



# Tax Alert

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## RRSP Creditor Protection

After many years of debate and delay, federal legislation to amend the Bankruptcy and Insolvency Act (BIA) finally received Royal Assent in December, 2007. It is expected to come into force later this year, although a final date has not been set.

One of the significant changes of interest to business owners will be bankruptcy protection for Registered Retirement Savings Plans (RRSPs). Under current legislation, most RRSPs and Registered Retirement Income Funds can be exposed to the claims of creditors in a bankruptcy.

Entrepreneurs and business owners often have most, if not all, of their liquid retirement assets put aside in registered plans. Those assets could be lost completely if a major uninsured lawsuit or other unforeseen circumstance came along.

It has been possible for many years to creditor-proof RRSPs by investing in certain insurance-based products, such as segregated funds. This is because insurance generally is protected from creditors under provincial legislation, whereas non-insured RRSPs fall under bankruptcy rules, which are federally regulated. Despite the creditor protection afforded to insurance-based plans, many people shy away from these investments because they typically come with higher fees and other features that may not be desired.

The current rules are seen as unfair because most workers with company-sponsored or

government-sponsored pension plans get automatic creditor protection on their retirement assets. Why should RRSPs be treated any differently than employer pension plans in a bankruptcy scenario?

The new legislation will apply across Canada and will exempt amounts held in RRSPs from seizure in bankruptcy, except for a clawback of contributions made shortly before bankruptcy. Where provincial legislation exempts RRSPs from seizure, that legislation will continue to apply. Where provincial legislation is silent regarding the treatment of RRSPs, they will be exempt under the new federal legislation.

The clawback period for contributions made prior to bankruptcy is under debate, but is likely to be 12 months. The purpose of the clawback is to prevent individuals facing imminent bankruptcy from moving assets into an RRSP with the intention of defeating creditors.

It appears the legislation will only provide creditor protection in cases of bankruptcy. Creditors still can seek a court order against a debtor who has not declared bankruptcy.

Other significant changes were made to the BIA and its companion legislation, the Companies' Creditors Arrangement Act. The main goals of the changes are:

- to encourage restructuring of viable businesses as an alternative to bankruptcy;

- to improve the protection for workers in bankruptcy, including a new statute to create a Wage Earner Protection Plan; and
- to make the insolvency system more fair and reduce the potential for abuse.

Business owners are faced with numerous risks and should be proactive in taking steps to legally protect their assets from the unforeseen claims of creditors. Our society is becoming increasingly litigious; a lifetime of work and savings can be wiped out quickly by an unexpected legal claim.

There are many well-accepted ways to creditor-proof assets, including:

- incorporating a business;
- securing funds lent to one's business;
- using multiple corporations to isolate assets from creditors;
- obtaining appropriate insurance coverage; and
- sprinkling assets among family members and trusts.

Your Collins Barrow advisor can help you to navigate through the complexities of structuring your business and personal assets in a way that will maximize creditor protection and your peace of mind. The time to act is now, before a creditor comes knocking or a lawsuit lands on your desk. By then, it will be too late.

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## Use of the Principal Residence Exemption



Most people believe that any capital gain (increase in value) on the house they own and live in is not taxable. In reality, however, the capital gain *is* taxable, but a special rule in the *Income Tax Act* (principal residence exemption) allows taxpayers to reduce the capital gain based on the number of years they live in the house, and designate those years for purposes of the exemption. For the majority of taxpayers, this results in no taxes payable upon the sale of their homes.

The types of properties that can qualify as a principal residence include detached and semi-detached houses, condominiums, cottages, mobile homes and even houseboats. The key requirements are that the property must be owned, must be "ordinarily inhabited," and the land portion cannot in most cases exceed one-half hectare (about 1.2 acres).

Whether a property is "ordinarily inhabited" really depends on the facts of each case. However, the Canada Revenue Agency (CRA) acknowledges that the test may be satisfied even where the owner lives in the property for only a short time. This would cover situations where an owner sold a property early in the calendar year or purchased a property late in the year. Further, the CRA acknowledges that a

seasonal residence, such as a cottage, would be ordinarily inhabited if it is used during vacation, as long as the main purpose for owning the property is not to earn income. It is possible to earn "incidental" income without jeopardizing the ability to claim the principal residence exemption.

Where an owner moves out of a home and converts it completely to a rental property, the "ordinarily inhabited" test obviously would no longer be met. In addition, at the time of conversion, the CRA considers such owners to have sold the property at fair market value and to have reacquired it at the same amount. Any income tax on the increase in value can be avoided by using the principal residence exemption or by making a special election to defer the gain to a later year. If the special election is made, the property can qualify as a principal residence for up to four additional years, even though it is no longer "ordinarily inhabited." This would cover situations where the owner was required to move (within Canada) for work or other purposes, and planned to return to his or her present location.

A further consideration is that the land portion of a principal residence cannot normally exceed one-half hectare, since the excess portion is considered *not* to contribute to the use and enjoyment of the property. Exceptions may be permitted where an owner can show that some or all of the excess portion is required for the use and enjoyment of the house. For example, consider a rural property where the house is situated such that a long laneway is required to reach a public access road. The land needed for the laneway may exceed one-half hectare but may still qualify since it is necessary for the use of the home. Further, where a municipal law or regulation at the time of acquisition requires a minimum lot size or restricts the ability to obtain a severance, the excess portion could qualify.

Where there is no excess land and a portion of the property is severed, the principal residence exemption would be available not only on the land with the home but also for the vacant severed portion.

Where more than one residence is owned -- a house and a cottage, for example -- the rules should be examined to minimize tax liability. For years after 1981, only one residence per family unit may be considered the "principal" residence. In some cases, paying tax on the house will be less than paying tax on the cottage, depending on the increase in value over the purchase price. In other cases, splitting the principal residence exemption between the house and cottage might result in lower taxes overall. The exemption is claimed by designating one property as the "principal" residence for every year of ownership. However, there is a "bonus" year built into the exemption formula, which, if claimed correctly allows the gain on one property to be completely exempt while allowing a portion of the gain on the other property to be covered by the exemption when it is sold in the future. A designation of a property as a principal residence is only required in the year of disposition, so no decisions have to be made until one property is sold.

Where a 1994 capital gains election was made on a cottage, additional analysis on the use of the principal residence exemption may lead to a lower tax bill on the sale of the property.

The principal residence exemption rules and calculations are complex. We recommend that you consult with your Collins Barrow advisor to determine how best to apply them in your circumstances.

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## Donation of Flow-Through Shares

Many *Tax Alert* readers probably have heard or read something about a plan to reduce dramatically the after-tax cost of donations by using flow-through shares.

The plan involves a donor wishing to make a sizeable donation first purchasing shares listed on an exchange that are "flow-through shares" as defined in subsection 66(15) of the *Income Tax Act* (the *Act*) pursuant to a subscription agreement with the corporate issuer. The donor immediately donates these shares to the desired charity, and the charity then immediately sells the donated shares to a pre-arranged third-party buyer. By proceeding in this way, the donor is able to deduct Canadian Exploration Expenses (CEE) renounced in respect of the flow-through shares, and claim investment tax credits and charitable tax credits or deductions. All of this, combined with the elimination of income tax on capital gains from gifts of public company shares, results in a significant reduction in the cost of an intended donation.

For example, the after-tax cost to an individual donor, resident in the Province of Ontario, making such a donation would be less than 21% of the cash received by the charity. The net after-tax cost of the cash paid by a corporate donor would be about 13%. Put another way, an individual donor wishing to gift \$100,000 to a charity will have reduced the after-tax cost of that gift from approximately \$53,600 to approximately \$20,600. If provincial tax credits are available the cost may be reduced even further.

Recently, the Canada Revenue Agency (CRA) issued an advanced tax ruling regarding this planning strategy. In general terms, the CRA ruled as follows:

- The arrangement is a gifting arrangement pursuant to paragraph (a) of the definition of "gifting arrangement," and is a tax shelter pursuant to paragraph (b) of the definition of "tax

shelter" in subsection 237.1(1) of the *Act*.

- The donation of the flow-through shares to a charity by the donor will not prohibit the donor from deducting the CEE renounced prior to the donation in computing the donor's income, or deducting any investment tax credit the donor would otherwise be entitled to deduct pursuant to subsection 127(5) of the *Act* in computing the donor's tax otherwise payable.
- Assuming the parties deal at arm's length, the donation of the shares to the charity will not cause the shares to be prescribed shares thereby disqualifying them as flow-through shares.
- An amount equal to the fair market value on the day of donation of the shares donated by an individual donor to the charity will qualify as a gift for the purposes of the definition of "total charitable gifts" in subsection 118.1(1) of the *Act*.
- An amount equal to the fair market value of the donation of the shares donated by each corporate donor to each charity will qualify as a gift under paragraph 110.1(1)(a) of the *Act*.
- If the shares are capital property to a donor, no portion of the capital gain arising from the gifting of the shares will be included in computing the donor's taxable capital gain.
- If the shares would otherwise be considered capital property to the donor, participation in the arrangement, in and of itself, will not result in the shares not being considered capital property to the donor.
- Any CEE and investment tax credit renounced to the donors will not constitute an "advantage" under proposed subsection 248(32) under Bill C-10, so there will be no restriction on the charitable tax credit or deduction.

The CRA did not rule on the fair market value of the gifted shares, whether the parties dealt at arm's length with each other,

whether the shares were flow-through shares, whether any of the expenses renounced by the issuer to a donor would qualify as either CEE or as flow-through money expenditure, or whether the property held by the donor was on income or capital account.

Now that the CRA has effectively blessed this planning, individuals and corporations contemplating significant donations should consider seriously using this plan either to reduce the cost of the donation or to increase greatly the amount the intended charity will receive. As always, you should consult with your Collins Barrow advisor before implementing such planning.

*This article was contributed by Philip Friedlan, LL.B, MBA, Friedlan Law, Toronto/Markham, Ontario. Philip practices taxation law and estate planning and has specific knowledge of this planning strategy and this ruling.*



## Payments to Non-Residents



Where a person pays to a non-resident of Canada a fee, commission or other amount in respect of services rendered in Canada, of any nature whatsoever, the payor is required to withhold income tax from that payment. Pursuant to paragraph 153(1)(g) and Regulation 105 of the *Income Tax Act* (the *Act*), the payor must withhold and remit to the Receiver General income tax of 15% of the amount paid to the non-resident. If the services are rendered in the Province of Quebec, an additional 9% must be withheld and remitted to the Minister of Revenue for Quebec.

The income tax withheld must be remitted on or before the 15th of the month following the month in which the payment was made to the non-resident. Information slips (form T4A-NR) must be prepared and filed by the last day in February in the year following the year in which the payment was made. A copy of the information slip must be provided to the non-resident for the non-resident's tax filings, as the income tax withheld is considered on account of the non-resident's Canadian income tax liability.

Pursuant to subsection 227(8.4) of the *Act*, failure to withhold renders the payor liable to pay the tax on behalf of the non-resident. Subsection 227.1(1) of the *Act* extends this liability to directors of a corporate payor. Further, failure to withhold will subject the payor to a potential penalty of 10% of the amount that should have been withheld. For repeat failures or in cases of negligence, that penalty will double to 20%. Interest is also charged at the prescribed rate.

The obligation to withhold applies to every person paying for services rendered in Canada by a non-resident. "Every person" includes individuals, corporations, trusts, and each member of a partnership. The obligation to withhold applies to payments made to non-residents, including non-resident individuals, non-resident corporations, non-resident trusts, and non-resident participants in partnerships or joint ventures. The types of activities that require withholding include consulting, engineering, legal, accounting, seminars and conferences, construction, installations, forestry, manufacturing, oil and gas, and entertainment.

The obligation to withhold does not apply in cases in which the non-resident is an employee of the payor. In that case, standard payroll withholdings will apply. However, the obligation to withhold will apply in cases where a non-resident employee remains on the payroll of the foreign employer and is seconded to provide services to the payor carrying on business in Canada.

As discussed above, the income tax withheld and remitted is considered payment on account of the non-resident's Canadian

income tax liability. In cases where that liability is established by the non-resident service provider to be less than the amount that was remitted, the non-resident is entitled to a refund of the excess. Similarly, where the non-resident service provider can demonstrate, based on treaty protection or estimated net income, that the 15% withholding tax will be in excess of the non-resident's ultimate Canadian income tax liability, the non-resident may apply for a waiver or reduction in that withholding amount. The application is made by filing the appropriate information with the Canada Revenue Agency (CRA).

### Summary

Paragraph 153(1)(g) and Regulation 105 of the *Act* do not impose a liability on the non-resident service provider. Rather, they impose an obligation on the payor to withhold and to remit income tax on behalf of the non-resident service provider. The penalties for failure to comply with these rules can be onerous for the payor. The CRA normally will limit audit periods to the current year plus the two previous years. In some cases, the audit period is extended to six previous years.

Whether you are a purchaser or a provider of non-resident services rendered in Canada, it would be wise to consult your Collins Barrow tax advisor to discuss the applicability of these rules.

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