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Hidden Treasure: Is There Tax-Free Money Buried in Your CORPORATE TAX RETURN?

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Owner managers of small to medium-sized private corporations know that there are basically three ways to extract money from their corporations. They can return funds invested, either through shareholder loan repayments or return of capital, they can pay a wage, or they can pay a dividend. For the most part, obtaining this money tax-free requires either shareholder loans or the return of other tax-free capital.

There is, however, another type of dividend that is often overlooked. CDA dividends -- those paid from the corporation's Capital Dividend Account -- are completely tax-free to the shareholder. They are an effective, but often forgotten or under-used, source of funds from corporations.

What is a CDA and how are CDA dividends obtained?

Capital gains in Canada are taxed at a lower rate than most other forms of income. This is so because only half of capital gains are subject to tax. This is a fairly simple concept at the personal level, but it becomes a bit more complicated at the corporate level.

CDA dividends -- those paid from the corporation's Capital Dividend Account -- are completely tax-free to the shareholder. They are an effective, but often forgotten or under-used, source of funds from corporations.

There are two key factors relating to CDAs. First, though corporations technically are taxpayers, the non-incorporated shareholders are the *ultimate* taxpayers in the Canadian tax system. Secondly, the system is designed so that, in theory, there should be no advantage or disadvantage to earning income inside or outside a corporation.

When a private corporation earns a capital gain, it too pays tax on only half of the gain. In order to maintain the "non-taxable" status of the other half of the gain, the Canada Revenue Agency (CRA) created the CDA mechanism.

A corporation's CDA (with some exceptions) includes the following amounts:

1. The excess of the non-taxable portion of capital gains over the non-deductible portion of capital losses (including business investment losses) incurred by the corporation;
2. the accumulated capital dividends received by the corporation from other corporations;
3. the non-taxable portion of gains resulting from the disposition of eligible capital property; and
4. the net proceeds of life insurance policies of which the corporation was the beneficiary.

In the majority of cases, the CDA comes from the non-taxable portion of a capital gain. However, it is common for life insurance policies to be part of estate/succession planning arrangements for small business corporations.

Once a capital dividend amount has been determined, the corporation can file an election with the CRA to declare a non-taxable CDA dividend to its shareholders. If holding companies are involved in the corporate structure, multiple elections may be required.

The election is due on or before the earlier of the day the dividend becomes payable and the first day on which any part of the dividend was paid. Penalties will apply for late filing.

There are also penalties for electing to pay more CDA dividends than are in the CDA pool. Amounts paid in excess of the CDA pool can be taxed at a 75% rate. (Proposed legislation, if enacted, could reduce the rate to 60%.) Thus, for every $100 of excess dividend, the corporation would pay a tax of $75.

More and more, private corporations are investing funds in the stock market. While this may be an effective use of the corporation's excess funds, it can present some difficulties in filing the election. As discussed above, the non-taxable portion of capital gains is netted with the non-deductible portion of capital losses. This is done on a cumulative basis, and therefore capital losses can cause significant problems when trying to determine the

IN THIS ISSUE

Hidden Treasure: Is There Tax-Free Money Buried in Your Corporate Tax Return? 1
Subsidized Housing Projects: Increasing GST/HST Recovery 2
Canadian Unlimited Liability Companies: A Viable Vehicle for U.S. Investors Expanding into Canada 3
Welcome to America! 4
The End of the Joint Venture Fiscal Year 7

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CDA pool at a particular point in time.

Once a CDA balance is calculated, the corporation generally should avoid any loss transactions prior to filing the election. Unfortunately, the stock market typically does not wait for Canada Post to deliver elections. Sometimes, in order to preserve capital, investments must be sold at a loss. In such situations, however, the CRA provides a mechanism whereby a corporation, with the consent of its affected shareholders, can elect to treat the amount of a CDA dividend that was paid in excess of the CDA amount available as a regular taxable dividend. While this election will make part of the "tax-free" dividend taxable, it will also avoid a corporate tax of 75%.

So, is there tax-free money buried in your corporate tax return? While most corporations do not regularly sell assets at a gain, it is possible that yours did at some point. It may very well be that all you need to do is file an election to get the tax-free money that is owing to you. Your Collins Barrow advisor can help you find out. §

Subsidized Housing Projects:
INCREASING GST/HST RECOVERY

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Charities and qualifying non-profit organizations generally are eligible to recover rebates of 50% of GST paid and a varying percentage of the provincial portion of HST paid in the course of their activities. However, where such entities operate subsidized housing projects, that recovery can be increased to as much as 100%.

Organizations that own and operate subsidized housing projects for low-income tenants can apply to the Canada Revenue Agency (CRA) for a designation as a municipality, allowing them to access the rebate rates that are available to municipalities.

The designation applies only with respect to housing supplied to low-income tenants on a "rent-geared-to-income" basis. As a municipality, the organization can use the municipal rebate category for only this portion of its activities. GST collection and recoveries on other activities will be unaffected.

The municipal designation also allows an organization to recover a rebate of the provincial portion of the HST. The potential combined total GST/HST recovery is shown in the following table.

Province	Regular Rebate	Designated Municipality Rebate
Ontario	69.6%	86.46%
New Brunswick	50%	73.62%
Nova Scotia	50%	71.43%
British Columbia	54.08%	85.42%
Other Provinces	50%	100%

Note that this tactic is not advantageous in Newfoundland and Labrador, which does not provide a provincial municipal rebate. Thus, the organization would find its overall rebate decreased.

Once granted, the designation applies to current and future projects that meet the eligibility criteria. The organization need not reapply for each new housing project. The initial application normally is approved from the date of first tenancy so that operating costs can be recovered in full. Capital costs, including construction or acquisition of the property, may be recoverable depending on the date of the CRA approval and of the GST/HST payments.

The eligibility requirements for this designation are:

- The organization must be a charity, co-operative housing corporation, not-for-profit organization or public institution (such as a school authority, university, hospital authority or local authority).
- The organization must supply residential accommodation on a long-term basis to persons or families with low to moderate income, and its rental policies must target these persons.
- More than 10% of the housing units in a project must be supplied on a rent-geared-to-income basis.
- The organization must receive funding from a level of government (municipal, provincial or federal) to assist in the provision of housing.

The organization must own the housing project or have a leasehold interest in the project that allows it to act as the landlord in providing the units on a long-term basis (at least one month) to individuals and families. The individual units must be private quarters each with a kitchen and a bathroom.

The accommodation provided must *not* include the provision of services such as meals, laundry, personal care, counselling, health care or housekeeping, although the CRA will permit these services to be provided for a separate charge.

The organization must be able to demonstrate that its tenant selection policy includes income testing. For example, rent could be limited to a percentage of the gross household income with a maximum income threshold, after which the tenant is no longer eligible for the subsidy. Alternatively, housing could be supplied only to those whose incomes fall below a maximum threshold stipulated by the government department that supplies the funding.

We understand from the CRA that many providers of subsidized housing are not taking advantage of this program. If you think you may be eligible, please contact us to discuss the program. **§**

Canadian Unlimited Liability Companies:
A VIABLE VEHICLE FOR U.S. INVESTORS EXPANDING INTO CANADA

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The Fifth Protocol of the Canada-U.S. Tax Convention (the Treaty) introduced new anti-hybrid rules in Article IV(7) intended to deny Treaty benefits for amounts of income, profit or gains involving hybrid entities. The new rules generally operate to deem an amount of income, profit or gain to be not paid to or derived by a resident of a contracting state in certain circumstances. Since the benefits of the Treaty are extended only to residents of the contracting states, the particular amount of income, profit or gain will not have the benefit of any reduced rate of tax that would otherwise be available under the Treaty.

The provinces of Alberta, British Columbia and Nova Scotia allow for the creation of unlimited liability companies (ULCs) under their respective statutes. A ULC is a hybrid entity; it is treated as a corporation for Canadian tax purposes and can be treated as a flow-through or disregarded entity for U.S. tax purposes.

A ULC may be an attractive vehicle for a U.S. investor expanding into Canada for reasons that may include:

- It avoids double taxation in the U.S. as, unlike Canada, the U.S. does not provide full integration between corporate and personal taxation that may arise in corporate structures.
- It allows for losses to flow through to the shareholders to offset a U.S. shareholder's income.
- It allows for investment in passive investments in Canada without triggering U.S. anti-avoidance rules for foreign holding companies.
- It provides flexibility to defer U.S. income tax on the ULC's income (Canadian tax rates are lower than U.S. tax rates) by allowing U.S. shareholders to elect to treat the ULC as a corporation for U.S. income tax purposes so that the ULC income will not be taxed in the U.S. until it is repatriated.
- It has less stringent requirements to have Canadian directors.

Since a ULC is considered an ordinary corporation for Canadian tax purposes, interest, dividends, royalties and other payments from a Canadian ULC to a U.S. shareholder are subject to 25% withholding tax under the *Income Tax Act* (Canada). The Treaty historically has reduced or eliminated such withholding taxes on many types of payments to U.S. recipients, allowing ULCs to remain tax-efficient for U.S. investors. Under the Treaty, the withholding rates on these types of payments range from 0% to 15%. Effective January 1, 2010, as a result of the ratification of the Fifth Protocol of the Treaty, Treaty-reduced withholding rates on payments by a Canadian ULC to a U.S. recipient are denied where the ULC is treated as a fiscally transparent entity for U.S. tax purposes.

On its own, the denial of treaty benefits on payments of dividends, interest and other payments by ULCs to U.S. investors would make ULCs tax inefficient vehicles for U.S. investors. However, the Canada Revenue Agency has published a series of advance income tax rulings and technical interpretations that

accept the use of various repatriation strategies to avoid the application of the new anti-hybrid rule in certain situations. The Canada Revenue Agency accepts these repatriation strategies only in certain circumstances. By way of example, a disregarded U.S. limited liability company (LLC) investing in a ULC can be tax inefficient, and even punitive in some situations, from a Canadian tax perspective.

With careful tax planning in the proper circumstances, and in situations where the benefits of a ULC align with a U.S. investor's tax and business objectives, the ULC remains a useful alternative for structuring investment or expansion by U.S. investors and businesses into Canada.§

WELCOME TO AMERICA!

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President Obama's recent initiatives to grow the U.S. economy have been premised on removing the hurdles to unlocking America's innovation and creativity. The "We Can't Wait" initiative, which liberalizes visa procedures to increase travel and tourism in the U.S., will pump money into the U.S. economy and, ideally, will create an increase in the number of U.S. residents. New residents to the U.S. will be surprised to learn of the far-reaching reporting obligations under the U.S. Tax Code and related financial legislation.

This article reviews the new reporting requirements for IRS Form 8938 "Statement of Specified Foreign Financial Assets," introduced under the Foreign Account Tax Compliance Act (FATCA), which in turn was enacted as part of the 2010 Hiring Incentives to Restore Employment Act (the HIRE Act). Those rules introduced various foreign tax reporting and compliance provisions, including a requirement for taxpayers to report their foreign financial asset holdings if the amount of those holdings exceeded certain minimum thresholds.

Unlike the TDF 90.22-1 Foreign Bank Account Reporting (FBAR) rules, which are mandated under the Bank Secrecy Act, Form 8938 is mandated under the Internal Revenue Code. As such, there can be duplication of reporting of affected accounts under both the FBAR and FATCA reporting rules.

General rules

Form 8938 is required to be filed with a taxpayer's 2011 U.S. income tax return if the filer is a "specified person" who owns "specified foreign financial assets" with a value over the specified threshold.

Definitions

A "specified person" includes:

- U.S. citizens;
- permanent residents, such as green card holders;
- individuals satisfying the day count residency tests; and
- non-resident aliens who elect to be treated as U.S. residents for tax filing purposes

Included in the definition of "specified foreign financial assets" (SFFAs) are:

- any financial account (i.e., depository account, custodial account, debt or equity interests in the financial institution) maintained by a non-U.S. financial institution (which includes non-U.S. investment vehicles such as foreign mutual funds, hedge funds and private equity funds);
- other foreign financial investments and assets if held for investment;
- financial instruments or contracts that have a non-U.S. person as the counterparty;
- a capital or profits interest in a foreign partnership;
- an interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, and similar type arrangements;
- an option or other derivative instrument with respect to any of the above examples;
- life insurance or annuities with cash surrender values;
- a beneficial interest in a foreign estate or trust; and
- deferred compensation and pension plans held by U.S. expatriates working abroad.

Clarifying guidance

Real estate, whether developed or rented, is not a reportable asset. However, real estate may become reportable if the specified individual holds title to the

asset through a foreign entity. In addition, if the real estate is leased, a contract for investment is created and the above definition would capture such lease arrangements between a U.S. person and a non-U.S. person.

A specified individual need not report a beneficial interest in a foreign trust or foreign estate unless the taxpayer has reason to know of the interest. If the taxpayer receives a distribution from the trust or estate, however, knowledge is attributable to that person.

Loans between U.S. taxpayers and their foreign family members fall within the definition of an SFFA.

For taxpayers living in the U.S., the specified threshold requirements are:

Single	If the aggregate value of all SFFAs meets or exceeds ▪ $50,000 as at December 31 or ▪ $75,000 at any time in the year
Married Filing Joint	If the aggregate value of all SFFAs meets or exceeds ▪ $100,000 as at December 31 or ▪ $150,000 at any time in the year
Married Filing Separate	If the aggregate value of all SFFAs meets or exceeds ▪ $50,000 as at December 31 or ▪ $75,000 at any time in the year

For taxpayers living outside the U.S., the specified threshold requirements are:

Single	If the aggregate value of all SFFAs meets or exceeds ▪ $200,000 as at December 31 or ▪ $300,000 at any time in the year
Married Filing Joint	If the aggregate value of all SFFAs meets or exceeds ▪ $400,000 as at December 31 or ▪ $600,000 at any time in the year
Married Filing Separate	If the aggregate value of all SFFAs meets or exceeds ▪ $200,000 as at December 31 or ▪ $300,000 at any time in the year

Where SFFAs are owned jointly, the determination of whether the threshold has been met or exceeded depends on the identity and filing status of the joint owners. In these instances the following rules apply:

Married Filing Separate and each is a U.S. person (specified person) For determining the thresholds: ▪ each owner includes only 50% of the assets value For reporting on Form 8938: ▪ each spouse files a separate Form 8938 and reports 100% of the jointly owned asset
Married Filing Joint and each is a U.S. person (specified person) For reporting on Form 8938: ▪ file one Form 8938 and report each SFFA owned by either person
Married Filing Separate and one spouse is not a U.S. person (specified person) For determining the thresholds: ▪ the U.S. person includes 100% of the asset's value For reporting on Form 8938: ▪ the U.S. person reports 100% of the value of the SFFA
Joint owners who are both U.S. persons and one is not a spouse For determining the thresholds: ▪ each person includes 100% of the asset's value For reporting on Form 8938: ▪ the U.S. person reports 100% of the value of the SFFA

Treaty positions and closer connection positions

Where a U.S. resident alien or permanent resident (green card holder) elects under an income tax treaty to be treated as a non-resident of the U.S. for tax purposes, that person continues to be treated as a specified person and Form 8938 must be filed.

Non-U.S. persons, including "snowbirds," who rely on the "closer connection" exception to avert the U.S. day count under the residency rules, should be able to steer clear of the Form 8938 reporting since the exception is under U.S. domestic provisions. However, the IRS has not yet provided definitive guidance in this area.

Exceptions

There are certain exceptions to reporting the SFFA information. Taxpayers are not required to report the specified foreign financial asset if they report the asset on certain other forms filed with the IRS (i.e. Form 3520 for foreign trusts or Form 8891 for RRSPs).

Additionally, taxpayers who are not required to file either a Form 1040 or Form 1040NR tax return need not file Form 8938, even if they own specified foreign financial assets with a value over the applicable reporting threshold. Refer to the IRS website for an updated list.

Penalties

The penalty for failure to submit the required disclosure is $10,000, increasing by $10,000 for each 30-day period following notification of non-compliance. However, a 90-day grace period exists before the second penalty is assessed. The maximum penalty is $50,000.

These new reporting rules are only one component of the U.S. global enforcement of reporting offshore accounts for U.S. persons. Our next Tax Alert will highlight the reporting requirements for passive foreign investment company rules (PFIC). **§**

THE END OF THE JOINT VENTURE FISCAL YEAR

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The 2011 federal budget eliminated the popular tax deferral for companies carrying on business through partnerships with different year-ends than their corporate partners (see Collins Barrow Tax Flash, October 2011). Up to that point, the Canada Revenue Agency (CRA) had a long-standing policy allowing joint venture (JV) participants to include income at the end of a joint venture fiscal period, similar to a partnership, as opposed to inclusion of revenues and expenses up to the participant's own taxation year-end. The policy generally allowed JVs to prepare accounting and tax information for all participants based on a single year-end, even where that period did not coincide with the tax year of one or more participants.

In June 2011, the CRA announced that the previous policy for JV fiscal periods was no longer applicable, and for taxation years ending after March 22, 2011, revenues and expenses arising from JV activities could no longer be reported using a separate JV fiscal year. However, the CRA also announced that it would permit administrative transitional relief similar to that provided for partnerships, namely that the additional JV income required to be included in the first affected taxation year of a participant could be deferred over the following five years. This transitional relief is available only to JV participants that relied on the former administrative policy.

For example, assume company Opco has a September year-end and, prior to 2011, reported income from a JV based on the JV's December year-end, in accordance with the previous CRA policy. Opco would include in its September 30, 2011, taxable income JV profits or losses for the JV year ended December 31, 2010, as well as profits and losses for the nine-month period ending September 30, 2011. Opco could then deduct a reserve in respect of the full amount of income earned from January to September 2011, and include that income in its 2012 to 2016 tax years (15% in 2012, 20% in each of 2013, 2014 and 2015, and 25% in 2016).

One convenience denied to JV participants, as compared to members of partnerships, is the ability to compute income or loss for stub periods based on a proration of income or loss for the previous fiscal period. In the example above, had the JV been a partnership, Opco could have computed January to September 2011 income as 9/12 of the preceding calendar 2010 income (subject to the option to compute actual income for that period), allowing the partnership to continue to prepare its tax information for a single fiscal year-end. But for JVs, no such shortcut is permitted and each participant will need to acquire details of JV revenues and expenses consistent with that participant's tax year. Accordingly, JVs whose participants have varying tax years may find themselves having to provide monthly tax information, if they are not doing so already. In the oil and gas industry, JVs are common, but they typically involve monthly reporting to participants so the impact in most cases is negligible. Real estate projects also frequently are conducted through JVs, often with fiscal-year reporting, so many of those JVs will have increased reporting requirements to participants.

To obtain the transitional relief in respect of income from a JV, a taxpayer must attach to the tax return for the first year ending after March 22, 2011, a letter indicating the election to benefit from the policy. If the tax return has been filed without indicating the election, the taxpayer may still make the election by sending a letter to the local tax office no later than September 22, 2012. §

Collins Barrow publishes *Tax Alert* quarterly for its clients and associates. It is designed to highlight and summarize the continually changing tax and business scene across Canada. While *Tax Alert* suggests general planning ideas, we recommend professional advice always be sought before taking specific planning steps.

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