Collins Barrow
Chartered Accountants

TAX ALERT

Summer 2010 **Editor:** Robert W. Rock, CA, CFP I rrock@collinsbarrow.com I 613.768.7547

Tax Avoidance Transactions: New Federal Reporting Requirements

Ross Cammalleri, CA, is a Tax Partner in the Vaughan office of Collins Barrow.
Stephen Panno, CA, is a Tax Specialist in the Vaughan office of Collins Barrow.

In an attempt to follow the lead of other jurisdictions, including the United Kingdom, United States and the Province of Quebec, Canada's Minister of Finance announced new reporting requirements for certain tax avoidance transactions, as part of the March 4, 2010 Federal Budget.

While the proposed new reporting requirements released on May 7, 2010 for consultation may not be as stringent as those in the aforementioned jurisdictions, they will allow the Canada Revenue Agency (CRA) to identify aggressive tax planning in a timely manner. It is proposed that these measures would apply to avoidance transactions entered into after 2010, as well as those that are part of a series of transactions completed after 2010.

The CRA is expected to provide more guidance in the future with respect to the information to be reported on the prescribed form.

Reportable Transactions

In the context of the proposed reporting requirements, a reportable transaction is a tax "avoidance transaction" (as defined for the purposes of the General Anti-Avoidance Rule (GAAR)) that features two of the following three "hallmarks" that commonly exist when taxpayers enter into aggressive tax planning arrangements:

1. the promoter or tax advisor is paid a fee contingent on successfully obtaining a tax benefit;
2. the promoter or tax advisor requires confidential protection with respect to the transaction(s); and/or
3. contractual protection was provided to the taxpayer (i.e. indemnity or compensation in case of failure of the transaction(s)).

Filing Requirements

The taxpayer seeking the tax benefit must report the transaction on or before the taxpayer's filing due date for the taxation year in which the tax benefit arose (though the actual prescribed reporting form has yet to be developed). To the extent that a taxpayer fails to report the transaction, the tax benefit arising from the transaction will not be available until it is reported. Promoters and/or tax advisors who are entitled to fees, as described in the "hallmarks," are also required to file an information return in prescribed form. Parties who fail to disclose the required information could share joint and several liability for penalties, subject to specific liability caps and a due diligence defence. The CRA is expected to provide more guidance in the future with respect to the information to be reported on the prescribed form.

Taxpayer Uncertainty

The Department of Finance has indicated that a disclosure of a "reportable transaction" will not in any way be considered an admission that GAAR applies to the transaction(s). However, this is a controversial position since a reportable transaction must first be an "avoidance transaction" and that term is not used in the *Income Tax Act* other than as a defining transaction subject to GAAR. This would suggest

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that there is a greater likelihood that the underlying transaction(s) could be challenged under the existing GAAR provisions of the *Income Tax Act*. Accordingly, there is uncertainty as to how CRA auditors will use the disclosed information and whether their audit focus and risk assessments will change as a result of the proposed reporting requirements. Hopefully, after the Department of Finance completes its public consultations, the proposed legislation will be modified to address many of the concerns now being raised by tax practitioners.

In the meantime, please contact your Collins Barrow tax advisor for additional information and updates relating to the proposed reporting requirements for tax avoidance transactions. **§**

US Income Tax Exposure: **New "Permanent Establishment" Rules**

Julianne Favron, CA, CPA is a member of the Tax Group in the Ottawa office of Collins Barrow.

For a number of years, Canadian businesses have been able to limit their exposure to United States (US) federal income taxes based on the definition of a "permanent establishment" (PE) in the Canada-US Income Tax Treaty. However, with some recent amendments to the Treaty, a number of which came into effect January 1, 2010, that may no longer be the case.

What's New?

The Fifth Protocol, signed September 21, 2007, broadens the definition of a PE by adding two new tests for businesses that provide services in the US but do not otherwise have a PE by virtue of a fixed place of business located there. If a business meets either of the two tests, it will be deemed to provide those services through a PE in the US, thus subjecting the taxpayer to US federal income taxes.

The Tests

Under the first test, there are two requirements. First, services must be performed in the US by an individual physically present there for 183 days or more in any 12-month period. Second, during that 12-month period, more than 50% of the business' gross active business revenues must be income derived from the services performed in the US by that individual. This test determines whether a business has a PE by virtue of the *physical presence* of a single individual. As such, all days present in the US will count toward the 183 days, whether or not they are spent providing the services in question.

The second test provides that a business will have a PE in the US if services are provided there for an aggregate of 183 days or more in any 12-month period with respect to a project or connected projects for customers who are either residents of the US or who have a PE in the US. This test determines whether a business has a PE by virtue of the *services* it provides. As such, only days during which services are provided count toward the 183 days. If different employees are in the US working on the same project on different days, each of those days will be counted toward the 183 days. If they work the same day, it will only count as one day.

It is important to note that both tests are based on a rolling 12 months rather than a particular calendar year.

The Impact

Once the 183 days are met and a PE is considered to exist, a business will be taxed in the US on profits attributable to the activities carried on in performing the services that resulted in the creation of the PE. Businesses should also consider the impact of the above changes on their US tax-related filing deadlines as these differ from Canadian tax filing deadlines. The IRS does provide the opportunity to file extension requests.

In addition, employment income earned by the business' employees working in the US will be subject to US income tax if the employment income related to the PE exceeds $10,000. This will cause administrative issues involving US payroll taxes and US tax filings by the employee working in the US.

As a result of these changes, documentation of the number of days employees spend in the US will become crucial in order to determine whether these new rules will result in increased US income tax exposure.

Employers should consider recording their employees' activities in the US effective January 1, 2010 to support any tax filings.

Going Forward

This article provides only a brief summary of the changes made to the definition of a PE and the implications that go along with it. If your business provides services in the US, please consult your Collins Barrow advisor to ensure your tax filings are complete and accurate. **§**

Special EI Benefits **for the Self-Employed**

Doug Greenhow, CA, CFP is a Tax Partner in the London office of Collins Barrow.

Small business owners, professionals and other self-employed individuals recently were given optional access to the same special Employment Insurance (EI) benefits available to salaried employees. According to a Government of Canada news release, the *Fairness for the Self-Employed Act* was introduced to recognize "the challenges facing self-employed Canadians as they deal with the dual pressure of being entrepreneurs and caring for their families." However, there is a cost to these new benefits, as well as several other drawbacks. Consequently, it is anticipated only a small percentage of self-employed workers will opt into the program.

EI Benefits Available:

- **Maternity Benefit** – up to 15 weeks of benefits to birth mothers.
- **Parental/Adoptive Benefits** – up to 35 weeks to biological or adoptive parents while they are caring for their newborn or newly adopted child.
- **Sickness Benefit** – up to 15 weeks if unable to work due to illness or injury.
- **Compassionate Care Benefits** – up to 6 weeks if absent from work temporarily to provide care for a loved one who is gravely ill.

The weekly benefit amount is 55% of average weekly self-employed earnings from the calendar year before the year a claim is submitted. The maximum weekly benefit is $457 and there is a two-week waiting period before benefits are paid.

Costs and Drawbacks

- The program does not cover unemployment from lack of work – the main benefit of the regular EI program for salaried employees. The potential for abuse to the program was deemed too great to provide this type of support.
- Self-employed individuals who opt into the program pay the same EI rates as salaried employees, currently 1.73% of net self-employed earnings to an annual indexed maximum

(currently $747). However, unlike Canada Pension Plan premiums on self-employed income, participants do not have to pay an "employer" portion as well.

- Participants must have been enrolled in the program at least one year before claiming any benefits, and must have earned a minimum of $6,000 in self-employed income in the preceding calendar year.
- Once enrolled, participants may only withdraw if they have never made a claim. Any claim will require the participant to continue paying EI premiums on self-employed income for the rest of the participant's career. In the long run, therefore, these premiums could easily exceed the amount of benefits obtained from the program.
- Any business income generated while benefits are being paid can reduce the EI benefit amount. For many business owners, it is difficult to stop working altogether, and this could impair the entitlement to benefits.

We recommend you weigh the advantages and disadvantages carefully before opting into this program. Please contact your Collins Barrow tax advisor to help you make an informed decision. **§**

Collins Barrow publishes a quarterly 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.

www.collinsbarrow.com
info@collinsbarrow.com

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