

# TAXING TIMES



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## NOTICE TO READER

The following commentary has been prepared by Parker Garber & Chesney, LLP based on information available to the public on the date of publishing.

Readers are cautioned that this commentary is informational only and that any issues specific to the reader's needs be addressed with the appropriate tax professional.

The reader is cautioned that this document is not meant to provide advice specific to the reader's particular situation and that advice cannot be given in such a manner.

## **TAX CASES**

### **CHILD CARE EXPENSES**

In the recent case of *Jones v. The Queen*, the Canada Revenue Agency (CRA) disallowed the cost of after-school gymnastic classes for the taxpayer's daughter. The Tax Court of Canada ruled, in an Informal Procedure, that the taxpayer's claim met the requirement that the primary reason for enrolling the child was to provide after-school child care to accommodate the taxpayer's employment obligations. In spite of the long-held view by CRA that such activities are more educational than child-care the court has supported the position that the extent of activity involved in the child care arrangement should not determine the deductibility of the expense.

Although this was an Informal Procedure decision, it appears that CRA has not appealed the decision and this will expand the definition of costs for child care.

### **AUTOMOBILE EXPENSES**

In another Informal Procedure decision, *Podlesny v The Queen*, the taxpayer claimed expenses on two vehicles, both of which were used at various times during the years. CRA ruled that the taxpayer could only claim expenses and capital cost allowance for one vehicle. The Tax Court allowed the taxpayer's appeal on the basis that it was not unreasonable for the taxpayer to have two vehicles available at the same time and since the taxpayer had maintained detailed records substantiating his business use of both vehicles.

## **GENERAL ISSUES**

### **KEEPING RECORDS**

Taxpayers often enquire concerning the rules for keeping and destroying accounting records. The first consideration is to determine what qualifies as a "record". The CRA includes all accounting and other financial documents, in paper or electronic format in their definition. These would include ledgers, journals, vouchers, financial statements and all supporting source documents (invoices, receipts, contracts, deposit slips, cancelled cheques, cash register records, credit card receipts, purchase orders, work orders, delivery slips, emails and general correspondence).

CRA will accept electronically formatted records of original paper documents.

Corporations are also required to retain minutes of directors' and shareholders' meetings, share registers, general ledgers and all contracts and agreements related to general ledger entries.



Trusts are also required to retain wills, codicils, probate lists, trust agreements and deeds, letters of wishes, records of allocations and designations and transfers of income and capital.

CRA requires that all records must be maintained for a minimum of six years from the end of the last taxation year to which they relate.

## **US TAX ISSUES**

### **ESTATE TAX**

Non-resident aliens (for our purposes, Canadians with US-based assets) have potential exposure to US Estate tax. The residency rules for estate tax are not the same as for US income tax. Basically, a Canadian who is temporarily living in the US on a visa would be subject to US estate tax if they died in the US. This issue may even affect snowbirds that die while in the US.

Protecting your estate from potential US tax exposure may be achieved for vacation property located in the US, even with the elimination of the sole-purpose corporation. Canadians buying US vacation properties should consider setting up a non-US trust with cash and naming the spouse and issue (children and grandchildren) as beneficiaries. The trust would then purchase the property and this should protect the property from potential estate tax. Gains from the sale of the property could be allocated to the beneficiaries, possibly reducing the overall tax liability.

Canadians moving to the US, even on temporary assignment, should review their options before leaving Canada to ensure that they have reduced their exposure to both income and estate tax in the US.

Many Canadians with US investments have incorporated Canadian holding companies to avoid US estate tax. It is important that these structures be reviewed to ensure that US anti-avoidance rules have not been offended. The company should have a non-tax purpose. Often this can be dealt with by having other shareholders, likely family members, to give the structure more purpose. Also, IRC 2036 sets the stage for an IRS attack on structures designed solely for the purpose of avoiding estate tax.

### **NON-REPORTING PENALTIES**

The US has various reporting requirements for anyone who may be subject to US income or estate tax. This may include those who are exempt from such taxes but are still required to file information returns stating the eligibility for the exemption. The failure to file such returns may result in the exemption being disallowed and therefore increasing the tax exposure. Penalties for non-reporting for estate tax are 5% of the value of the estate + \$10,000 per month.



## **GIFTS**

In Canada gifts, other than those to minors, are not generally subject to income tax. The US does however have a gift tax regime that is connected to their estate tax. When a Canadian resident gifts to a US resident or citizen (i.e. anyone subject to US tax) the recipient must report such gifts on form 3520. This is an information form that does not trigger any tax liability but the failure to file is subject to penalties and interest.

## **CROSS-BORDER TAX ISSUES**

There are many Canadian citizen-residents that may inadvertently subject themselves to US tax liability resulting from either marriage to a US citizen resident in Canada or by virtue of pursuing US opportunities. The planning needed to reduce US tax exposure must be done carefully or the potential harm may be substantial. A number of planning strategies that may result in unexpected income and estate tax problems are:

- Asset protection planning where the assets are put in the name of a US taxpayer spouse, resulting in unintended estate tax exposure.
- The Canadian spouse leaving estate assets to the US spouse will result in US estate tax if the Canadian predeceases the US spouse. The Canadian spouse's will should leave a life interest to the US spouse rather than allow the assets to accumulate to the US spouse.
- Life insurance owned by a US citizen will result in an increase in their estate. Policies should be owned by non-US taxpayers or a trust (non-US) to avoid this problem.
- Gifts of US situs assets from one Canadian resident to another may attract US gift tax even though neither party is generally subject to US tax.
- Estate freezes that are a common Canadian planning tool can cause US gift tax exposure if a US citizen undertakes such an action. Careful planning is necessary to avoid this pitfall. Also, if a Canadian parent undertakes an estate freeze that benefits children that are either US citizens or residents can trigger substantial US tax consequences for the children
- US beneficiaries of Canadian trusts can suffer Canadian tax consequences as a result of the 21-year deemed realization rules if proper planning is not undertaken in anticipation of the distribution of the capital. This is of great concern as many children of Canadians decide to move to the US for education or work-related opportunities. Before these beneficiaries leave Canada, proper planning should be put in place.



- US taxpayers resident in Canada that own shares of Canadian corporation may subject the corporation to US reporting requirements.
- Personal ownership of a US corporation by a Canadian can expose the asset to US estate tax, US withholding taxes of 15% on dividends and full tax rates in Canada on the dividends. Interposing a Canadian holding company will avoid US estate tax, reduce withholding tax to 5%. In addition the dividend received by the Canadian holding company is exempt surplus and the dividend paid out to the individual would be taxed at dividend rates.
- Many US advisors suggest that Canadians moving to the US obtain green cards. For US tax purposes, a green card is deemed US citizenship for income tax purposes and subjects the holder to substantial additional tax exposure. In addition, some Canadians returning to Canada fail to surrender the green card. In spite of the fact that they are not citizens of the US and are no longer resident in the US, the green card deems them taxable, and their estate as well.
- Canadian corporations expanding their business operations into the US may become subject to US income tax and reporting requirements. If the filings are not completed on a timely basis the IRS may tax the gross income of the operation, without any benefit for deductions. In addition, each state has its own regime, some of which are simple and straight-forward and some that are not only complex but have very low requirements to establish taxability in the state.
- A Canadian corporation that may qualify as a small business corporation may lose that status if it expands its operations into the US through a subsidiary corporation. This could also trigger corporate attribution problems if the company had previously been involved in an estate freeze.
- Canadians doing business with US suppliers may be required to withhold tax on payments for licensing, royalties and consulting services under section 105 of the Income Tax Act.

Many other issues concerning inter-corporate dividends, sales of shares, passive US investments, real estate partnerships and the use of LLCs can have an impact on both sides of the border and these issues should be addressed before proceeding.

## **FIRM NEWS**

We moved to new premises in December and now have easier access from Hwy 404 and Hwy 407. The building has many visitor parking spaces and an elevator. Just look for The Capital Centre and National Bank signs. We located at the south-west corner of West Pearce and Leslie, the first light north of Highway 7.



We also want to welcome our latest additions to the PGC family. Ron Perryman C.A. joins us with a wealth of knowledge in auditing and computer implementation and Charity DiPaola has joined our administration staff.