Collins Barrow
Chartered Accountants

Tax Alert

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Tax Planning and Fair Market Value

As a small business owner, you are well aware that proper tax planning and corporate structuring are essential for increasing your wealth and protecting the assets you have built up over many years of hard work. After carefully planning your financial, legal and personal affairs, and with so much at stake, would you put your plans at risk by not taking the necessary steps to ensure success? Many business owners do just that, by failing to value their assets appropriately prior to implementing their plans. Cutting corners on your tax plan by not obtaining a valuation of your assets is like buying a new car and neglecting to top up the engine oil. The plan might work well for a while, but there is a significant risk that it will come to a rather abrupt and unpleasant end.

The term "fair market value" (FMV) is used well over 1,000 times in the *Income Tax Act* (the Act), a number that indicates some importance. The Department of Finance has stated its interest in valuation because it is essential to the administration of the Act. FMV is defined in case law as:

> "*the highest price, expressed in terms of money or money's worth, obtainable in an open and unrestricted market, between knowledgeable, informed and prudent parties acting at arm's length, neither party being under any compulsion to transact.*"

Essentially, this definition means that a transaction at FMV represents a transaction between unrelated parties working for their own interests. Transactions occurring between persons who are related to each other usually are not considered to be at FMV because it is not clear whether the parties are working in their own self interest or if they are working in concert to achieve some other desired result. Consider a parent seeking to gift an asset to a child. Except in specific circumstances, the Act requires gifts to be transferred at FMV or significant penalties and interest charges may result. Not having exposed the asset to a market place to see what price an unrelated party would pay, it would be prudent for the parent to have the asset valued to reduce the risk of reassessment by the Canada Revenue Agency (CRA).

Many tax plans involve a number of related-party share transactions that meet certain shareholder objectives but do not change the beneficial interest in the underlying property. For example, an owner/manager may want to "freeze" his/her interest in a business to ensure future growth accrues to other family members. The "freeze" transaction does not change the owner's beneficial interest in the underlying property on the date of the freeze, but does direct future growth to other persons who will now own the common shares. Many of these transactions are considered "rollover" transactions in that they are elected or deemed to occur at the original cost of the asset and, therefore, no income tax is triggered at the transaction date.

So now you might ask: if there is no change in the beneficial interest in the underlying property and the transaction is going to be a tax-free rollover at cost, why do I need a valuation at all? The answer is that the Act requires these transactions to occur at FMV. While the transaction may be a tax-free rollover at your cost, the consideration you receive must equal the FMV of the asset(s) you transfer. Otherwise, there is a risk that an unintended benefit will accrue to another person who is a party in the transaction. For example, imagine that an owner freezes his value in a company with a tax-free rollover at $500,000 and allows his/her children to acquire ownership in the company at a nominal amount. If the CRA subsequently reassesses the value of the owner's company at $1,000,000, there would be a $500,000 transfer of value to the children. Needless to say, this situation would give rise to some nasty tax consequences that might include double taxation of the $500,000 transferred value.

One tool that many professional advisors use to mitigate the risk of reassessment by the CRA is the Purchase Price Adjustment clause (PPA). A PPA is designed to adjust the value of a transaction should the CRA or another competent authority determine a different value. In the above situation, it would allow the value of the transaction to be adjusted from $500,000 to $1,000,000 and side-step any adverse tax consequences. The catch is that the CRA will only accept a PPA under certain conditions, one of which is "the parties…..arrive at the [FMV] for the purposes of the agreement by a fair and reasonable method."

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Federal Home Renovation Tax Credit

The 2009 Federal Budget proposed a temporary home renovation tax credit for individual taxpayers in the 2009 tax year. The Government has not yet passed legislation to enact this proposal, but it appears likely that the proposal will become law.

In this article we will answer the questions most frequently asked by our clients recently regarding this proposed new credit.

When must the costs be incurred?

The credit applies to goods purchased or work performed after January 27, 2009 and before February 1, 2010. If a contract was already in place prior to January 28, 2009 for work to be done, those contract costs will not qualify for the credit.

How much is the credit and how do I claim it?

The credit is a 15% non-refundable tax credit that may be claimed on your 2009 personal tax return. It applies to eligible costs more than $1,000 but not exceeding $10,000. As an example, if you spend $8,000 on qualified costs, you could claim $1,050 ($7,000 x 15%). The maximum claim available is $1,350 ($9,000 x 15%). This credit is claimable against federal income tax that you would otherwise owe.

Can each partner/spouse claim a credit?

No. There is one tax credit per family, being you, your spouse/partner, and children who are under 18 years of age at the end of 2009. The credit may be shared amongst members of the family.

Do the renovations have to be to my home or can they be done to a rental property or cottage?

Generally, the renovations must be incurred in relation to an individual's principal residence. As a result, renovations to your cottage may qualify if your cottage is owned by you and ordinarily inhabited by you, your spouse or partner, or your children. Renovations to a property that is used entirely for the purpose of earning business or rental income will not qualify. If a *portion* of your home is used for earning business or rental income, you will be allowed to claim the credit only for the renovations made in respect of the personal use portion of your home.

Will costs for items like appliances, window blinds and hot tubs qualify?

For renovations to qualify, they must be of an enduring nature, integral to the dwelling, and must not retain their own value independent of the renovation. As a result, costs relating to appliances will not qualify. Window coverings such as curtains and draperies would likely not qualify, but blinds, shutters and shades, which would alter the nature of the dwelling if removed and which are attached to your home, likely would qualify. With respect to hot tubs, it depends; the Canada Revenue Agency has indicated that the "plug and play" type of portable hot tub, which is not permanently wired into your home, would *not* qualify, but the larger types, that are wired directly into your home, would qualify.

If I borrow money to do the renovation, can I include the cost of borrowing?

No. Eligible costs specifically exclude interest costs.

What are some other examples of costs that will qualify?

- building an addition, garage, deck, fence or storage shed
- renovating a room such as a basement, kitchen or bathroom
- costs of fixtures that are attached to your home, such as furnaces, fireplaces, central air, water heaters, water softeners, ceiling fans, light fixtures, etc.
- installing a well or septic system
- installing a swimming pool
- painting your house (inside or out)
- re-shingling a roof
- installing or resurfacing a driveway
- installing new flooring
- laying new sod, shrubs, etc.

Do I have to submit the receipts with my 2009 personal tax return?

No. The receipts are not to be submitted with your tax return. However, you must retain them to substantiate your claim. It is important to ensure that your receipts provide sufficient detail to support your claim. You need to be able to show that the expenses were paid for by yourself or your partner, the date the costs were incurred, the type and quantity of goods purchased or services provided, and details regarding the vendor's name, business address and GST registration number.

Note that expenses incurred for goods or services provided from someone who is not dealing with you at arm's length (ie. generally someone related to you) will not qualify for the tax credit unless that person is registered for GST/HST.

While the legislation is not yet law, this is the time of year when many taxpayers are incurring home costs. Ensure that you obtain and retain proper documentation to support this claim on your 2009 personal tax return. Contact your Collins Barrow advisor to discuss further strategies to help you maximize this potential tax credit opportunity.

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Income Tax Advantages to Going “Green”

The Federal government has put in place a number of income tax measures designed to encourage business and industry to invest in and to use alternative and renewable energy sources. In addition, the federal government and many provincial governments have a number of funding programs in place to support the development of "green" energy.

The three main federal income tax measures offered to "green" energy projects include the special rate of capital cost allowance for Class 43.1 and 43.2 assets, the classification of certain expenditures as Canadian Renewable Conservation Expenses (CRCEs) and the use of flow-through shares. Natural Resources Canada has published and maintains a technical guide entitled "Class 43.1 Technical Guide and Technical Guide to Canadian Renewable and Conservation Expenses." The purpose of the guide is to describe the types of systems that qualify for Class 43.1 (and 43.2) treatment and those expenditures that qualify as CRCEs.

Examples of alternative and renewable energy systems include cogeneration and/or specified waste fuelled generation systems, active solar heating systems, heat recovery systems, wind energy conversion systems, systems to produce biogas and anaerobic digestion, and systems to covert biomass into bio-oil, to name a few.

Capital Cost Allowance Class 43.1 and Class 43.2

Class 43.1 provides for an accelerated write-off of capital cost allowance for certain capital expenditures on equipment that is designed to produce energy in a more efficient way or to produce energy from alternative renewable sources. Under Class 43.1, costs can be written off at a rate of 30% on a declining balance basis, subject to the "available for use," "half-year," and "specified energy property" rules. If it were not for Class 43.1, the costs of the qualifying systems would otherwise be written off at rates of 4%, 6%, 8% or 20%, depending on the property and equipment.

Class 43.2, introduced in 2005, provides for an accelerated rate of 50% on a declining basis for certain types of energy-saving property and equipment for renewable energy solutions acquired before 2020. For an asset to qualify under Class 43.2, it must meet all the requirements of Class 43.1 but is subject to higher efficiency standards.

Canadian Renewable and Conservation Expenses (CRCEs)

CRCEs are expenses paid to an arm’s length party in connection with the development of an energy project wherein at least 50% of the capital cost of the properties to be used in the project will be Class 43.1 or 43.2 properties. Examples of CRCE expenditures include the cost of temporary roads to the site, pre-feasibility studies, site approval costs, evaluation and feasibility studies, site preparation costs, and the costs of building service connections for the transmission of electricity or power. CRCEs can be deducted in the year incurred or carried forward indefinitely.

Flow-through Shares

CRCEs can be transferred to investors in flow-through shares. A principal business corporation can renounce any CRCEs that it incurs for the period that begins on the day the agreement was made and ends 24 months after the end of the month that includes the date of issue of the flow-through share(s). The amount that may be renounced to a shareholder is subject to a number of conditions, including the restriction that the amount renounced cannot exceed the consideration paid for the shares.

The flow-through share provisions contain a look-back rule that provides an additional tax advantage. Under the look-back rule, CRCEs incurred in the year after the flow-through share subscription agreement is concluded may be renounced to the shareholders effective in the first year so that all the CRCEs incurred in both first and second years can be deducted in the first year. Accordingly, an investor would be able to receive a deduction for the amount paid for the flow-through shares in the year of subscription even though the CRCE has not yet been incurred at the time of the issuance of the shares.

The flow-through share provisions allow principal business corporations to finance their operations adequately and to allocate certain expenditures to their shareholders for the purposes of assisting shareholders in sheltering their personal income from current taxation.

Funding

In addition to providing income tax incentives, the federal government has supported renewable energy through various funding programs. Most recently, the 2009 Federal Budget announced a $1-billion investment over five years for a Green Infrastructure Fund, through which funding will be allocated based on merit to support green-infrastructure projects on a cost-shared basis.

Provincial governments have also played an important role in advancing renewable energy in Canada. Like the federal government, multiple provincial governments have directly supported demonstration projects or have provided incentives for renewable energy technologies.

Investments in alternative and renewable energy sources provide a number of income tax advantages. Contact your Collins Barrow advisor to discuss the income tax incentives that may be available to your business.

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In the case of *Guilder News Co. (1963) Ltd. et al v. MNR*, the taxpayers included PPA clauses in their reorganization agreements to mitigate the risk of a valuation adjustment by the CRA (then called Revenue Canada). The CRA reassessed the shareholders on the transactions on the basis that the FMV of the assets sold was greater than the price stipulated in the agreement. The shareholder was assessed a benefit for the excess FMV over the price stipulated in the agreement, an assessment that would have resulted in double taxation of the excess FMV. The CRA did not recognize the PPA because the parties had not reasonably and in good faith attempted to transact at FMV. The court concluded that the PPA was a sham and that the shareholders never intended to transact at FMV and, therefore, the CRA was justified in not recognizing the PPA.

The shareholders in *Guilder* had made no reasonable attempt to determine the FMV of the shares transferred, but rather transacted using a price of convenience that met their reorganization objectives. Whether a valuation error is intentional or unintentional is irrelevant when you are audited by the CRA. Engaging a Chartered Business Valuator to provide an independent opinion of FMV establishes that the shareholders acted in good faith and arrived at FMV using a fair and reasonable method. An independent valuation protects the PPA clauses included in your tax planning, supports the tax plan you intended to implement, and avoids the penalizing implications that may come with a reassessment of value. Supporting the values inherent in your tax planning transactions protects your assets and keeps the plan running smoothly, even under the scrutiny of the CRA.

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Unexpected Income Tax Penalties

Many people file their income tax returns well before the April 30 deadline, only to receive yet another income slip (T3 or T5), or perhaps multiple income slips from an investment company, bank or insurance company. Inevitably, the temptation is either to ignore the additional slips or to add them to the next year's income tax return. The proper course of action, however, is to amend the appropriate income tax return and have the Canada Revenue Agency ("CRA") issue a Notice of Reassessment for that year's income tax return.

The CRA conducts a matching program, which takes place after the Notice of Assessment has been sent to you. Under this matching program, the CRA compares the information reported on your income tax return with third-party sources, such as employers and financial institutions. For example, the amount of income you report on your income tax return can be compared to the employment income shown on T4 slips that your employer has filed with the CRA, or to the investment income shown on T3 or T5 slips filed by financial institutions.

Once these unreported slips are matched to your income tax return, the CRA adjusts the income tax return to reflect the unreported income, and a Notice of Reassessment is issued. However, where you have also failed to report income in any of the three preceding years, the CRA assesses a penalty equal to 10% of the unreported income under subsection 163(1) of the federal *Income Tax Act*. The CRA also imposes a parallel penalty under the applicable provincial Income Tax Act equal to another 10% of the unreported amount, resulting in a total penalty of 20% of the unreported income.

Had you taken the proper course of action and amended your income tax return to report the additional income reported on the late slips received, you would, at worst, only be subject to interest on the resulting unpaid income tax, rather than incurring the 20% penalty on the unreported income, *plus* interest on the unpaid income tax. In order to avoid these penalties, the adjustment must be filed before the CRA completes the matching process and processes an adjustment to include the unreported income.

In our age of computerization, the CRA knows when you have these additional late slips. It is always less costly to correct what has been filed, rather than ignore the additional slips. Please consult your Collins Barrow advisor for assistance.

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Collins Barrow regularly publishes Tax Alert 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.