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TAX PERSPECTIVES
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Introduction

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This edition of Tax Perspectives focuses on tax changes, some resulting from the latest Federal Budget and others from works in progress (e.g., the FIE rules). Almost three years ago, we commented that the pace of tax reform in Canada was accelerating. We suggested it was due to the minority government. We predicted then that further changes would come, and keep coming. History has proven us right. Now we are faced with another election. Surely there is still more to come.

We wonder if the Department of Finance is feeling the strain of all of these changes (see In Brief).

In this issue, John Graham, our associate in Amsterdam, discusses decisions of the European Court of Justice. Remarkably, the constitution of the EU has undermined the tax systems of its member countries. Interesting reading.

Meanwhile, around TSG, business carries on as usual. We continue to build the TSG network, and our international associations. Stay tuned for more news in the next issue.

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2008 Federal Budget

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On February 26, 2008 the Conservative minority government released its third Federal Budget. While this budget will not be known for its tax "goodies", there were a few proposals worthy of discussion.

Some of the usual "tinkering" was evident in the Budget. For example, continued changes to medical expense eligibility and RESPs, adjustments to certain capital cost allowance rates, proposals to improve charitable gifting and donations to private foundations and an increase in limits for SR&ED tax credits were all evident in the Budget. However, this article will focus on three of the bigger proposals, being the introduction of the tax-free savings account, the adjustment to the dividend tax credit rate for eligible dividends, and proposed changes to section 116 certificates of compliance.

Tax-Free Savings Accounts

The tax free savings account ("TFSA") is proposed to be a registered savings account that will allow Canadian resident individuals who are at least 18 years of age to earn investment income tax-free inside the account. While contributions to the account will not be deductible, withdrawals from the TFSA (including withdrawals of earnings in the account) are not taxable. The new TFSA rules are proposed to commence in 2009 with an annual contribution limit of $5,000 (indexed to inflation). Any unused annual contribution room will accumulate. Eligible investments within TFSAs are generally proposed to mirror the qualified investment rules for RRSPs. Readers are likely aware that the qualified investment rules are rather restrictive and attention will need to be paid to this issue. TFSAs will be administered by financial institutions and trust companies that are currently eligible to administer RRSPs.

On the surface, and on a quick read, one might be unimpressed with the new TFSA rules, given the small amount of contribution room. However, significant planning can occur since earnings inside the TFSA accumulate tax free, withdrawals are tax-free and the contributions are cumulative. Tax practitioners will certainly be reviewing

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2008 Federal Budget

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these rules with a view to encouraging their clients to utilize them.

Eligible Dividend Rules

As has been the subject of other articles, the introduction of the eligible dividend rules has resulted in significant tax reductions for shareholders receiving dividends that are paid by Canadian public companies and private companies from high-tax corporate profits. Given the announcement of aggressive corporate tax rate reductions in the October 2007 Economic Statement, the 2008 Federal Budget proposes to adjust the dividend tax credit and gross up mechanisms to take into account the underlying corporate tax rate reductions.

This will result in the overall tax rate on eligible dividends increasing from 2010 to 2012. For example, the highest tax rate on eligible dividends for Alberta resident recipients was scheduled to be at 14.55% for 2009 and thereafter. However, that rate is scheduled to be increased to 19.29% in 2012 (by increasing the rate each year starting in 2010). Accordingly, shareholders and their tax advisors will need to consider such tax rate adjustments carefully and plan accordingly.

Gains of Non-Residents

A third significant announcement made by the Government in the 2008 Federal Budget was the introduction of amendments to simplify the procedures for non-residents who sell certain Canadian property (typically shares of private Canadian corporations). These changes intend to relieve certain administrative burdens in the process of obtaining clearance from paying Canadian income tax where the gain would be exempt by an international tax treaty.

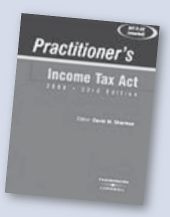
As many readers know, one of the biggest problems for non-residents is the process of getting an exemption from Canadian tax when selling an asset that is excluded from Canadian tax by the expressed provisions of a tax treaty. Under current law, if the purchaser does not withhold tax on the sale of certain "taxable Canadian property", even if the property is treaty exempt, then the liability for any tax is assumed by the purchaser. If the purchaser obtains a "certificate of compliance", the purchaser's risk is relieved. However, it has been taking an unreasonably long time lately for the CRA to process certificates of compliance, which has been causing problems in closing transactions. The proposals introduced will streamline and simplify the rules.

Enhanced Dividend Tax Credit Adjustments

	'08	'09	'10	'11	'12
Existing Dividend Tax Credit	19	19	19	19	19
Gross-Up	45	45	45	45	45
Proposed Dividend Tax Credits	19	19	18	16.5	15
Gross-Up	45	45	44	41	38

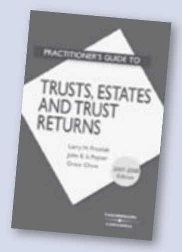
We are proud that members of the Tax Specialist Group have authored a number of publications that are referenced by tax, legal and accounting practitioners throughout Canada and internationally. We invite you to review these resources and contact our specialists for assistance where needed.

The Practitioner's Income Tax Act
David M. Sherman



The Practitioner's Goods and Services Tax Annotated
David M. Sherman

Practitioner's Guide to Trusts, Estates & Trust Returns 2007-08
Larry H. Frostiak, Frostiak & Leslie
Grace Chow, Cadesky and Associates LLP



Guide to the Taxation of R&D Expenses
Gary Bateman, Bateman Viner

Trusts and International Tax Treaties
Michael Cadesky, Cadesky and Associates LLP

Taxation of Real Estate in Canada
Michael Cadesky, Cadesky and Associates LLP

Some Consequences of Eligible Dividends

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In the Spring 2006 issue of Tax Perspectives, Maureen Cush reviewed the then new rules regarding eligible dividends. That article addressed the mechanics of those rules and the resulting reduced tax rates for eligible dividends. The focus of this article is on some of the issues and planning opportunities, primarily for Canadian Controlled Private Corporations ("CCPCs") that have been identified from working with this new system.

Bonus vs. High-Rate Corporate Tax

In prior years, it was common for corporations to declare bonuses to pay out income that exceeded the Small Business Limit; otherwise, this income was taxed at the highest corporate tax rate, causing significant double tax when dividends were paid. When the eligible dividend rules were introduced for 2006, much of the double tax was eliminated. Consequently, owners of corporations must now reconsider whether to declare bonuses or retain the income in the corporation. This decision can be impacted by many factors, including the future income projections for the shareholder. For 2007 it was relatively clear that in certain provinces (e.g., Alberta) the bonus alternative was preferable. That is less clear in other provinces, especially for 2008 and subsequent years where the opposite conclusion appears likely.

Cyclical Businesses and the Bonus/ High-Rate Corporate Tax Decision

In businesses that were subject to cyclical fluctuations, the strategy of paying bonuses could be flawed. Suppose bonuses were declared in one year and taxed at a high tax rate in the shareholder's hands, and in the subsequent year the business suffered a loss. In that scenario, the loss could only be carried back against "low rate" tax in the corporation and could not be used to recover the high-rate tax paid by the shareholder.

The introduction of the eligible dividend rules should make it more attractive for cyclical businesses to reduce bonuses and pay high-rate corporate tax. In situations where the corporation may encounter losses in any of the three succeeding years, consideration should be given to having some income taxed at the high rate, thereby making it easier to recoup the high-rate corporate tax by carrying back losses.

Interplay of Eligible Dividends and RDTOH ("Refundable Dividend Tax on Hand")

In most cases, it makes sense to pay sufficient taxable dividends to trigger a refund of RDTOH because the shareholder's tax is less than the refund received by the corporation. This provides an immediate cash flow advantage, and a longer-term capital gain advantage as the value of the shares is reduced by the payment of the dividends.

When eligible dividends can be paid, the cash flow advantage is enhanced as the spread between the shareholder's tax and the corporation's refund is widened.

In some situations, it may be advisable to pay high-rate corporate tax on business income to facilitate the payment of eligible dividends where a refund of RDTOH is being sought.

Charitable Donation Strategies

Where a corporation makes a charitable donation, it can have an adverse effect on the General Rate Income Pool ("GRIP"), which is the pot from which eligible dividends are paid. Accordingly, this situation needs to be analyzed carefully and it may be better in some cases for the individual shareholder to make the donations.

Pending Change of Control

Where a corporation is sold to a non-resident or public company purchaser, there may be a change of control when the share purchase agreement is signed. This change of control can have an adverse effect upon a pre-sale dividend payment strategy. Note that issuing rights to acquire shares can also impact this strategy.

Corporate Contributions through Amalgamation or Wind-Up

The GRIP and related balances for each of the merging corporations need to be reviewed to determine the account balances that will be available post-merger. In some cases, remedial action will need to be taken prior to the merger to preserve the balances.

Estates Holding Shares of Closely Held Corporations

Prior to the introduction of the eligible dividend rules, a so-called "pipeline" strategy was often employed to minimize the taxes triggered upon death. The object was to ensure that capital gains were triggered rather than dividends, as the tax rate on capital gains was usually lower than the tax rate on dividends. Now that the tax rate on eligible dividends approximates the tax rate applicable to capital gains in some provinces, this strategy needs to be reviewed carefully in light of the particular facts and circumstances.

Asset Sales vs. Share Sales

For many years vendors have favored the sale of shares rather than assets because the tax on capital gains was lower than the tax arising from the sale of assets. With the new eligible dividend regime there are many situations where there is no significant difference in the tax cost under either scenario.

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The European Court of Justice

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Would you be surprised to find that, even if you do not live in the European Union, decisions of the European Court of Justice can impact your taxes? *In today's global economy, international tax laws must be considered when investing, doing business internationally or working abroad.* Even if all your activities are in your home country, you will likely find your own government is changing its domestic tax laws to remain competitive globally. It is, therefore, interesting to consider some recent decisions of the European Court of Justice and how they are impacting tax laws.

EU law protects the ability of goods, services, capital, and labour to move freely within the EU.

Laws of individual EU member countries must uphold the following four "fundamental freedoms":
1. The free movement of goods;
2. The free movement of services and freedom of establishment;
3. The free movement of persons (and citizenship), including free movement of workers; and
4. The free movement of capital.

The European Court of Justice (ECJ) deals with cases, including tax cases, where one of these fundamental freedoms is breached. The cases have affected almost all taxes including value added tax, withholding tax, corporate income tax, personal income tax and inheritance tax.

One recent case concerned German inheritance tax. Under German law, certain assets (such as agricultural land and forests) in an estate could have a lower value if the assets were located in Germany than if the same assets were located in a different EU country. The German government said that the objectives were to maintain jobs in agricultural areas and prevent the disadvantageous breakup of farmlands. This was held to be in breach of the free movement of capital. ECJ held that the benefit of a reduced assessment should also be extended to similar property in other EU countries.

Germany was also on the wrong end of another case that concerns a difference in the valuation of an interest in a domestic partnership, compared with a foreign partnership. The value of the domestic interest in a partnership is effectively based on net asset values, rather than market values. On the other hand, the tax authorities generally take market value rules into account when valuing an interest in a foreign partnership. It is arguable that these differences in valuation methods are a restriction on the freedom of establishment. It has been held that a restriction on the freedom of establishment is prohibited, even if it is "of limited scope or minor importance".

Another case has been referred to the ECJ against Germany, Estonia and the Czech Republic for taxing dividends paid to foreign pension funds more heavily than those paid to domestic pension funds. It is considered that this is probably a restriction on the free movement of capital and possibly also on the freedom to provide services.

Finland has been taken to the ECJ by the European Commission for excluding public legal aid offices from the scope of VAT. Since these offices compete with the legal aid provided by private lawyers, it was argued that the exemption can give rise to a distortion of competition and, therefore, should be subject to VAT.

The Netherlands lost a case concerning dividends paid to a company established in another member state. It had introduced legislation to comply with the EU Parent-Subsidiary Directive, which allowed for a zero rate of withholding tax if the parent owned at least 25% of the Dutch company. However, for domestic purposes, a dividend received by a Dutch company which had a shareholding of at least 5% in another Dutch company, was not subject to dividend withholding tax. The ECJ held that the same percentage should be applied for shareholdings by companies in other EU countries. The legislation has since been amended.

France levies a tax of 3% in certain cases where a company with French real estate is owned by a non-resident company. The tax can be avoided, provided somewhat burdensome reporting requirements are complied with. French companies are not required to provide such reporting. This is a possible breach of the freedom of movement of capital. The ECJ has yet to decide on this.

Tax amnesties can also fall foul of the ECJ. A case has recently been taken to the ECJ with respect to Portugal, which in 2005 had a tax amnesty. The amnesty allowed people to regularise their position at a preferential tax rate if they invested in Portuguese Government bonds. In the view of the European Commission, this violates the free movement of capital, since it encourages people to invest in assets in Portugal in preference to other assets. It would seem quite likely that the Commission will win this case.

Sometimes the taxpayer does not win. The ECJ had a somewhat technical case to decide with respect to the merger directive, which allows certain types of cross-border mergers in the EU to be tax-free. The directive provides for an anti-abuse clause. The ECJ held that domestic legislation could be applied here.

New cases are being sent to the Court on almost a daily basis. It is worth checking with your tax advisor to see what cases are in progress and how you may be affected, especially when doing business in the EU.

Net Worth Assessments

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Out of the blue, with no advance warning, you receive a letter from the CRA requesting that you provide your personal banking records. This is followed by further requests for other personal information, such as credit card statements, and details of personal living expenses. Then, in a meeting, you are asked a number of questions, such as do you gamble, have you taken on any personal debts recently, and did you receive any large gifts from relatives or friends?

You realize at this point that something is unusual, and terribly wrong. However, you are not quite sure what it is. With your accountant at your side, you tackle these questions, and the CRA goes away. Many months go by and you hear nothing, until you receive a letter containing a number of schedules and spreadsheets. The letter states that the CRA has determined that you have unreported income totalling $600,000 over the past three years, that your corporation is going to be reassessed for this income, and so are you. In addition, a 50% penalty will be applied. The tax and penalties amount to 120% of the income, and interest will apply on top of this. You are now snared in a net worth assessment.

The CRA has been increasingly using net worth assessments to detect unreported income. But why did they pick on you?

The CRA uses a risk assessment model to determine whether a net worth assessment analysis is warranted. Typical targets are persons who operate cash businesses (construction is a favourite, along with retail stores and restaurants), who report low income or losses, have poor accounting records, and have an apparently increasing net worth. Sometimes the CRA gets leads from unidentified sources (such as an upset employee, or an estranged spouse). Sometimes they pick up the idea from preparing to audit the company, and identify something that appears unusual.

Regardless of how and why the CRA picked you as a candidate for a net worth assessment, once you are involved, there is no turning back.

How does a net worth assessment audit work?

The Income Tax Act allows the CRA to issue an assessment on an arbitrary basis, or by using various audit methods. The net worth assessment fits within this, and has been held to be valid. Defences such as a violation of charter rights have not found merit with the Courts.

The CRA does an analytical review of a person's net worth and then calculates the net worth at a point in time (January 1, 2003 for example). They then calculate the net worth three years later, say December 31, 2005. The difference is the increase in net worth. To this, reasonable living expenses are added, because these have to be funded in some way. Then the person's income during the three years in question is considered, to see whether it explains the increase in net worth and the estimated expenses over the period. If so, that is the end of the matter. If not, and no additional information is forthcoming, the difference is considered unreported income. The CRA then looks at the most likely source of unreported income (generally from a cash business of some sort, either carried on personally or in corporate form). The unexplained difference is considered by the CRA to be income of this business, triggering the assessments described above.

The CRA frequently has incomplete information, which makes net worth assessments inaccurate. Also, the CRA's assumptions can often be unrealistic. In one particular case, the CRA included cash withdrawals from ATM machines as living expenses. The amounts were used to buy groceries, which were separately listed under living expenses. Clearly there was a double count.

The CRA may also leave out important information. For example, if a person's assets increased significantly because they put a mortgage on their house, there is no increase in net worth. If the mortgage is not entered as a liability, the calculations can be materially wrong.

A net worth assessment is fought by finding errors with CRA's calculations. Often this comes from supplying additional information. Sometimes CRA will negotiate a settlement to finish the matter. Penalties can be waived by CRA on occasion.

Despite the inaccuracies of the net worth assessment audit approach, the CRA can be very tenacious in requesting the taxpayer to disprove the assessments. Even if the discrepancies are quite small (say $20,000 in a particular year), the CRA has been known to press forward with reassessments.

If you, or anyone you know, are unlucky enough to be asked about personal banking records, personal expenses, or other questions not directly related to income taxes, be wary. It could be the start of a net worth assessment. If you have done nothing wrong, you have nothing to fear. Still, get professional advice immediately.

The Principal Residence Exemption – Three Difficulties That Could Be Costly

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Very few things in life are free. In the world of Canadian taxation, the list is even shorter. One opportunity though, not to be missed, is the principal residence exemption.

Subject to certain limitations, the gain from the sale of the principal residence is completely tax-free. The limitations placed on the exemption relate to meeting the criteria necessary to qualify, rather than the absolute amount of the gain itself.

The first and most important limitation is the fact that a family (husband, wife and children under 18, in general), may only designate one principal residence in respect of any one year. If the family has two homes, such as a house in the city and a seasonal cottage, then only one may qualify for the principal residence exemption in any given year. It is not necessary to choose which residence will qualify for the exemption, until there is a sale. But, once a sale of one of the residences occurs, and that residence is designated as the principal residence, it is not possible to amend this selection in future years, even if the choice proved inopportune.

The principal residence exemption itself is computed as a fraction of the total capital gain. The fraction is the number of years that the residence is designated as a principal residence, over the total years of ownership. One extra year of eligibility is given. In the simplest case, if a residence is designated as the principal residence for all the years of ownership, the fraction will equal one, and the entire gain will be exempt. However, if it is only designated for some of the years in question, then a portion of the gain will be taxable. If held sixteen years, and designated as a principal residence for seven of those years, 50% of the gain would be exempt (one additional year of exemption is granted).

Herein lies the first difficulty with the exemption. The benefit of designating a property as a principal residence in any given year depends on two things; the number of years that the property will ultimately be owned until it is sold, and the gain which will be realized when it is sold. To illustrate how this can be problematic, consider the following simple example. In 2000, a family purchased a home in the city (the main residence) and also a summer cottage. The main residence was sold in 2007, for a gain of $400,000. The gain was claimed as being exempt under the principal residence exemption which, as a practical matter, simply means that the gain was left off the tax return entirely.

At that time, the summer cottage also had a gain of $400,000. However, after that, the value of the summer cottage shot up dramatically, and it was sold two years later for a gain of $800,000. By selecting the main residence as the principal residence up to 2007, the summer cottage may only be designated as a principal residence for 2008 and 2009 (2 years of a total period of ownership of 10 years). Under the formula, since one year is automatically given, this yields an exemption of 30%. Thus $240,000 of the $800,000 gain would be exempt, leaving $560,000 to be taxable.

The above example illustrates the main point, designating the wrong property for the exemption.

The second difficulty with the principal residence exemption is that the amount of land which may be claimed as being exempt is limited to one-half hectare (about one acre), unless the excess land can be shown to be necessary for the use and enjoyment of the property.

This creates problems, especially with cottage properties, where a large lot of lakefront property may easily exceed the size limits. Given the value of such properties today, this may become a material issue. While there is some case law on when excess land is considered "necessary" for the use and enjoyment of a property, the issue is far from clear.

The third difficulty with the principal residence exemption concerns foreign properties. Many people do not realize that a foreign residence can qualify as a principal residence. An old family home in the U.K., for example, may have become very valuable. The residence may qualify as a principal residence if it is occupied by a family member or close relative and, in some cases, even if it has been rented. So don't overlook a foreign property in the principal residence evaluation.

IN BRIEF

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CRA's Position on Safe Income Calculation

In general, safe income is the amount that can be distributed tax-free to a corporate shareholder in the course of reorganization, before a sale. It is often described as the "tax retained earnings". The notion of safe income is mentioned in the Income Tax Act but not defined. Therefore, the CRA determines safe income and then the courts decide whether the CRA's interpretation is correct. Many judicial decisions have modified the CRA's interpretation and no doubt there will be more as new situations arise.

In the past, it was the CRA's position that non-deductible expenses should not be deducted in computing safe income. However, in a Federal Court of Appeal case, Kruco Inc. (2003 DTC 5506), the court decided that a reduction in safe income was warranted for non-deductible expenses. Consequently, all expenditures will reduce safe income, whether or not they are deductible for tax purposes. Non-deductible items, such as interest on taxes and 50% of meals and entertainment expenses, reduce safe income on hand. According to the CRA's Income Tax Technical News No. 37, this adjustment will apply to dividends paid after February 15, 2008.

Restrictive Covenants

In 1999, the Fortino case (2000 DTC 6060) held that payments received for non-competition agreements were not taxable because they were not "income from a source". This decision was upheld in the Manrell case (2003 FCA 128) by the Federal Court of Appeal. The Department of Finance was not pleased with these decisions and issued a News Release on October 7, 2003 stating that non-competition receipts or restrictive covenant receipts would be taxable as ordinary income subject to certain exemptions. This meant that receipts in respect of non-competition and restrictive covenants became fully taxable. Amazingly, the new legislation has still not been finalized. Draft legislation was introduced three times and is currently under review by the Senate Committee on Banking, Trade and Commerce. It is not clear when the legislation will receive Royal Assent. In our view, the amendments are unduly complex and unduly harsh.

Theoretically, this means that the law as interpreted in Fortino and Manrell still applies. There is only draft legislation at present. Although the draft legislation is stated to apply from October 7, 2003, it is unclear how the government will be able to apply these rules in respect of amounts received as long as five years ago if taxpayers were bold enough to take the position after October 7, 2003 that such payments were tax-free. The 2003 year is now closed for reassessment and 2004 will be closing shortly.

Certificates of Compliance on Amalgamation

The CRA has recently clarified its position on the requirement for a compliance certificate when there is an amalgamation of Canadian corporations. In general, when a non-resident disposes of taxable Canadian property, the purchaser is required to remit 25% of the gross proceeds to the CRA. However, the seller can apply to the CRA for a compliance certificate (formerly known as a "clearance certificate"). When the compliance certificate is received from the CRA, withholding tax is based on 25% of the capital gain, rather than on the gross proceeds. Under many of Canada's tax treaties, there is no Canadian tax on the sale of shares of a Canadian corporation, provided that no more than 50% of the Canadian corporation's value is derived from Canadian real estate.

In the past, the CRA's position was that a compliance certificate was not required for the amalgamation of two Canadian private corporations. However, in Interpretation Bulletin IT 474R2, released on December 17, 2007, the CRA stated that a compliance certificate will be required in future. In the case of an amalgamation, there is no purchaser to remit the 25% withholding tax, as there has been no change in ownership. This would impose a 25% tax liability on the shareholders, with no outside cash to fund the liability.

On January 8, 2008, the CRA revised its Interpretation Bulletin again, to state that a compliance certificate is not required. This is very helpful, since the CRA is currently far behind in processing compliance certificates. In some cases, approval can take six to eight months. This is a significant problem, since withholding taxes are supposed to be remitted within 30 days of the transaction. To deal with this problem, the CRA has been providing "comfort letters", advising the purchaser that it does not have to remit withholding tax until a compliance certificate is approved or a notice is received from the CRA to remit the withholding tax. As announced in the 2008 Federal Budget, when a non-resident disposes of a treaty-protected property after 2008, a notification rather than a certificate will be required. It appears that even in situations where there is no treaty protection, a compliance certificate will not be required on the amalgamation of two Canadian companies.

Foreign Investment Entity Rules

In the last issue of Tax Perspectives, we reported that the Bill that incorporated the changes to the Foreign Investment Entity ("FIE") draft legislation was approved by the House of Commons and received first reading in the Senate on June 18, 2007. The legislation was reintroduced when Parliament reconvened last fall and is now stuck in the Senate, who have had the good sense to take a careful look at the legislation. With another election possible, we may see the legislation die again, even though it is stated to apply from January 1, 2007. There is no question that a country such as Canada needs FIE type legislation. However, the draft is unduly complex and will discourage Canadians from making foreign investments, which is unacceptable.

Some Consequences of Eligible Dividends continued from page 3

As purchasers usually have a strong preference for purchasing assets, careful analysis may reveal little tax burden to the vendor, which may make it easier to consummate a sale of the business.

Summary

The introduction of the eligible dividend rules has added a measure of complexity to many aspects of tax planning for corporations and their shareholders, particularly owner-managed businesses. Some of the old "rules of thumb" must now be discarded and replaced by a careful analysis of the facts in each situation. As there are significant variations between provinces in both corporate and personal tax rates, different results and conclusions may be obtained, depending upon the particular province where business is carried on and where an individual shareholder resides.

TAX PERSPECTIVES

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