

TAXTICS

February 2005

Making a Global Connection

inside

On January 20, 2005, Crawford, Smith & Swallow hosted an in-house tax seminar for twenty Chinese delegates from the Guangdong Local Taxation Bureau on behalf of PBB Global Logistics Inc., Corporate Travel. The seminar, presented by Chris Bodnar and Rob Steven, outlined the fundamentals of the Canadian taxation system, including tax policy and the audit and appeals process.

Crawford, Smith and Swallow was invited to present to the delegates as part of the group's 10-day visit to Canada to become acquainted with the Canadian tax system and understand the disparities that exist from the Chinese tax system as a means of promoting commerce between the two countries.

With a domestic market of 1.3-billion people, a growing economy and commitment to large

infrastructure spending, China presents increased opportunities and potential for North American traders.

PBB is a pioneer in providing hands-on sourcing assistance to businesses looking to access emerging markets. Their Access China program opens the door to a wide variety of business services specializing in the Chinese market, including market research, legal advice, insurance, financing and translation. The jewel in the crown of the Access China program is PBB's annual China: Trade Mission, which offers North American companies a unique opportunity to visit key commercial centers and participate in one-on-one meetings with carefully selected potential business partners.

Rob Steven, C.A., MAcc
Tax Associate, Crawford, Smith & Swallow, LLP

- *The Death and Rebirth of the "Reasonable Expectation of Profit" Test*
- *Estate planning with testamentary trusts*
- *Announcements*
 - *2004 UFE Grads*
 - *New Office Location*



Front Row: Rob Steven (left), Chris Bodnar & Mr. Deng Changxue, Vice Division Chief, Taxation Policy Division, Guangdong Local Taxation Bureau.

Back Row: Guo Leyun, Jiang Guohuang, Han Li, Chen Nengbo, Xie, Peng, Wu Guanglie, Wu Wensong, Shao Yubin, Wang Shuping, Zhang Shisheng, Hu Wei, Chen Fang, en Hui, Lu Xihao, Li Xiaobin, Chen Zhiqiang.

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CHARTERED ACCOUNTANTS LLP

Niagara Falls
4741 Queen St.
905-356-4200

St. Catharines
531 Lake St.
905-937-2100

Fort Erie
76 Jarvis St.
905-871-2610

Niagara-on-the-Lake
1567 Highway 55
905-468-7836

The Death and Rebirth of the “Reasonable Expectation of Profit” Test

Just when we thought the reasonable expectation of profit or REOP test was dead, it appears to have come back with a vengeance.

Simply put, the REOP test states that, for losses to be deductible, the business or income-producing property in question must have a reasonable expectation of profit. This test did not (until now) have statutory authority. Rather, it was an administrative test applied by the Canada Revenue Agency (“CRA”) and often, but not always, sanctioned by the courts.

In the past, the CRA has applied REOP to deny the deduction of losses generated by certain tax shelters and other tax-driven plans that it felt were abusive. In other cases, deductions would be denied where the venture had both personal and commercial elements. One example of the latter type is the highly leveraged Florida condominium property that is used in part to generate rental income and in part for personal use. Unfortunately, the test was applied in an indiscriminate manner and in circumstances where it was not warranted.

The courts struggled with the concept of REOP over the years and to say that the test was applied in an inconsistent manner would be charitable. Finally, however, in 2002 the Supreme Court was called upon to consider the REOP test and concluded that the test was not appropriate where the business venture contained little or no personal element. In addition, the Supreme Court refused to sanction the use of the test to second-guess the business judgement of a taxpayer.

Taxpayers and their advisors were relieved to be rid of the uncertainty caused by REOP – but not for long. The Department of Finance gave notice in its spring 2003 budget that it could not live with the Supreme Court decisions from a tax-policy perspective. On October 31, 2003, Finance released draft legislation designed to deal with this issue. In effect, Finance was proposing to legislate the REOP test to give it statutory authority and thus override the recent Supreme Court decisions. Although the stated objective of the draft proposals was to clarify the existing law, it is clear that the proposals represent much more than a simple clarification. It is equally clear that the proposals do anything but provide clarity; taxpayers will be saddled with an even greater deal of uncertainty than existed prior to the decisions of the Supreme Court.

Under these proposals, any loss realized in a particular year will not be deductible against other sources of income unless, in that year, it is reasonable to expect that the taxpayer will realize a cumulative profit from that business or property over the period in which the taxpayer has carried on, and can reasonably be expected to carry on, that business or has held, and can reasonably be expected to hold, that property. Although not yet legislated, these proposals are scheduled to apply to taxation years beginning after 2004.

The following are only a few of the points that should be noted:

1. The test must be applied each year during which the business is carried on or the income-producing property is held, not just at the beginning of the venture. Consider the example of an income-

producing property that, at the time of acquisition, was expected to generate a considerable amount of profit over its likely holding period (the determination of a likely holding period is an issue of its own). Losses are incurred in the first three years (as expected) and in year four, because of developments that were not expected at the time or purchase, it becomes obvious for the first time that the property will not generate cumulative profits. Although the losses in years one to three will be deductible, the losses for year four and subsequent years will not be deductible. This will be the result despite the fact that the venture was entered into purely for commercial reasons and on a financial basis that was sound at the outset.

2. What about the taxpayer who borrows money to invest in common shares? Capital gains will not be taken into account in determining expected holding period profits or losses and it therefore quite possible that low-dividend paying shares will generate holding period losses. Under these circumstances, it is clear that the proposed rules could be applied to deny the losses. The past administrative position of the CRA is that such interest would normally be deductible notwithstanding the likely losses. Finance has indicated that it does not expect any change in this administrative practice. If the policy choice is so perfectly clear, Finance should provide taxpayers with a specific exemption for common share investments.

3. The proposals contain no mechanism that would allow disallowed losses to be carried over and deducted against net profits earned in other years. While losses may be expected to exceed profits over the anticipated holding period, it could well be that profits might be realized in one or more of those years. As currently drafted, while the losses would be disallowed because of the cumulative losses expected during the holding period, the profits would be subject to tax. This is so patently unfair that it barely needs mentioning.

4. There is a complete lack of grandfathering provisions in the proposals. Taxpayers may have entered into business ventures relying on the law as it read at the time and may well have made significant long-term commitments. It would simply be wrong not to grandfather any ventures entered into, or to which the taxpayer was substantially committed, prior to October 31, 2003.

The professional tax community has suggested alternatives to these proposals, alternatives that would achieve the stated objectives of the proposals without all the collateral damage. We can only hope that these recommendations will cause Finance to rethink, if not abandon, the proposals. Given the history of these things, I do not think we should hold our collective breaths.

George F. Johnson, C.A.

Senior Tax Partner, Crawford, Smith & Swallow, LLP

Readers are urged to consult their professional advisors prior to acting on the basis of material in this newsletter. If you have any questions regarding the content of this newsletter, please contact Crawford, Smith & Swallow. Copies of the newsletter in PDF format are available on our website:

<http://www.crawfordsmithandswallow.com/taxtics-main.html>

Estate planning with testamentary trusts

Donald has decided that it is time to update his will. He has heard some talk about the benefits of testamentary trusts and visits Crawford, Smith & Swallow for advice.

We begin by having Donald explain to us his personal situation and ask him how he would like to see his estate divided amongst his family. We learn that Donald is married to Melania and that he has two adult children both of whom are active in his family business. He would like to ensure that the children ultimately inherit his shares of the business. Donald explains that he currently owns a real estate business worth \$5 million and has an investment portfolio worth \$5 million.

After presenting to Donald various alternatives, he asks for more details on testamentary trusts. We begin with the following introduction.

A trust is established when property is transferred to one or more persons who hold the property for the benefit of others. A testamentary trust is a trust provided for in a person's will and established on his or her death.

There are essentially two types of testamentary trusts: spousal and non-spousal. The distinction being that with a spousal trust: 1) the surviving spouse must be entitled to the income of the trust and none, some or all of the capital of the trust during his or her lifetime and 2) tax on accrued gains on assets transferred into a spousal trust can be deferred until such time as they are disposed of by the trust or on the death of the surviving spouse.

Donald indicates that he is very intrigued by the spousal trust given the \$5 million deferral on the accrued gain that would otherwise be taxed at the time of his death. He is leaning towards a non-spousal trust, however, because he wants to ensure that the shares are ultimately inherited by his children.

We explain to Donald that if he names his children as the ultimate capital beneficiaries of the spousal trust, they will receive the shares on the death of Melania. Donald is satisfied with that result, but wants to know more about the available tax savings.

We begin by indicating that the tax savings arise as a result of a testamentary trust being taxed on its income at graduated tax rates in the same manner as an individual. In contrast, his spouse (should she survive him) would pay tax at the highest marginal personal tax rate on any additional income when it is combined with her other sources of income. A testamentary trust also has no requirement to pay instalments of tax.

In order to reinforce the concept and quantify the amount of the annual tax savings for Donald we show him the following chart:

<u>Source of Income</u>	<u>No Trust</u>	<u>Trust</u>	<u>Annual Savings</u>
Interest of \$100,000	\$46,000	\$33,000	\$13,000
Dividends of \$100,000	\$31,000	\$18,000	\$13,000

Donald then asks whether many of the above benefits would still be available should his spouse predecease him and he sets up a non-spousal trust.

We explain that the annual tax savings in our chart would still be available but that the tax-deferred rollover would not be available at the time of his death. We recommend to Donald a number of options for eliminating the potential double taxation that might occur as a result of the deemed disposition of his shares on death.

The non-spousal trust will also be deemed to have disposed of its property at fair value every 21 years. This could only be avoided by transferring the trust property to the beneficiaries before this time.

We indicate that he could set up a separate trust for each of his two children in order to multiply the amount of the tax savings.

We advise Donald that he should take some time to make sure that he is comfortable with our suggestions and that he should contact us should he have any questions or should he want to proceed.

The above is only an excerpt from the meeting that was held, there were a number of more detailed tax and non-tax issues discussed that have not been covered in this article. For this reason, we recommend that both your accountant and lawyer be involved early on in the decision of whether to establish a testamentary trust.

The names and situation in this article are fictitious and have been used solely to illustrate the effectiveness of testamentary trusts. Any resemblance to a real estate mogul with his own TV show is purely coincidental.

Chris Bodnar, C.A.

Tax Partner, Crawford, Smith & Swallow, LLP

New Location!

The partners and associates of Crawford, Smith & Swallow are pleased to announce the opening of the firm's newest office in Niagara-on-the-Lake. The office will be managed by Robert A. Weier, CA, Partner. A lifelong resident in the Niagara area, Rob joined Crawford, Smith and Swallow in 1999. He graduated from Brock University with an Honours Bachelor of Accounting degree in 1994 and received the designation of Chartered Accountant also in 1994. Rob provides small to medium sized businesses with a wide range of accounting, auditing, and taxation services.



The office is located at:
1567 Highway 55
Niagara-on-the-Lake, Ontario
L0S 1T0

Phone: (905) 468-7836
Toll Free: 1-800-416-5612
Fax: (905) 468-7909
robw@stcath.crawfordss.com

Federal Budget 2005

Minister of Finance Ralph Goodale presented the first Budget of the current Liberal minority government on February 23, 2005 placing an emphasis on "...an unrelenting dedication to sound financial management—to balanced Budgets or better, year after year." Balanced or better Budgets are again forecast for 2004-05 and each of the five succeeding fiscal years.

The tax changes announced in the Budget are relatively minor and most of the benefit of these changes will not be felt for several years. Among the changes proposed are the following.

Corporate Tax Reductions

To foster investment and growth the Budget proposes two corporate tax reduction measures. The corporate surtax of 1.12%, which was introduced in 1987 as a measure to cut the deficit, would be eliminated effective as of 2008. The federal corporate tax rate would be reduced as follows:

<u>Rates</u>	<u>Up to</u> <u>\$300,000</u>	<u>Over</u> <u>\$300,000</u>
<u>Legislated</u>		
2008	13.12%	22.12%
<u>Proposed</u>		
2008	12.00%	20.50%
2009	12.00%	20.00%
2010	12.00%	19.00%

Capital Cost Allowance

The Budget proposes increases to depreciation rates (CCA) for hydrocarbon transmission pipelines and related pumping and compression equipment, combustion turbines generating electricity, electricity transmission and distribution equipment, and cables used for telecommunications infrastructure.

Retirement Savings Limits

To encourage Canadians to save more for retirement the yearly limits on retirement

savings are proposed to increase. The RRSP deduction limit would still be based on 18% of earned income for the prior year, but the limits for RRSP's would be increased as follows:

<u>Year</u>	<u>Existing</u>	<u>Proposed</u>
2005	16,500	16,500
2006	18,000	18,000
2007	Indexed	19,000
2008	Indexed	20,000
2009	Indexed	21,000
2010	Indexed	22,000
2011	Indexed	Indexed

Deposit insurance coverage on registered and non-registered accounts is proposed to increase to \$100,000.

Foreign Property Rules

Retirement plans are restricted to investing no more than 30% of their assets in foreign property. Foreign assets held in excess of those limits are subject to a penalty of 1% per month. The Budget proposes to repeal the foreign property rule effective as of 2005 to allow for broader international diversification.

Basic Personal Amounts

The amount of income that a Canadian can earn on a tax-free basis is proposed to increase from \$8,012 in 2004 to at least \$10,000 by 2009. The personal credit allowed in respect of a spouse with a low income or no income at all is proposed to increase to at least \$8,500 by 2009. The first of such increases is scheduled for 2006. The tax savings will be modest.

Expansion of the Disability Supports Deduction

Persons with disabilities may receive tax relief for the cost of disability supports (e.g. sign-language interpretation services, talking textbooks, etc.) incurred for the purposes of employment or education through the disability supports deduction. The effects of this deduction are that no income tax is

payable on income (including government assistance) used to pay for these expenses, and that this income is not used in determining the value of income-tested benefits. The 2005 Budget proposes to expand the list of expenses eligible for the disability supports deduction.

Medical Expense Tax Credit - Caregiver

The Budget 2004 enabled those who provide such care to claim up to \$5,000 of medical and disability-related expenses. The 2005 Budget will double that amount to \$10,000—starting in 2005.

Medical Expense Tax Credit – Eligible Expenses

The Budget proposes three additions to the list of expenses eligible for the METC, including costs relating to phototherapy equipment, oxygen concentrators, and medical marijuana.

Child Disability Benefit

The Budget proposes that the maximum CDB will be increased for the 2005–06 benefit year to \$2,000 from \$1,681.

Adoption Expense Tax Credit

The Budget proposes to introduce a 16-per-cent non-refundable credit for eligible (non-reimbursable) adoption expenses for the completed adoption of a child under the age of 18 years.

Refundable Medical Expense Supplement

The refundable medical expense supplement provides assistance for above-average medical and disability-related expenses to low-income working Canadians. The supplement is available to workers with earnings above a threshold that is indexed annually. For 2005, the threshold is \$2,857. The supplement is equal to 25 per cent of an individual's medical expense tax credit (METC) and disability supports deduction claims, up to a maximum of \$571. For 2005 and subsequent taxation

years, the maximum refundable medical expense supplement has been increased to \$750.

Deductibility of Interest and Other Expenses

In October 2003, the Department of Finance released for public consultation a package of legislative proposals regarding the deductibility, for income tax purposes, of interest and other expenses (*see the article on the "Reasonable Expectation of Profit" in the February 2005 issue of our TAXTICS newsletter*). The Department of Finance announced in the Budget that it intends to release a new proposal for comment. In addition, the Canada Revenue Agency is to release its comments addressing certain administrative questions relating to deductibility.

Taxation of Dividends

In the days leading up to the Budget, it had been widely speculated that the personal rate of income tax on dividends might be reduced to eliminate (or at least reduce) the disparity between the taxation of capital gains and dividends. Currently, capital gains realized by individual residents of Ontario are taxed at an effective maximum rate of 23.20%. Dividends received by the same individuals are taxed at a maximum rate of 31.34%. The Budget itself, however, contains no proposals to reduce the rate of tax on dividends and, in fact, does not address the issue at all.

Income Trusts

In the 2004 Budget, the Government expressed its concerns over the risk to tax revenues posed by business income trusts. No steps were taken at that time but the Government did announce its intention to engage in further consultation. A consultation paper is to be released shortly dealing with business income trusts and certain related issues.

ANNOUNCEMENT

The partners and staff of Crawford, Smith and Swallow Chartered Accountants LLP are pleased to announce that (bottom left to right) Mr. Jeremy Doan, Ms. Renee Reynolds, (top left to right) Ms. Rosa Rocca, Mr. Kun Kim and Mr. Michael O'Connor have successfully completed the Uniform Evaluation (UFE). The UFE is the uniform examination standard for entrance to the CA profession in Canada.

Mr. Doan graduated from the Brock University Honours Bachelor of Accounting Degree co-op program in 2004 and recently completed the Master of Accounting Degree program. Jeremy was one of eighteen Ontario UFE finalists to be recognized on the national honour roll. Jeremy provides accounting, auditing and taxation services from our Niagara Falls office.

Mr. Kim graduated from Brock University with a Bachelor of Accounting Degree in 2001. Kan provides accounting and auditing services from our Niagara Falls office.

Mr. O'Connor graduated from Sir Wilfred Laurier University with an Honours Bachelor of Business Administration Degree in 2001. Mike provides accounting, auditing and taxation services from our Niagara Falls office.

Ms. Reynolds graduated from the Brock University Honours Bachelor of Accounting Degree co-op program in 2003. Renee provides accounting, auditing and taxation services from our St. Catharines office.

Ms. Rocca graduated from the Brock University Honours Bachelor of Accounting Degree co-op program in 2003. Rosa provides accounting, auditing and taxation services from our Niagara Falls office.



**crawford
smith &
swallow**

Niagara Falls
4741 Queen St.
905-356-4200

St. Catharines
531 Lake St.
905-937-2100

Fort Erie
76 Jarvis St.
905-871-2810

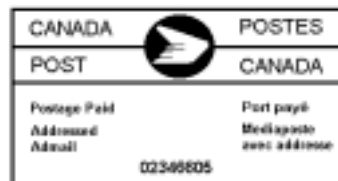
CHARTERED ACCOUNTANTS LLP

Crawford, Smith and Swallow
Chartered Accountants LLP

4741 Queen Street
Niagara Falls, Ontario
L2E 2M2
Telephone (905) 356-4200
Telecopier (905) 356-3410

**crawford
smith &
swallow**

Offices in:
Niagara Falls, Ontario
St. Catharines, Ontario
Fort Erie, Ontario
Niagara-on-the-Lake, Ontario



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