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TAX PERSPECTIVES
A PUBLICATION OF THE TAX SPECIALIST GROUP (TSG)
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Introduction

Michael Cadesky, FCA, TEP
Cadesky and Associates (Toronto)

This edition of Tax Perspectives discusses Canadian and international tax matters relevant to our clients and associates. Articles focus on dealing with the Canada Revenue Agency (CRA) as well as selected international matters.

We are pleased to announce that David Sherman, a noted author and editor of a popular annotated version of the Income Tax Act has joined TSG and will act as a resource to member firms. David's profile is featured in this edition.

We regret the loss of Moody, Shikaze, Boulet of Calgary, who have merged with an international accounting group and will become RSM Richter. Kim Moody was a frequent contributor to Tax Perspectives and a founding member of TSG. We thank him for his contributions and wish him well.

Not wanting to stand still, we have established Compra Transfer Pricing Group Inc., a firm specializing, as its name suggests, in international transfer pricing. It is headed by Elizabeth King, PH.D., who has been involved with transfer pricing engagements for over 20 years. This will give TSG member firms the added dimension of being able to access top international expertise in this area. Lastly, we have extended our network to China with the opening of a Shen Zhen office, to be managed by Thomas Lee of Hong Kong. Enquiries concerning our China services may be directed to any member firm.

SUMMER 2005

VOLUME V NUMBER 1

Tax Planning – Why Bother?

by **Michael Cadesky,** FCA, TEP
Cadesky and Associates (Toronto)

Sometimes people are reluctant to consider tax planning ideas. It is suggested that the exercise is too complicated, expensive, or risky. "The government will not like and will challenge it" is a common complaint, usually accompanied by "you can't fight City Hall."

Well, here are some statistics to consider:

- In the U.S., since 1990, the top 50% of income earners have paid over 90% of the nation's income taxes. In 2000 and 2001 they in fact paid 96%. A sobering thought. The top 5% of income earners in 2001 paid more than 53% of all income taxes.
- Those in the distinguished top 1% paid a hefty 32% of all personal income taxes. The Canadian statistics are similar.

Faced with carrying the nation's income tax burden, it is no small wonder that higher income taxpayers have a keen interest in tax planning!

The trend worldwide is that income tax rates are generally a little lower than they were 10 years ago. To counterbalance this, governments are becoming more aggressive about what is subject to tax and enforcement of the tax system.

We are heading into uncharted waters. Technology and globalization are threatening local jobs. Businesses cannot afford increases in payroll taxes. As the population ages, and medical advancements prolong life, the need to support our elderly will place a major burden on governments. So, what does the future have in store? Time will tell, but one thing is certain: the personal income taxes paid by the top segment of income earners will continue to fund the nation. As the nation's financial needs increase, so will the demands placed upon this group.

Dealing With the Canada Revenue Agency ("CRA")

Hugh Woolley, CA

Lewis & Co (Vancouver)

One's success in dealing with a CRA audit can depend on the approach taken.

Several years ago I read Stevie Cameron's book, "Blue Trust," about the life of prominent Montreal tax lawyer, Bruce Verchere. The book fascinated me so much that I decided to read the articles that Mr. Verchere had written for the Canadian Tax Foundation. At the 1981 Annual Conference, Mr. Verchere presented a paper on Income Tax Appeals: Practice and Procedures. Twenty-four years later this article is still interesting reading and includes such passages as: "…the method of ensuring compliance with the Income Tax Act gives rise to an adversary system…" "...the tax litigation process starts as soon as the assessors commence their audit..." "...Revenue Canada does not undertake an audit or investigation in the expectation of coming up empty-handed."

Between 1990 and 1992, I worked under the Interchange Program at the CRA's Rulings Directorate. I quickly learned that the CRA is not a monolithic entity that speaks with a single voice, but is rather a collection of very individualistic personalities who frequently differ in their opinions and approaches. For this reason, it is virtually impossible to describe the single best approach in dealing with the CRA. Compounding this, not all clients have the same risk profile, with some being either more aggressive with their tax filings or more disorganized with their collection and retention of records.

In my practice, while assisting accounting firms in managing tax audits and resolving disputes, I have seen that some have greater success with the CRA than others. Generally, I have found that those who manage the process from start to finish consistently achieve better results. I suggest that there are two simple explanations.

Firstly, by dealing with the auditor in a respectful fashion, at an early stage, one develops a rapport with him or her, which makes it more difficult for the auditor to issue a punitive or unreasonable assessment.

Secondly, by dealing with issues as they arise, one can "nip problems in the bud." Delays in addressing issues or miscommunication frequently cause positions to become entrenched, which makes it much more difficult for the position to be reversed later.

So how do you manage the process to best advantage?

So how do you manage the process to best advantage?

It makes sense to review possible areas of tax exposure before the audit commences. This allows for more control over the audit.

For an operating business, begin by giving the auditor a tour of the company's facilities and show the non-financial operations of the business. Let the auditor see employees working on the shop floor. This not only brings the financial statements to life, but also enables the auditor to see the human side of a company's operations.

I like to have the auditor meet with the company's owner, the head of accounting and the company's tax advisor. This allows the client to provide a history of the business and, hopefully, present the company in a favourable light, often by finding some common ground with the auditor. Such a meeting will satisfy the auditor's requirement to interview the owner, before having an opportunity to formulate any detailed questions. Having the tax advisor present during the meeting permits the interpretation of questions directed to the client and clarification of answers provided by the client. This avoids issues being blown out of proportion. Often, an unprepared client will reply to a question without understanding the tax significance of the question or the answer given.

Give the auditor a private room to review the accounting records. I do not subscribe to the theory that, if you put the auditor in a cold closet, he or she will want to leave as quickly as possible.

Usually, I ask the auditor to compile a list of questions to give to the client at the end of each day. Allowing the auditor

continued on page 6

Madeira – Some Canadian Tax Planning Possibilities

Arnold Sherman, CA, CTA, TEP

H. Arnold Sherman Professional Corporation (Calgary)

Where is Madeira? It is an island in the Atlantic Ocean, about 900 km south of Lisbon, off the coast of Morocco. Madeira (population – 250,000) is an integral part of Portugal – just as Newfoundland is an integral part of Canada.

Madeira has its own corporate tax regime, separate from mainland Portugal, under which it is possible to pay no corporate tax until 2011.

The double tax treaty between Canada and Portugal, effective in 2002, applies to Madeira. Because of that treaty, income from an active business carried on in Madeira by a subsidiary of a Canadian corporation will not be taxed when paid to the Canadian parent by way of dividends.

Canadian manufacturing business transferred to Madeira has potential to save a great deal of corporate tax

A profitable Canadian manufacturing business transferred to Madeira has the potential to save a great deal of corporate tax. With an active business in Madeira, there will be no Portuguese tax, and no Canadian tax. Unlike some other low- and no-tax jurisdictions, Madeira has a skilled labour force and adequate infrastructure. Because of the high cost of shipping by sea, only products suitable for airfreight should be considered for manufacture or assembly in Madeira.

Apart from the manufacturing possibilities, I have identified two other tax planning ideas for Canadians.

The first is an actual case. Although it concerned an Italian manufacturing company, the same approach would be open to a Canadian manufacturer selling into the European Union ("EU").

An Italian parent company had set up a manufacturing facility in India. The product (electronic balances) was shipped to various countries in the EU. In each country, import duties were paid. The company arranged to air freight the components of the balances to Madeira, where they were assembled and shipped to EU countries free of duty. EU rules are that, provided some value has been added, there is no duty on shipments between EU countries. Portugal is, of course, an EU member. No Portuguese import duties were payable on components shipped into the Madeira free zone, where assembly took place. Duty savings more than offset the additional airfreight costs. Furthermore, to the extent that value was added in Madeira, an appropriate portion of the total profit could be allocated to Madeira, and would be exempt from all corporate taxation, as explained above.

The second example relates to e-commerce. Under a Directive issued by the EU in 2000, companies based in a non-EU country, including Canada, doing business directly with the final customer in the EU, must include value-added tax (VAT) in their billing, at the rate applicable in the EU country to which the product was delivered. Products covered by the Directive include music, games, software etc., downloadable via the Internet.

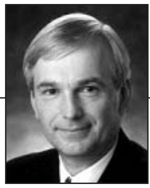
There are 25 EU countries, each with its own rate of VAT. The non-EU seller (such as a Canadian corporation) is required to calculate VAT for each country, collect it, and remit it to the country concerned. This is an almost impossible task, so there is widespread non-compliance.

In a few years' time, the contingent liability of the sellers may be enormous, including interest and substantial penalties. Sooner or later, the guillotine will fall, and assessments will be raised. The US Internal Revenue Service has proven that tax authorities can get access to worldwide credit card information, which will be one way in which EU Governments will be able to obtain the information they need. Collection will probably not be a problem. EU countries will follow the lead of the US Patriot Act, which gives the US the right to retain funds from interbank and correspondent balances. Furthermore, more and more double tax treaties provide for assistance with collection.

There is a solution! A Canadian selling company can set up a subsidiary in Madeira to be used as an invoicing company. Madeira VAT at 13% (the lowest rate in the EU) will be added to all invoices to the final consumer, unless the consumer is registered for VAT in their own country. Some management companies in Madeira are already providing this service to non-EU sellers.

A Canadian company can set up a subsidiary in Madeira to be used as an invoicing company

I have suggested several ways in which Canadian corporations can benefit from the tax status of Madeira. There are many others.



Voluntary Disclosures – Should I or Shouldn't I?

Ralph Green, CA, TEP

Ralph H. Green & Associates (Saint John)

It is not uncommon for a taxpayer to discover a mistake in filing a return or inadvertently fail to report income. If subsequently audited by CRA and the mistake or omission discovered, the taxpayer may be subjected to significant penalties. While no one likes to pay tax, in a self-assessing system, it is imperative that everyone complies with the rules. While one is free to conduct one's affairs so as to minimize tax, this does not include not reporting income! If an advisor becomes aware of situations where a client has unreported income and the client is not willing to make a voluntary disclosure, the advisor must resign from the assignment.

The Voluntary Disclosure Program ("VDP") is now administered by the Appeals division of the CRA and is widely used. The VDP can be used to make a disclosure of information not provided (such as foreign reporting forms) or to correct incomplete or inaccurate information or to disclose new information. It can also be used to disclose income not reported on income tax returns, ineligible expenses, or GST, which is underpaid.

The purpose of the CRA's VDP is to promote voluntary compliance. The VDP encourages clients to come forward and correct past deficiencies, thereby becoming compliant.

The risk and potential for prosecution, penalties, and sleepless nights are often enough incentive to convince a client to make a voluntary disclosure. It is CRA's policy not to impose penalties when a voluntary disclosure is made. CRA approaches the matter in a non-judgmental way. No reason need be given for the non-disclosure. The taxpayer will only be required to pay the tax owing together with interest. The VDP can be used by any delinquent taxpayer - from an individual to a large corporation. The relief provided is determined on a case-by-case basis, but involves as a minimum an up-front waiver of penalties and an agreement not to prosecute. Unpaid taxes and interest, however, must be paid.

The program has four conditions:

1. The disclosure must be voluntary. (A disclosure is not considered voluntary if it arises after the CRA or the tax department of a province has begun an audit, or a request for information has been issued).
2. The disclosure must be complete.
3. The disclosure must involve a potential penalty. It cannot be used just to make adjustments to a tax return.
4. The disclosure must involve information that is at least one year past due. It cannot be used to avoid late-filing penalties for current tax returns.

To make a voluntary disclosure, proceed as follows:

1. Contact your professional advisor (accountant or lawyer).
2. Have your professional advisor contact the VDP section of CRA. Consider making the disclosure on a "*No Names*" basis while the terms of the disclosure are discussed. The taxpayer's representative can negotiate the details of the disclosure with a VDP officer. If the client does not accept the settlement, the file is closed on a "*No Names*" basis. If an acceptable disposition of the file has been reached, the representative discloses the client's name and identifying information. This allows a client to be more secure in the knowledge of how the disclosure will be handled. A "*No Names*" disclosure is considered effective as of the day the representative provides the VDP officer with some identifying information about the disclosure. The first three digits of the client's postal code ensure that the disclosure is being made to the right Tax Services Office. Any audit action started after the disclosure is initiated will not invalidate the disclosure.
   It should be noted that a final submission should be made within 90 days from the date of the initial submission.
3. Ensure that each disclosure is complete and can be verified and that supporting documentation is available upon request.
4. Ensure that the client has a plan to pay the taxes owing.
5. Do not delay. If you delay and an audit is commenced or an enforcement action is initiated by the CRA, it is unlikely that a voluntary disclosure will be accepted.

If a taxpayer has been dodging taxes and the CRA finds him or her, the taxpayer will have to pay all taxes due as well as late-filing penalties and interest. In some circumstances, a client may be relying on years becoming statute-barred. However, CRA can re-assess in certain circumstances beyond the statute-barred period of three years, so this is no defense.

In many voluntary disclosures, there is a range of possible settlements, some better than others. Suppose the disclosure involves foreign investment income, which has not been reported. How many years will the voluntary disclosure cover? Will the CRA go back to the beginning or accept just the past six years (usually the minimum period)? Will the capital sum be treated as unreported income or as capital?

The CRA also has some discretion in providing interest relief. This can be beneficial, especially if the disclosure covers many years.

Voluntary disclosure is a victory for everyone concerned. The CRA wins because it recovers a portion of back taxes without having to hunt down the taxpayer. The taxpayer wins peace of mind. The taxpayer's identity is protected and the possible penalties and/or imprisonment are avoided.

R&D – Some Developments

Gary Bateman, P. Eng., MBA, CA, TEP

Bateman MacKay (Burlington)

Now is a good time to discuss both the old news and the new developments about the SR&ED program in Canada.

The old news is that a lot of corporations for one reason or another still do not claim the federal and provincial tax credits that are available to them. Any corporation that makes or improves a product, or creates or improves a process should consider the program.

The largest barrier is often the company's own employees who will say, "It can't be this easy" or "we do this all the time so it can't qualify as research." But, yes, often it does qualify, adding significant cash to the operations of the corporation in the form of tax refunds or credits.

Briefly, the qualifications:

- To describe current standard practice and then the departure from that standard practice that is a technological advance for the corporation.
- This advance must have an uncertainty as to its success, which must be described.
- Finally, the corporation must perform the research in a systematic documented manner in which it analyzes the competing alternative solutions to the uncertainty of achieving the technological advance.

Now the new development. CRA is revising the required form to claim the SR&ED tax credit, the T661. Most offices will accept the old form until July 31, 2005 and some offices will allow it until August 31, 2005. If you file an old form after that date, it will be returned to you.

Using the old form can be very dangerous if you are filing close to the final deadline of 18 months after year-end. If you are in this situation and you did not use the new form, the outcome is that you could lose the opportunity to get the credit.

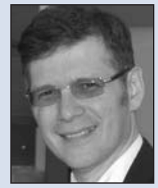
The eventual goal of the change is to allow, in the future, the electronic filing of a tax return that has an SR&ED claim. We are not there yet, but this will happen in the future. We will keep you informed of the progress towards this end.

The common practice of most R&D performers who are researching the method of building a new or improved product is to construct a prototype. Then one must determine if the prototype can be built economically and successfully on a full-scale production line.

continued on page 6

Profile

DAVID M. SHERMAN, , LLB, LLM



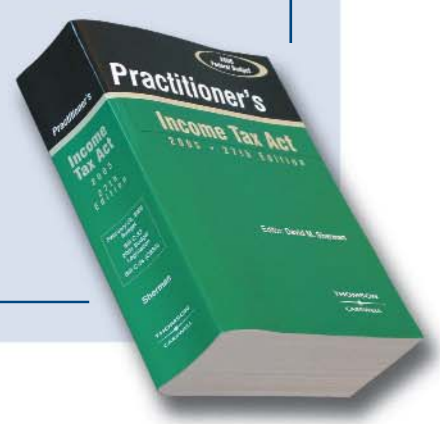
David Sherman is a tax lawyer and one of Canada's best-known authors on income tax and GST. His *Practitioner's Income Tax Act* (published by Carswell) is widely recognized as the leading Income Tax Act in Canada due to his commentary and annotations. His other publications include:

- Department of Finance Technical Notes
- The Practitioner's Goods and Services Tax, Annotated
- Canada GST Service
- Canada GST Cases
- GST Times
- Basic Tax and GST Guide for Lawyers.

He has a technical knowledge of the GST unsurpassed in Canada, having written detailed commentary on every section of the GST legislation and every reported court decision relating to the GST.

When not busy updating his many publications, David provides consulting services, especially for tax disputes (audits, objections and appeals) involving GST. His encyclopaedic knowledge of the GST, income tax legislation, and case law enable him to come up with solutions to tax assessments that few others would find, and he has had tremendous success in having his submissions accepted by CRA auditors and appeals officers.

David's family lineage includes another well-known tax advisor, Arnold Sherman, our Calgary representative.



R&D – Some Developments continued from page 5

This is when the fun starts. The Income Tax Act does not clearly describe whether this portion of the activity is SR&ED. To exclude such costs, the CRA relies on the definition of commercial production, which is not eligible for SR&ED. To muddy the waters further, most corporations will either sell or try to realize some benefit from the prototype. After all, why not?

Administratively, the CRA has developed two definitions to try to help with this difficult analysis. Experimental Development. This can be described as the creation of a prototype, including its sale before any commercial production has occurred. Then, to mirror real life, the second definition is Experimental Development with Commercial Production. This occurs when some aspect of SR&ED is performed on the production line while commercial production is occurring.

Needless to say, the SR&ED eligible cost calculation is different in each case. For Experimental Production, all costs are eligible costs and fully earn a tax credit. For Experimental Production with Commercial Production, it becomes more complicated. An attempt must be made to calculate the cost of the component of the overall product, which is being researched. This part, and only this part, is an eligible cost. As long as a reasonable attempt is made, the method will be accepted.

On each prototype, the corporation is still exposed to the potential of the claw back of the material cost, if the prototype is sold. But, the labour cost would still be an eligible cost for the SR&ED tax credit, not subject to the clawback, even if the prototype is sold.

In practice, clients don't document nearly enough of "partial" SR&ED situations and it is here that real opportunity lies for most claimants.

Dealing With the Canada Revenue Agency ("CRA") continued from page 2

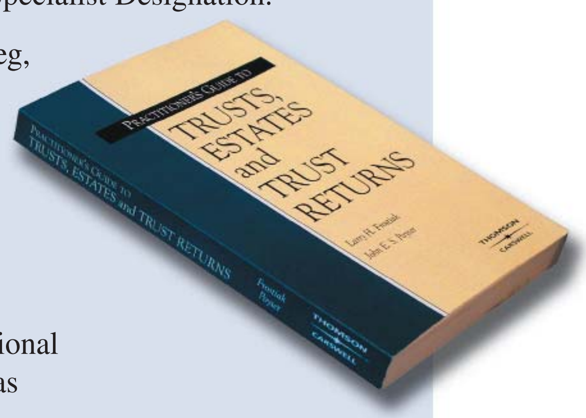
free access to all company employees will cause two problems. Firstly, it makes the auditor's job too easy, as you end up doing all the work, and, secondly, an answer may be misconstrued by the auditor. At the end of each day, the client should contact the tax advisor and prepare suitable answers to written queries.

No approach will always work and there is nothing you can do to convert the most hard-line auditor. However, it has been my experience that attempting to create a relationship with the auditor based on mutual respect and trust is the strategy most likely to yield the best overall result.

Around TSG

Bill Daye, FCA, TEP, of Daye and Company, Edmonton, was recently awarded the CICA highest honour, the CICA Award for Excellence in Income Tax Practice and Education. Bill has been Chair of the CICA's Committee on Tax Specialist Designation.

Larry Frostiak, CA, TEP, of Frostiak and Leslie, Winnipeg, co-authored the Practitioner's Guide to Trusts, Estates and Trust Returns, published by Carswell. Larry is also Treasurer of STEP Canada (Society of Trust and Estate Practitioners) and was recently awarded STEP's Volunteer of the Year Award for his services.



Michael Cadesky, FCA, TEP, was elected Chairman of STEP Worldwide. STEP is the world's leading professional organization for trusts and estates professionals, and has 11,000 members in over 60 countries.

IN BRIEF

Howard L. Wasserman, CA, CFP, TEP

Cadesky and Associates (Toronto)

FIE – Non-Resident Trust Rules

The long awaited legislation on Foreign Investment Entities ("FIEs") and Non-Resident Trusts was released on July 18, 2005. It is to apply retroactive to January 1, 2003. The rules are similar to the previous version released in 2003, but do differ in certain important aspects. For example, payments from a non-resident trust which is deemed Canadian resident, may be subject to withholding tax when made to a non-resident. There are also exceptions and transitional rules.

All situations involvong non-resident trusts and FIEs must now be reviewed under this new legislation, which we believe is likely to be the final version.

With the rules applying retroactive to 2003, practical difficulties will arise. For example, does one amend previous tax returns or leave them alone?

The FIE rules give rise to a great deal of complexity, especially in obtaining the necessary information to comply with these rules.

Non-Resident Trust Rules are still not final. The Great Wall of China was built in less time.

Basically, all non-resident investment funds will need analysis to see if income is to be reported under the FIE rules.

We will be preparing an analysis of these rules for the next Tax Perspectives.

The rules were first unveiled in February, 1999, and the delay in enacting the legislation is unprecedented. One observer remarked that the Great Wall of China was built in less time.

New Loss & Interest Deductibility Rules

On October 31, 2003, the Department of Finance issued draft proposals on the deductibility of expenses, which affect the ability of all taxpayers to claim losses. These rules were to apply starting January 1, 2005. Following an outcry about the proposed rules, government officials stated that they are reviewing the rules and there could be major changes. At the date of this publication, nothing further has been proposed.

These new rules, if enacted, will significantly change the deductibility of losses

Under these rules, a taxpayer can claim a loss only if, in the year, it is reasonable to conclude that there will be a cumulative profit from the business or property. This will require an annual evaluation to determine in each year if a loss can be claimed. There is no grandfathering of these rules, which means that there may be situations from January 1, 2005 where losses that were previously deductible will not be allowed.

Currently, losses are deductible as long as there is a source of income. There is no need for there to be net income. These new rules, if enacted, will significantly change the deductibility of losses. The proposals are problematic for many reasons and will create controversy and litigation. Taxpayers will not easily agree that their tax losses are non-deductible.

Affiliated Persons

On September 16, 2004, the Department of Finance issued new rules on the definition of "affiliated persons." These rules are important with regard to the denial of losses on transactions between affiliated persons. In the past, trusts were not affiliated to persons. Under the proposed rules, a person and a trust may be affiliated if that person or a spouse is a discretionary beneficiary of the trust. This means that, for example, if an individual transfers an asset with an accrued loss to a trust, and the beneficiaries of the trust include the individual and/or a spouse, then the loss is denied. There are additional rules when the trust is non-discretionary. In the latter case, a person and a trust would be affiliated where the person and/or affiliated persons are entitled to 50% or more of the income or capital of the trust. These rules will apply to any transactions that occurred after March 22, 2004.

Claiming foreign tax credits

Canadian taxpayers may claim a tax credit for foreign taxes paid. A recent case, *Meyer* (2004 D.T.C. 2393), denied a foreign tax credit where U.S. taxes, which could have been reduced under the Canada-U.S. Tax Treaty, were paid. Based on this case, if foreign taxes may be reduced by a treaty claim or by filing a foreign tax return to obtain a refund, only the smaller amount of tax will be allowed as a credit in Canada.

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