

This simple freeze, however, creates a number of problems:

- An effective loss of control over the asset;
- A potential income attribution problem if the recipient is a minor or a spouse;
- An immediate deemed disposition of the asset for tax purposes, with tax payable on any capital gains; and
- A potential funding problem on the note for the recipient.

Of course, if the taxpayer has unused capital losses available, a sale at fair market value today may be an effective means of implementing the estate freeze with no immediate tax cost. Otherwise, better techniques are available.

2. Sale or Gift to an Inter-Vivos Trust

The control issue to the "freezor" can be addressed by effecting a transfer or sale of the asset to an inter-vivos trust. The taxpayer can then exercise control over how the property is used, either by the selection of trustees and/or by restrictions specified in the trust document.

Care must be taken to ensure that the trust is appropriately structured, so that the income attribution rules of the Act are not triggered, where minor children or a spouse are beneficiaries of the trust.

3. Holding Company Freeze

By incorporating and transferring growth assets to a holding company, it is possible to:

- Freeze the asset values;
- Avoid income attribution;
- Defer taxation;
- Maintain control; and
- Transfer future appreciation to the next generation.

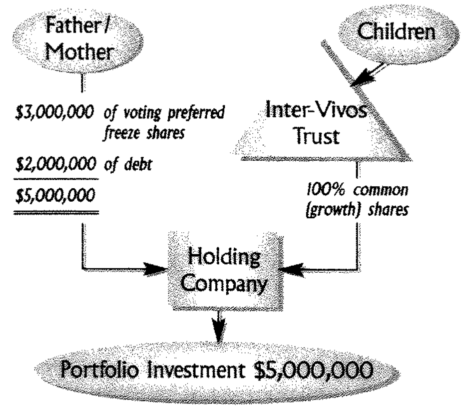
If an appropriately prepared election is filed with CCRA, the realization of capital gains can be deferred on a transfer to a corporation.

Consider the following example:

Father holds a portfolio of marketable securities with potential future appreciation. The cost is $2,000,000 and the fair market value, $5,000,000.

An estate freeze in favour of a holding company could be implemented, with the common shares of the holding company owned by an inter-vivos family trust. Consideration issued by the holding company would include voting preferred "freeze" shares issued to the father, thereby ensuring that he retains voting control over the corporation.

Care should be taken to ensure that a benefit is not deemed conferred on the trust or the children. For this reason, it is imperative that proper valuations are used.



The benefits of this structure include:

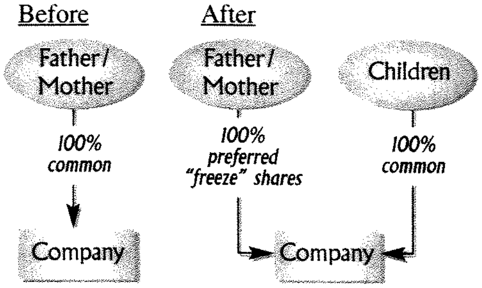
- Effective freeze of taxpayer's assets at $5,000,000
- Deferral of capital gains;
- Effective transfer of growth in the portfolio to the inter-vivos trust for children; and
- Ability to manage income attribution issues.

4. Section 86 Reorganization of Capital

An estate freeze can also be achieved by means of a share capital reorganization within the corporate structure.

A new holding company is not required. The existing capital of the corporation can be reorganized by exchanging (on a tax-deferred basis) all of the common shares of the corporation for non-participating preferred "freeze" shares having a value in aggregate, equal to the value of the "old" common shares so exchanged.

The transfer of the future growth in the corporation is achieved by issuing "new" common growth shares to the intended recipients. The following is an illustration of a share capital reorganization.



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The Proxy Decision

Gary Bateman, CA, TEP

Bateman MacKay (Burlington)

One of the more complex decisions to make in an SR&ED claim is in how to calculate overhead expenditures. The choices are filing a "Proxy Method" or a "Traditional Method" claim.

Briefly, the Proxy Method allows for a gross-up of labour costs by 65% to cover overhead. The Traditional Method uses actual costs.

The decision on which method to use must be considered before collecting data and compiling the file, as each method contains different elements and the data is assembled differently. Currently, the biggest difference in required data is in the labour area. If you are electing "**Proxy**," the labour cost is limited to those costs directly involved in the R&D effort (otherwise known as the "directly engaged rule").

An example of this is a chemical researcher who is actually holding the test tube and performing the test with his direct supervisor. The chemist is obviously directly involved but what about the supervisor? If a senior level person is *involved* in SR&ED, the challenge is to prove that that person directly *supervised* or performed the SR&ED. This example can be applied to any industry. This rule is not designed to eliminate the corporate president from the R&D claim if that is where the technical ideas come from, but how the person is involved must be clear.

Further, if you are using the Proxy Method, the labour cost must be the net cost. This encompasses the R&D portion of all employee costs, with the exception of specified employees, who are employees who own more than 10% of the corporation. The net cost does not include benefits or bonus payments of specified employees.

So why would you claim the **Traditional Method?**

The 'directly engaged' rule is relaxed. This means that the R&D group admin person not directly involved in the R&D other than in a supporting role would now be eligible. Further, any person in the corporation whose efforts can be 'attributed' to the R&D effort is eligible. Examples of attributable staff would be purchasing, personnel, payroll and senior executives. In addition, benefits for specified employees are NOT excluded from the claim.

The only remaining challenge is to attribute overhead in an acceptable manner. You may use a percentage of total factory floor space to attribute costs to a dedicated R&D lab. For example, the lab may cover 5,000 square feet of a 20,000 square foot factory, which would attribute 25% of overhead costs to the claim. Overhead expenditures and their attribution to R&D should be reviewed for overall reasonability.

Regulation 2902, which contains a list of unallowable expenditures, must be reviewed before the R&D claim calculation can be considered complete. This list is extensive and contains, for example, rent, accounting and legal fees, capital depreciation costs, interest expense, penalties and certain membership fees.

It is worth pointing out that in December 1992, when the proxy rule was first introduced, one of the chief reasons was to reduce audit time spent 'discussing' the various possible expenditures that may be included.

CCRA will accept a traditional overhead claim but in the words of one senior official "it better not come out to 65%". In other words, there should be a clear reason overhead is higher than the Proxy Method. Few employees and many consultants or very high cost prototypes are reasons to claim the traditional overhead method. Generally though, the Proxy Method yields a higher tax credit claim in most cases.

In Brief

A Summary of Certain Recent Developments

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No Stock Option Relief

The Department of Finance has decided not to give relief to those individuals who have exercised stock options and whose shares were subsequently worth far less than the original exercise price. In the situation described above, the individual would have employment income and a capital loss. Since the capital loss can only be offset against capital gains, there is no relief for the employment income portion, which has been recognized.

This was a common situation during the high-tech boom of prior years, where employees were exercising stock options and holding the shares on the assumption that those shares would continue to increase in value. But certain employees were forced to exercise stock options, such as those who left the company or were otherwise faced with expiration of the options. Sometimes escrow arrangements prevented the shares from being sold.

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Setting Up in China

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Thomas Lee & Partners (Hong Kong)

Following China's entry into the World Trade Organization (WTO) in 2001, China has continued to be a major market for the inflow of foreign capital. Foreign investors wish to tap the relatively low cost of labour and resources and sometimes the huge domestic market.

In this brief article, I shall provide a basic overview of the business structures in China and the taxation system governing the operations of these entities.

Nationwide Investment Policy

In order to encourage the earning of foreign currency and modernization, China has classified industries as "Encouraged," "Restricted," "Prohibited" and "Permitted."

The wholesale and retail of general commodities fall into the "Encouraged" category. However, the wholesale and retail of certain special products (e.g., agricultural products including tobacco, chemical fertilizers, pesticides, etc.,) is classified as "Restricted" and will not be open to foreign investors until a future date. Certain activities are "Prohibited" and are not open to foreign investors despite the accession of China to the WTO. These include the newspaper, broadcasting and film industries.

Foreign investors should take into consideration the investment priorities of the Chinese government, and match them with their own investment strategies in China.

Fewer restrictions are placed on the establishment of joint ventures than on wholly foreign-owned enterprises because of local involvement and less stringent approval requirements. More favourable tax incentives are placed on the "Encouraged" category. On balance, projects that introduce new technology, and those that are export-oriented, are most likely to receive approval and tax incentives.

Form of Legal Entities in the PRC for New Business

There are various forms of legal entities that may be established in the PRC, as follows:

1. Equity Joint Venture (EJV)

An EJV is a separate legal entity, and takes the form of a limited liability company registered in China. The parties have joint management of the company, and the profits and losses are distributed according to the ratio of each partner's capital contribution. However, the foreign participant is not able to recover the original investment until the termination of the joint venture.

A WFOE is established exclusively with the foreign investor's capital. It may be wholly owned by foreign investors.

The EJV also brings together the respective skills and technologies of each party. The participants share profits, risks, and losses in proportion to their respective contributions to the registered capital of the EJV. The capital subscribed by the foreign investors should not be less than 25% of the registered capital.

All EJV's are governed by Law on Joint Ventures using Chinese and Foreign Investment, which was promulgated in 1979 and amended in 1990. There are also a number of other laws and regulations that affect the joint venture's operations relating to such matters as taxation, employment and foreign exchange.

2. Cooperative Joint Venture (CJV)

A CJV may operate under a structure similar to that of a western-style partnership, or the parties to the venture may apply for approval to have the company structured as a separate legal entity with limited liability. For a CJV that has obtained legal entity status, the investment contributed by foreign investors should not be less than 25% of the registered capital. The profit and loss distribution ratio is defined in the contract and may vary over the contract term, unlike the Equity Joint Venture above.

The foreign investor in a CJV may repatriate his original investment prior to the expiration of the joint venture. This kind of partnership structure is less often used than an EJV.

All CJV's are governed by the Law on Sino-Foreign Cooperative Enterprises that was promulgated in 1988.

3. Wholly Foreign-Owned Enterprise (WFOE)

A WFOE is established exclusively with the foreign investor's capital. It is similar to a corporation with share capital and incorporation documents. It may be wholly owned by foreign investors.

All WFOE's are governed by the Law on Sole Foreign Investment Enterprises that was promulgated in 1986 and amended in 2000.

4. Representative Offices

Foreign enterprises are permitted to open representative offices in China (i.e., branches). Legally, these are to be established purely for liaison purposes, and their activities are limited to the provision of services that do not give rise to earnings. The permissible activities of representative offices include the following:

- Investigating and collecting market information;
- Providing introductory services to potential buyers and sellers;
- Assisting in making arrangements for trade visits to China;
- Coordinating with the parent company and other associate companies or affiliates.

Such a representative office is exempt from business tax and enterprise income tax, but a representative office of a foreign company is technically not permitted to perform profit-making activities. Any other services performed beyond the approved scope of a representative office's business will render it subject to business tax and enterprise income tax on an actual or deemed income basis.

Choice of Location

Foreign investors must be sensitive in the choice of location for the enterprise. Tax incentives vary by location, which may greatly favour one place over another.

Post Approval Requirement for Setting Up

After getting the approval to set up, the entity must apply for the registration with the Administration of Industries & Commerce to establish its legal existence. Other procedural matters such as tax registration, customs registration and financial registration have to be completed within a reasonable time before the entity may become operational.

Capital Injection

The law does not set out the minimum registered capital of EJV's and WFOE's. However, the minimum capital should also take into account the operating capital requirement of the proposed business investment since borrowing locally is restricted. For an investment below US$3 million, the registered capital should be at least 70% of the total investment. In addition, the capital requirement will be higher in Special Economic Zones because of the various tax incentives offered.

Tax incentives vary by location, which may greatly favour one place over another.

No less than 15% of the registered capital must be contributed within three months of the issuance of the business licence and the rest should be made within three years.

China Tax Regime for Foreign Investment Enterprise (FIE)

All FIE's (including EJV's and WFOE's) are subject to various PRC taxes such as Foreign Enterprises Income Tax ("FEIT"), Business Tax, Value-Added Tax ("VAT"), Customs Duty, etc. FIE's of different forms are nevertheless all taxed in the same way.

Apart from the above taxes, FIE's may also be subject to other local taxes and charges.

Customs Duty

Import tariffs vary, depending on the existence of preferential tariff arrangements between the PRC and the country of origin, and the nature of the goods. The average import duty rate was around 12% in the year 2002.

Business Tax

Business tax is imposed on various types of services as well as the transfer of intangible assets and immovable properties in the PRC. Transportation, construction, telecommunication, cultural and sports industries are taxed at 3%. Entertainment services are taxed at rates from 5% to 20%.

Banking, insurance, leasing, hotels and tourism, the transfer of intangible assets and immovable properties, and other service sectors are taxed at 5%.

Business tax is usually paid by the user of the service, and, unlike the VAT, is not refundable to businesses.

Value-Added Tax

VAT is imposed on the supply of goods, the provision of certain services, and on imports into the PRC. VAT is charged at the standard rate of 17% of the taxable value, which is reduced to 13% for certain necessary goods and special equipment. In addition, there are certain tax exemptions and zero-rated supplies. VAT payable on the purchase of goods ("input VAT") is deductible from the VAT payable on sales. Input VAT may be refunded on export of goods.

Income Tax

FIE's are subject to income tax on their worldwide income. The standard tax rate is 33% (30% national tax and 3% local tax). However, FIE's may enjoy reduced tax rates of 15% to 24%, depending on their business location, industry, registered capital and term of operation. They may also enjoy a period of tax-exempt status or payment at half rates. The table below summarizes the incentives.

Tax rate	Reduced from 33% to 15% or 24%
Tax Exempt Period	2 or 3 years exempt, then 3 years at half rates
Tax refund	40% of tax paid for reinvestment of profits
Withholding tax on dividends to foreign non-resident shareholder	Exempt

Individual Income Tax (IIT)

The employment income of both Chinese and foreign employees in China are subject to tax at progressive rates from 5% to 45%. The individual income tax is calculated month-by-month and is determined by the residence status and the length of stay in the PRC. The employer is required to withhold and pay tax on behalf of its employees. Foreign persons working in the PRC for less than five years may obtain an exemption on non-Chinese source income.

Conclusion

An understanding of Chinese government investment policy and the China tax regime is important to the effective establishment of a business in the PRC. Foreign investors should keep abreast of the latest developments in Chinese investment policy and taxation, and obtain professional advice before beginning the process of establishing a PRC business.

The Estate Freeze-Old Tools Revisited continued from page 4

The biggest advantage of a share capital reorganization is that it does not require the filing of tax election forms. Therefore, there is less scrutiny by CCRA. It also avoids the need for a new company.

Summary

There are obviously a number of "Estate Freeze" structures available. Space permitting, more would have been described. They provide the professional planner with many effective tools to accomplish a client's estate planning needs.

The Department of Finance's refusal to provide relief is premised on its belief that employees who exercised stock options and decided to hold the shares, then became investors from that point onward. But there are many situations where that simply is not the case. The Department of Finance concluded that it is difficult to justify special relief to individuals who simply choose to accept a market risk and lose.

Accountant Client Privilege

In a recent case, the Federal Court of Appeal came to the conclusion that there is no accountant-client privilege. In this case, the CCRA asked for information pursuant to subsection 231.2(1) from the client's accountant. The accounting firm tried to argue that they were not required to provide the information requested. However, the Federal Court of Appeal stated that the worst that could happen if the person is discouraged from seeking income tax advice from an accountant because of the lack of privilege, is that the person might fail to take advantage of a tax saving opportunity. This was contrasted with an individual's physical, mental and spiritual integrity, which is presumed to be protected by solicitor privilege. The counsel for the accounting firm noted that in the United States, there is a certain level of privilege with accountants, but this is authorized by statute. The Federal Court of Appeal's response to this was that any change of this nature would have to be made by Parliament and not by the Court.

The other important point from this case is that tax advisors must not only provide the documents requested, but also must answer virtually any question which CCRA considers necessary in reviewing the taxpayer's affairs. The taxpayer and/or advisors will be required, at their own expense, to respond to the questions posed by CCRA or face penalties.

Replacement Shares on Immigration

The Department of Finance recently produced a comfort letter dated June 2, 2003 relating to the proposed amendment to section 128.3. Section 128.3 provides that where an individual acquires a replacement share, the new share will be deemed to be the same as the old share for many of the deemed disposition rules on departure from Canada.

Property owned by an individual is not subject to the deemed disposition rules on emigration from Canada if the individual, during the last 10 years, was not resident in Canada for more than 60 months and owned the property when the individual first took up residence in Canada or inherited the property after that time. Since section 128.3 did not apply to this subparagraph, a short-term resident who received new shares, say, in a corporate restructuring, after coming to Canada, for old shares owned prior to arrival, would be deemed to dispose of these new shares on leaving. This seemed unfair since there are rules that allow returning residents to "unwind" transactions subject to the departure tax rules.

The Department of Finance has reviewed this situation and has decided that section 128.3 should apply and will propose amendments to that effect. How far the rule will go remains to be seen.

TAX PERSPECTIVES

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