

Tax Alert

Tax-Free Savings Account Changes

On January 1, 2009, the very popular tax-free savings account (TFSA) became available to Canadians who are 18 years of age or older. The TFSA allows individuals to make non-deductible contributions of up to \$5,000 per year, and any income or capital gains realized in the account are not taxable and may be withdrawn from the account at any time without tax. Furthermore, if the account holder makes a withdrawal from the plan, he or she may return the funds to the TFSA in a subsequent taxation year to “top it up.”

In order to prevent abuses of the TFSA, the existing legislation contains provisions to penalize individuals who make contributions in excess of the \$5,000 annual limit. The penalty is levied on the amount of the overcontribution at the rate of 1% per month.

In addition, there are restrictions as to the type of investments that a TFSA can purchase. In general, these restrictions parallel the rules for registered retirement savings accounts, which limit investments to shares and debt of publicly traded corporations and mutual funds, as well as Guaranteed Investment Certificates and term deposits. The legislation also prohibits investments in entities in which the account holder has a significant interest (10% or more), or with which he or she does not deal at arm's length – generally referred to as “prohibited investments.” An individual who owns a TFSA that acquires a non-qualified or a “prohibited investment” is currently subject to a penalty of 50% of the fair market value of the property. This penalty is refundable if the investment is disposed of by the end of the year following the year in which the investment was acquired, except where the individual knew or ought to have known that the investment was ineligible. Furthermore, income and capital gains realized on “prohibited investments” are subject to a tax of 150% of the tax that would be payable by the TFSA were it not for its special tax-free status. This tax is payable by the individual. (The 50% mark up is a proxy for provincial tax payable, since the provinces do not have similar provisions.) Finally, a TFSA that earns income or capital gains from non-qualified investments (other than “prohibited investments”) is itself subject to tax on that income.

Notwithstanding these rather onerous penalties, some tax planners devised creative schemes to use TFSAs to generate income and capital gains that exceed the penalties. These schemes generally resulted in assets remaining in the TFSA in excess of the prescribed annual limits.

These assets then continued to earn income on a tax-free basis within the account, and could also be withdrawn later without tax.

As a result, on October 16, 2009, the Minister of Finance announced new provisions to restrict perceived abuses of TFSAs. Specifically, the following additional penalties will be charged:

1. Income and capital gains earned on overcontributions and on “prohibited investments” will be taxed in the individual's hands at the rate of 100% (i.e. the entire amount of the income).
2. The existing tax on income and capital gains from “prohibited investments” will be cancelled.
3. The tax payable by the TFSA on income and capital gains earned on non-qualified investments (other than “prohibited investments”) will be extended to include income on that income, and so on, thus restricting tax-sheltering of this ancillary income in the future.
4. Withdrawals of amounts in respect of overcontributions, prohibited investments, non-qualified investments, and income earned on those amounts will not constitute “distributions” for TFSA purposes and, as a result, will not create additional TFSA contribution room (i.e. they cannot be considered in the “top up” calculation).

Finally, it seems that some individuals engaged in “swap” transactions, whereby assets are purchased and sold between a TFSA and another account, such as a registered retirement savings plan (RRSP) or registered retirement income fund (RRIF). When structured properly, these “swaps” allowed transfers of value from the RRSP/RRIF to the TFSA without paying the tax that would otherwise be payable on an RRSP/RRIF withdrawal. The new provisions will impose a penalty of 100% of the TFSA amounts reasonably attributable to these types of asset transfer transactions.

The new provisions will be applicable to all transactions after the date of the announcement. Draft legislation has not yet been introduced. Contact your Collins Barrow advisor to find out more about how these new TFSA rules will affect you.

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New Measures to Curb Aggressive Tax Planning Schemes in Québec

In October, 2009, the Québec government adopted new measures aimed at aggressive tax planning schemes, which are defined as transactions that comply with the letter of the law but not the spirit. These new measures target transactions that reduce the effective tax rate on a particular source of income to a level below the rate sought by fiscal policy. The Québec government's position is that this type of planning undermines the fairness and integrity of the tax system and threatens the Québec tax base. The Minister hopes these measures will force taxpayers to think twice before undertaking such transactions. In effect, these measures bring the concept of self assessment to a whole new level, and in essence have transformed tax professionals into the Québec government's watchdogs.

In general, these new measures will apply to transactions carried out on or after October 15, 2009. However, they will not apply to a transaction that was part of a series of transactions that began prior to October 15, 2009 and was completed before January 1, 2010.

The following measures were adopted:

1. a mandatory early disclosure mechanism;
2. an amendment to Québec's general anti-avoidance rule (GAAR);
3. an extension of the normal limitation period for the application of GAAR; and
4. a new regime of penalties where GAAR is found to apply.

Mandatory disclosure is now required for all confidential transactions and transactions subject to conditional remuneration. Confidential transactions are those providing a tax benefit of at least \$25,000 or a reduction of income of at least \$100,000, and that are subject to a contract between the taxpayer and the advisor requiring the taxpayer to respect a confidentiality agreement with regard to third parties. Transactions subject to conditional remuneration are those in which the remuneration of the advisor is contingent upon the realization of the tax benefit.

All confidential transactions and transactions subject to conditional remuneration must be disclosed to Revenue Québec by the taxpayer who carried out the transaction no later than the due date of the taxpayer's first tax return for the year in which the transaction begins. The disclosure must be made on a prescribed form, which must be sent under separate cover, either by registered mail or electronically, to the "Direction principale de la lutte contre les planifications fiscales abusives." The information provided must consist of a detailed description of the facts as well as a statement of the tax consequences resulting from the transaction. It is worth noting that the disclosure will be considered complete if Revenue Québec does not contact the taxpayer and request

additional information within 120 days following the transmission of the form.

Failure to disclose a transaction that qualifies for mandatory disclosure by the due date for filing the taxpayer's return of income entails a minimum penalty of \$10,000 plus \$1,000 a day, to a maximum of \$100,000. In addition, failure to disclose will have the effect of suspending the period of limitation with respect to the transaction until the prescribed form is filed. Consequently, Revenue Québec would be able to reassess the taxpayer with respect to any tax consequences arising from the avoidance transaction at any time.

Prior to the enactment of these new measures, GAAR was only applicable to transactions that resulted in abuse or misuse of the Québec *Taxation Act*. The new measures will expand the definition of an avoidance transaction to make GAAR applicable to transactions the primary purpose of which is to obtain a tax benefit under the laws of Québec, federal laws, or the laws of any other province.

Additionally, the new measures will extend the normal period of limitation by three years in situations where GAAR applies to a transaction, thereby extending the reassessment period to six or seven years. This extension can be avoided by making either a mandatory or preventive disclosure.

The measures also provide for the introduction of a new penalty regime where GAAR is found to apply to a transaction. A taxpayer who has not properly disclosed a transaction to which GAAR applies will be subject to a penalty equal to 25% of the tax benefit derived from the abusive transaction. Moreover, the promoter of the transaction may be liable to a penalty equal to 12.5% of the consideration received from the transaction. The penalty can be avoided by filing a preventive disclosure of the transaction with Revenue Québec. The procedure for making a preventive disclosure is similar to the one described above for mandatory disclosures.

For now, these measures are unique to Québec. One cannot predict how successful they will be in deterring aggressive tax planning in the future. However, what is known is that the consequences for non compliance may be severe. Consequently, any entity with activity in Québec should be familiar with these rules. It remains to be seen whether the federal or any other provincial government will use the Québec experience as a model before enacting similar measures.

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Employee Taxable Benefits: Recent Policy Changes

We are approaching the time of year to prepare T4 slips and summarize non-cash benefits for employees. Below are some recent policy changes announced by the Canada Revenue Agency (CRA) with respect to the determination of employee taxable benefits. Changes are applicable to the calculation of 2009 benefits, except where otherwise noted.

Overtime meals

Meal allowances and reimbursements paid for employees working overtime will no longer be considered taxable benefits where the following conditions are met:

1. the value of the meal or allowance is reasonable (generally, not greater than \$17);
2. the employee works two or more hours (formerly three) of overtime either right before or right after his or her scheduled hours of work; and
3. the overtime is infrequent and occasional in nature.

The allowance will be considered taxable remuneration where the employee frequently works overtime or where working overtime becomes the norm. The CRA continues to define "infrequent" overtime as ordinarily less than three times per week, but will now accept overtime exceeding that rate on a temporary basis to meet occasional or seasonal workload demands.

Travel allowances

The CRA accepts that travel allowances for travel and meals within a "municipality or metropolitan area" can be excluded from the employee's income provided the allowances are paid primarily for the benefit of the employer (i.e. to allow the employee's duties to be carried out more efficiently) and are not indicative of an alternate form of pay.

Loyalty programs

Where employees collect loyalty points, (i.e. travel points such as Aeroplan) by incurring reimbursable business expenses on personal credit cards, a taxable benefit arises since those points can be exchanged for goods or services. But it can be difficult to assess the value of that benefit. How much is that flight from Vancouver to Halifax, with overnight connections through Kamloops and Winnipeg, really worth? The CRA formerly required employees to calculate and report the value of those points, but in addition to woeful levels of compliance from taxpayers, the CRA endured some setbacks attempting to enforce assessments in the Tax Court. For example, in *Giffen*, the Court refused to allow the CRA to calculate benefits for travel points at the full retail value of airline tickets, opting instead for a more reasonable discounted value that recognized the restrictions that typically apply to such tickets.

As a result of these difficulties, the CRA no longer requires a benefit to be recognized in the following circumstances:

1. the employer does not control the points accumulated;
2. the points are not converted to cash;
3. the plan or arrangement is not indicative of an additional form of salary; and
4. the plan is not established for tax avoidance purposes.

However, if the employer controls the points accumulated, then the employer is still required to report the fair market value of any benefits received by the employee on his or her T4 slip.

Company vehicles required to be taken home at night

Travel in a corporate-owned vehicle between home and work is normally considered personal use and results in a taxable benefit to the employee, generally calculated at \$0.52 per kilometre for the first 5,000 kilometres and \$0.46 for each additional kilometre. However, this rate can be reduced to \$0.24 per kilometre (the operating cost taxable benefit rate for 2009) where the following conditions are met:

1. The vehicle is not an "automobile" as defined in the *Income Tax Act* (the definition excludes emergency response vehicles, certain vans and pick-up trucks, etc).
2. The vehicle is provided on the condition that the employee may not use it for personal use outside of driving it to and from work.
3. The employer has *bona fide* business reasons for requiring the employee to take the vehicle home at night, such as security concerns for leaving the vehicle at a worksite, or to gain faster response time for an employee who is on-call for emergencies.
4. The vehicle is specifically designed or modified for the employer's business or trade and is essential to perform employment duties, beyond mere transport of the employee.

Note that the use of these vehicles is not considered personal, and therefore no benefit arises, if the employee proceeds directly to, or directly home from, a point of call (i.e. scene of emergency).

Non-cash gifts or awards

In the past, the CRA allowed employers to provide up to two non-cash gifts and awards totaling \$500 or less without taxation to the employee. Under the revised policy, effective in 2010, gifts aggregating more than \$500 will still be taxable, but the number of gifts making up this amount will no longer be restricted. In addition, the CRA now allows employers to provide a separate non-cash long service award (not exceeding \$500) to be given to an employee without assessing a taxable benefit. Performance-related awards (i.e. sales targets) and cash or near cash awards, such as gift certificates, will continue to be taxable benefits to the employee.

Employer-funded scholarship programs

The CRA recently lost several court cases in which it attempted to tax

employees whose children received employer-funded scholarships. In September, 2009, the CRA issued a technical interpretation advising that it has reconciled its assessing policy to these decisions. Where an arm's-length employer provides a post-secondary scholarship, bursary or free tuition to family members of an employee under a scholarship program, the amount will *not* constitute a taxable benefit to the employee. The employer is required to issue a T4A slip to the student, although generally such scholarships will be tax-exempt.

Benefits to shareholder employees

Where an employee is also a significant shareholder, benefits sometimes

accrue to that individual by virtue of his or her role as a shareholder rather than as an employee. In such cases, some of the relief provided under tax laws and CRA policy for employee benefits might not apply. Worse, the cost of providing shareholder benefits is generally not deductible by the corporation. Therefore, additional care is needed when designing benefits for owner/managers and other significant shareholders.

Contact your Collins Barrow advisor for more information on employee taxable benefits.

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Should You Incorporate Your Personal Service Activities?

In the past, individuals considering incorporating their personal services activities were given a warning that the corporation could be viewed as carrying on a personal services business, which would result in negative tax consequences. The income earned within the corporation would be taxed at the top corporate rate, deductions would be limited, and a higher overall tax rate would apply once the income was withdrawn by way of dividends from the corporation.

With corporate tax rates decreasing and lower personal tax rates applicable to eligible dividends, the strategy of incorporating personal services activities should be revisited.

What is a personal services business?

Subject to specific exceptions, the *Income Tax Act* describes a personal services business carried on by a corporation as a business of providing services where the incorporated employee, but for the existence of the corporation, would reasonably be regarded as an employee of the business to which the services are provided. Whether or not an individual would reasonably be regarded as an employee of the business to which the services are provided is a question of fact, and is based on such factors as the degree of control over the activities of the individual and the ownership of tools and equipment.

Tax consequences

There are two main tax consequences for corporations carrying on personal services businesses:

1. Personal services business is excluded from the definition of active business in the *Income Tax Act*. As such, income earned from carrying on a personal services business is not eligible for the small business deduction and is therefore taxed at the top corporate rate. Consequently, dividends paid by the corporation could be identified as eligible dividends, which are subject to an enhanced dividend tax credit.

2. The *Income Tax Act* limits deductible personal services business expenses to:
 - the salary, wages or other remuneration paid in the year to an incorporated employee of the corporation;
 - the cost to the corporation of any benefit or allowance provided to an incorporated employee in the year; and
 - any expenses incurred to negotiate contracts or collect amounts owing for services rendered.

Tax planning opportunities

Although a corporation carrying on a personal services business is not able to benefit from the small business deduction, there exists an opportunity to defer tax by retaining income in the corporation. That opportunity will increase further as corporate tax rates decrease over the next few years.

The actual amount of tax deferral depends upon the province in which the tax is paid. In Ontario and Alberta, for example, the 2010 deferral would be approximately 15% and 11% respectively.

Incorporating a personal services business may also provide income-splitting opportunities by providing a dividend stream through the ownership of shares by family members. It is important, however, to consider the various anti-avoidance provisions in the *Income Tax Act*.

Summary

As corporate tax rates continue to drop, the incorporation of your personal services activities should be considered in conjunction with your overall tax planning. Contact your Collins Barrow advisor to determine whether incorporating your personal services activities is appropriate for you.

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