BUCHANAN BARRY LLP
CHARTERED ACCOUNTANTS

TAX NEWSLETTER

September 2015

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TAX SHELTER DANGERS

Other than “approved” shelters such as Registered Retirement Savings Plans (“RRSPs”), Tax-Free Savings Accounts (“TFSAs”) and flow-through shares, there are few, if any, tax shelters that still work to reduce your tax bill.

Taxpayers should be aware of some of the dangers of investing in a scheme designed to reduce income tax, quite aside from whether the scheme technically “works”:

1. If the scheme is a **“tax shelter” as defined in the *Income Tax Act* (Canada)**, the promoter is required to obtain a tax shelter Identification number from the Canada Revenue Agency (the “CRA”), to provide you with that number, and to report your name and Social Insurance Number (“SIN”) to the CRA as an investor in the shelter. This ensures that the CRA will audit your investment, and if it does not like the effects, your tax benefits may be denied, although you can normally challenge the CRA decision through the courts.

   A “tax shelter” is defined, very generally, as any scheme where the promoter represents that the savings you can obtain for tax purposes will exceed the amount you invest in the scheme.

2. **If the promoter fails to register** the shelter, or **if you do not file a Form T5004**, *Claim for Tax Shelter Loss or Deduction* with your return showing what shelter you are using and how much you are claiming, then your losses or credits will be denied even if they would otherwise qualify.

3. If the scheme is not a “tax shelter” as defined, but has two of the three **“hallmarks” of a tax avoidance plan**, it must be reported to the CRA on a special return (RC312, *Reportable Transaction Information Return*). Again, if it is not reported, the tax benefits can be disallowed and the CRA may have unlimited time to reassess you. The “hallmarks” are:

   (a) contingent fees for the promoter (usually a percentage of the tax you save);

   (b) “confidential protection”, meaning you are not permitted to disclose the details of the scheme to others; and

   (c) “contractual protection”, such as insurance or a promise to defend the scheme if you are reassessed by the CRA to deny its benefits.

4. **Charity donation shelters** receive special attention. These involve a mechanism whereby you get a tax receipt from a charity for much more than the cash you actually put into the arrangement. Even if the promoter assures you that the scheme works and

has been vetted by a law firm, note the following:

- — The CRA does not accept *any* charity donation shelters as valid, other than simple donations of flow-through shares (for which special rules provide that a capital gain needs to be reported).
- — If you do not report the shelter as a tax shelter on your return, then as per above your donation credit should be denied, and there is no limit to when the CRA can reassess you.
- — Assuming you report the shelter, the CRA will refuse to issue your initial Notice of Assessment until it has audited the shelter, at which point it may deny the donation credit.
- — Even if you appeal the CRA's assessment denying you the donation credit, you must still pay half of the amount in dispute while the appeal is underway.

5. Quite aside from all the special tax shelter rules, the CRA can use the **general anti-avoidance rule ("GAAR")** to deny you any deduction or credit that is part of an "avoidance transaction" and is considered to constitute a misuse or abuse of the words of the *Income Tax Act* (Canada), Income Tax Regulations or any tax treaty.

The bottom line is that, unlike 20-30 years ago, most tax shelters simply do not work anymore. Stick to RRSPs, TFSAs, flow-through shares and legitimate deductions for business expenses — all of which can provide substantial savings.

EMIGRATION FROM CANADA

If you are considering emigrating from Canada, tax considerations will be extremely important. The tax implications can be (and are) the subject of a whole book; below we review just some of the most important highlights. It is generally wise to obtain professional advice that is tailored to your specific situation.

Will you become a non-resident of Canada?

If you become non-resident, you will no longer be subject to Canadian income tax on all of your worldwide sources of income. You will generally be taxed only on certain "Canadian-source" income (*e.g.*, income from rent on property in Canada, dividends from Canadian corporations, or capital gains on Canadian real estate). From a Canadian tax point of view, it may therefore be desirable to become non-resident. Of course, taxes should not be an overriding consideration; other issues such as health care, cost of living, safety, political stability, civil rights and quality of life must not be overlooked.

Just because you are moving out of Canada does not automatically mean that you will become non-resident.

First, you have to establish that you have **taken up residency somewhere else**. Canadian courts have held that you have to be resident somewhere. Generally, you are considered resident in the place where you regularly, normally or customarily live in the settled routine of your life. There are no precise rules to be applied; each case depends on its facts.

Second, since it is possible to be resident in more than one country at the same time,

you must establish that you have "cut your residential ties" with Canada. Those ties are evidenced by such things as:

<u>"Significant" residential ties</u>

- keeping a home in Canada
- having your spouse remain in Canada
- supporting dependent children who remain in Canada

<u>"Secondary" residential ties</u>

- keeping personal property such as furniture, clothing, and automobiles in Canada
- having bank accounts with Canadian banks
- having credit cards issued by Canadian financial institutions
- social ties such as memberships in Canadian clubs and religious organizations (on a resident basis)
- maintaining provincial health care coverage
- keeping a Canadian driver's licence, or a vehicle registered in Canada
- professional memberships in Canada (on a resident basis)

<u>"Minor" residential ties</u>

- having a seasonal residence in Canada
- renting a safety deposit box in Canada
- renting a post office box in Canada
- keeping a telephone listing in Canada
- continuing to use stationery and business cards with a Canadian address

No one factor is conclusive, but in the CRA's view all of the "significant" ties and most of the "secondary" ties must be cut to establish non-residence. The CRA will also look at your general mode and routine of life, and whether you are making regular or extended visits to Canada.

Note that certain people are deemed to be resident in Canada even though they are working abroad. This includes members of the Canadian Forces and Canadian diplomats posted outside Canada, as well as their spouses if the spouse was ever resident in Canada for tax purposes.

Tax treaty "tie-breaker" rules

Canada has tax treaties with over 90 countries, including of course the United States and all of our significant trading partners other than tax havens. The tax treaties provide **tie-breaker rules for determining residence**, if a person would otherwise be considered resident in both countries under the domestic laws of each country. Most tax treaties follow the same model, though there are minor differences among them. (Tax Information Exchange Agreements that Canada has with many tax havens are not tax treaties, and the paragraphs below do not apply to them.)

If you are resident in another country under a "treaty tie-breaker" rule, then you are deemed by the *Income Tax Act* (Canada) (subsection 250(5)) *not* to be resident in Canada, even if you have not cut your ties with Canada.

Thus, if you move to a country with which Canada has a tax treaty, it is easier to become non-resident, by means of a "permanent home" or having your "personal and economic relations" stronger in the other country.

Departure tax payable if you become non-resident

If you become non-resident for Canadian tax purposes (including due to a treaty tie-breaker rule as per above), you may be

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required to pay tax as a result. This is sometimes called the "departure tax". In fact, it is ordinary income tax payable on capital gains that are deemed to be triggered when you become non-resident.

On becoming non-resident, you are deemed to dispose of much of your property at its **fair market value**. Thus, capital gains may be triggered, depending on your cost base in each property. However, this rule generally does *not* apply to certain property, including:

- real property (*e.g.*, land and buildings) in Canada, which will instead be taxed when you eventually sell it;
- interests you have in RRSPs, RRIFs, RESPs, RDSPs, TFSAs and a whole alphabet soup of other plans and arrangements;
- various rights you may have, such as under an employee stock option agreement;
- property used in carrying on an active business through a permanent establishment in Canada.

This is only a very general overview; the departure tax has many complications, and you should obtain professional tax advice relating to your specific situation.

Note that if you do not pay your Canadian tax liability, the CRA can, under Canada's tax treaties with some countries, arrange for the local tax authority to enforce collection of the Canadian tax you owe. This can happen in the United States, the United Kingdom, Germany, the Netherlands and Norway, and will be possible in New Zealand and Spain once pending amendments to Canada's tax treaties with those countries come into force.

Passive income — withholding taxes

Once you are non-resident, Canada will impose a withholding tax on most kinds of "passive" income, other than interest (which since 2008 is taxed to non-residents only in limited circumstances). This includes:

- dividends from Canadian corporations;
- rent on real estate in Canada;
- royalties paid from Canada;
- pension income, including OAS and CPP/QPP payments;
- RRSP/RRIF withdrawals.

The withholding tax rate is 25%. However, if you are resident in a country with which Canada has a tax treaty, the rate may be reduced to 15%, 10%, 5% or even zero. The tax on interest, dividends and some royalties is generally reduced by treaty; the tax on other amounts may not be. In each case you must check the details of the particular tax treaty as it applies to that specific type of income. Note that, in many cases, the Canadian withholding tax will be allowed as a foreign tax credit in the country of which you are resident, so the withholding tax should not represent a real cost to you.

CHARITY DONATION RECEIPTS

Aside from not using charity donations for tax-shelter purposes (see the first article above), you should be aware of the stringent requirements for donation receipts

in section 3501 of the Income Tax Regulations.

Receipts may be issued on paper, and mailed or delivered to you; or electronically, and sent by email or web link pickup. Regardless of which form is used, you should check every receipt to make sure it complies with the list below, and ask the charity for a replacement receipt if it does not. Otherwise your donation could be denied when your claims are audited months or years after filing your return.

Based on subsection 3501(1) of the Regulations, every receipt must contain the following to be valid:

(a) The name and address in Canada of the charity, as recorded with the CRA.
(b) The registration number (also known as a "Business Number") assigned by the CRA to the charity. This takes the form of 9 digits, plus "RR" (for charity registrations), plus four digits for the branch number, most often 0001. Example: 123456789RR0001.
(c) The serial number of the receipt.
(d) The place where the receipt was issued.
(e) Where the donation is of money, the date on which — or the year during which — the donation was received by the charity.
(e.1) Where the donation is of property other than money:
  (i) the day on which the donation was received,
  (ii) a brief description of the property, and
  (iii) the name and address of the appraiser of the property, if an appraisal was done.
(f) The date on which the receipt was issued.
(g) The name and address of the donor including, for an individual, the individual's first name and initial.
(h) The amount that is
  (i) the amount of the donation, if it was money, or
  (ii) if the donation is of property other than money, the amount that is the fair market value of the property at the time the donation was made.
(h.1) A description of the "advantage", if any, in respect of the donation and the amount of that "advantage". This refers to any benefit you may have received in exchange for making the donation. For example, if you paid $500 for a ticket to a fund-raising dinner and the dinner was worth $50, the "advantage" is $50.
(h.2) The "eligible amount" of the donation. This is the amount of the donation minus the "advantage" above. In the above example, the "eligible amount" that you can claim for tax purposes would be $450.
(i) The signature of a responsible individual who has been authorized by the charity to acknowledge donations. (A "facsimile signature" is permitted where all receipt forms are preprinted and serially numbered; the CRA also permits a copy of a signature for electronic receipts, such as those provided by email.)
(j) The Canada Revenue Agency name and Internet website. While the website is "cra.gc.ca" or "www.cra-arc.gc.ca", the CRA expects to see "cra.gc.ca/charities" or "www.cra-arc.gc.ca/charities", or the equivalent in French, on the receipt.

It is good practice to check every receipt against these requirements as you receive

it. You might be surprised how often small charities have some detail missing on their receipts. If you draw any missing items to the charity's attention, you will be helping the charity stay in compliance (and avoid risking revocation of its charity status), as well as helping all other donors ensure they can get their donation credits.

GST/HST BETWEEN RELATED CORPORATIONS

If you have more than one corporation under your control, what happens for purposes of the Goods and Services Tax ("GST"), Harmonized Sales Tax ("HST") or Quebec Sales Tax ("QST"), if they charge amounts to each other?

(GST, HST and QST all follow the same rules. This discussion does not apply to the provincial retail sales taxes in B.C., Saskatchewan and Manitoba. For simplicity, we will refer simply to "GST" below.)

For example, Xco might charge Yco management fees, or Xco might charge Yco rent for use of Xco's office building. These charges might be done for tax purposes, or for creditor proofing, to ensure that an operating company does not have too many assets in case of unexpected liabilities.

In most cases, except for interest paid on a loan, such fees are subject to GST.

Provided Yco is carrying on a business of making supplies that are taxable (or "zero-rated") under the GST, and is GST-registered, Yco can claim input tax credits to recover all GST it pays to Xco, so the GST cost is really just a temporary cash-flow cost. Nevertheless, there is still a cost, and the GST requires extra paperwork and accounting.

However, for "closely related" corporations, an election is available to *not* have to charge this GST. "Closely related" basically means under common corporate control. For example, if Xco owns all the shares of Yco, or Zco owns both of them, then they are closely related. However, if you personally owns all the shares of both Xco and Yco, they are not "closely related" as the term is defined in the GST legislation.

Since 1991 when the GST was first introduced, this "closely related corporations election" has not required the corporations to file anything with the CRA. It was enough for them to simply agree between them that no GST would apply to the intercorporate charges, and complete Form GST25 and keep it in their records in case of audit.

Since January 1, 2015, however, the election must be completed on new form RC4616 (available from the CRA web site), and filed with the CRA. **Any pre-2015 elections on Form GST25 are valid only until the end of 2015**.

If you have corporations that charge any fees or rent to each other without GST applying, make sure to have them complete a Form RC4616 and file it with the CRA no later than December 31, 2015. Otherwise, if it is ever audited, the corporation charging the fees or rent will be assessed by the CRA for the unremitted GST plus interest and possibly penalties.

Also, make sure that you are not using the election for corporations that are not "closely related" as defined in the legislation.

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AROUND THE COURTS

An unexpected cost of filing a tax return late

In the October 2014 case of *Yuet Yi Fung v. The Queen*, a taxpayer suffered a significant penalty for filing her return late, even though no tax was owing.

In spring 2012, Ms. Fung was caring for a premature newborn baby as well as a four-year-old. She did not owe any tax for 2011. She was busy at home, and put off filing her return.

When she eventually filed her return in October 2012, Ms. Fung included a Form T1135, *Foreign Income Verification Statement*, reporting that she owned more than $100,000 of "specified foreign property".

The problem was that for a taxpayer with over $100,000 in "specified foreign property", the T1135 is due no later than the due date for the taxpayer's income tax return. Since the T1135 was filed late, penalties applied. The *minimum* penalty is $25 per day, up to 100 days. Ms. Fung was therefore assessed a $2,500 penalty. She asked the CRA to waive the penalty, and the CRA refused. She then applied to the Federal Court for judicial review of the CRA's decision.

The Court ruled that the CRA's decision was within the "range of possible, acceptable outcomes". The CRA could choose whether or not to waive the penalty, had considered Ms. Fung's arguments, and its decision to not waive the penalty was not unreasonable. Her ignorance of the T1135 filing deadline was no excuse.

This case provides an important lesson about the importance of filing the T1135 on time!

ERRATUM for our August Newsletter

In our August Newsletter, there was an error in the last sentence of the second paragraph under the heading "Sale Of Building With Terminal Loss And Land With Gain". It should read:

"In general terms, a terminal loss on the sale of a building occurs when you sell the building for proceeds that are less than the undepreciated capital cost (UCC) of the building – normally meaning that the building was previously ***under***-depreciated for income tax purposes relative to its actual value". (Emphasis added to correct the error.)

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This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.