DFK An Independent Member Firm of DFK Canada Inc. and DFK International

Newsletter

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Determining Province of Residence for Tax Purposes

Beth Porter, CA, CFP, Partner, Noseworthy Chapman Chartered Accountants

While the Canada Revenue Agency (CRA) regularly reviews residency with respect to individuals being residents or non-residents of Canada, they also conduct reviews with respect to provincial residency where it is not clearly determinable. Under the tax laws of Canada, generally speaking, an individual pays tax based on where they resided on December 31st of the year. There are some exceptions to this, the most common being business income.

Where an individual has residences in more than one province, there is the debate as to which province the person resides in for taxation purposes. For example, a person may live with their family in one province and have a second residence in another province in which they work or are attending school for an extended period of time. Typically, the temptation arises to make the argument that, for tax purposes, a person is resident in the province having lower tax rates. However, no different than when determining in which country a person truly resides, a person's province of residency is also determined by looking at certain criteria:

1. Firstly, a person is considered to be resident in the province where they have the most significant residential ties, for example where they have a permanent home available to them or where their spouse and children reside.
2. Secondly, where residency cannot be determined based on the first test, there are a number of secondary ties that must be considered collectively, such as:
   - location of personal property (clothing, furniture, automobiles);
   - social ties, such as memberships in religious and recreational organizations;
   - economic ties, such as bank accounts, investments, etc.;
   - provincial medical insurance coverage;
   - provincial driver's license and motor vehicle registration;
   - location of seasonal dwellings; and
   - memberships in professional organizations.

It is important to consider the above criteria if a person potentially could be considered a resident in more than one province. Where an individual has filed incorrectly, the CRA will reassess, along with penalties and interest if applicable in the circumstances.

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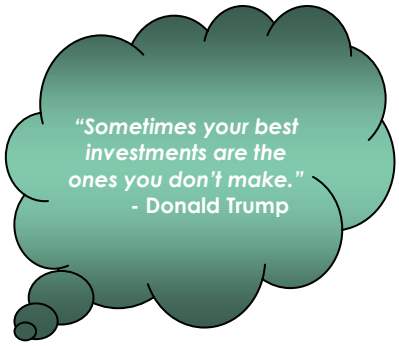


Special points of interest:

- *Harmonized Sales Tax (HST) comes into effect in Ontario and BC July 1, 2010*
- *Proposed technical changes to Tax-Free Savings Account*
- *Changes to mortgage requirements*
- *Personal tax instalments:*
  - *June 15, 2010*
  - *September 15, 2010*
  - *December 15, 2010*

Are You Ready? GST/HST Rules and Filing Requirements

Mark Servello, CGA, Tax Manager, Kenway Mack Slusarchuk Stewart LLP, Chartered Accountants

Harmonized Sales Tax (HST) in British Columbia and Ontario

Implementation of the proposed changes to the GST/HST rules and filing requirements is coming soon. In some cases, the proposed changes are already applicable.

Effective July 1, 2010, HST will apply in British Columbia (BC) and Ontario. BC will have an HST rate of 12% and Ontario's HST rate will be 13%.

It should be noted that transitional rules are applicable to most transactions that straddle the July 1, 2010, implementation date. In most cases where transactions straddle July 1, 2010, HST will apply to any amount that becomes due, or is paid without having become due, on or after May 1, 2010.

New Electronic Filing Requirements

For GST/HST reporting periods that end on or after July 1, 2010, the following registrants will be required to file their GST/HST returns electronically:

- All registrants with greater than $1,500,000 in annual taxable supplies (except for charities). The $1,500,000 annual threshold includes the annual taxable supplies of all associated persons.
- Registrants that are required to recapture input tax credits for the provincial portion of the HST on certain taxable supplies acquired in BC or Ontario.
- Builders that are affected by the transitional housing measures announced by BC or Ontario.

The Canada Revenue Agency has four electronic filing options available:

- GST/HST Netfile
- GST/HST Telefile
- Electronic Data Interchange (EDI)
- GST/HST Internet File Transfer (GIFT)

The electronic filing options available to a particular registrant will depend on that registrant's reporting circumstances. Penalties will apply, if a GST/HST return is not filed in the correct format.

Place of Supply Rules

Earlier this year, changes were announced to the place of supply rules for determining whether a supply is made in a particular province. There were no changes made to the rules for supplies of tangible personal property or supplies of real property; however, significant changes were made to the rules for supplies of intangible personal property and most services.

In the past, the HST place of supply rules for property and services generally relied on the location of the supplier to determine whether a sale was subject to the provincial component of the HST. These rules have been changed for supplies of intangible personal property and most services. In most cases, the supplier's location would not be relevant, since the reliance has now been placed on the location of the consumer of the intangible personal property or service.

These changes apply to all supplies made on or after May 1, 2010, and also apply to any supply made after February 25, 2010, and before May 1, 2010, if the consideration for the supply did not become due and was not paid before May 1, 2010.

Changes in the place of supply rules and the implementation of HST could result in planning opportunities. Now would be a good time to contact your accountant to discuss ways they can assist you during this implementation period.

HST will apply in BC and Ontario on July 1, 2010.

Corporate-Owned Life Insurance and the Capital Dividend Account

Terry Soloman, CA, TEP, Partner Tax Services, MRSB Chartered Accountants and
Paul Morton, CA, CFP, TEP, Partner Tax & Advisory Services, Ginsberg Gluzman Fage & Levitz, LLP

It is very common for owner/managers to have life insurance policies issued to cover various cash needs that would arise in the event of an untimely death. These cash needs may include repayment of business loans and payables, providing cash flow for the business during the difficult time following death, shareholder commitments in buy/sell agreements which are triggered on death, or providing a nest egg for family left behind.

The type of insurance used may be term or permanent coverage. Many permanent policies also allow a significant cash build-up by "overfunding" the policy (i.e., paying more than the required insurance premiums). The growth of the investment pool can then occur on a tax-free basis.

In most cases, the policy owner is a corporation because it is more tax-efficient to use corporate dollars to fund the premiums. In the past, it was possible to separate the policy ownership from the beneficiary (e.g., operating and holding companies, respectively). However, recently, the CRA has stated that the policy owner and the beneficiary must be the same corporation or a shareholder benefit will be assessed. This would apply in the case where a subsidiary corporation owns a policy with a parent company named as the beneficiary. It is not clear if the ownership was reversed because the subsidiary corporation is not a shareholder but other issues can arise when the parent corporation is the owner of a policy with cash value.

The death benefit in excess of the adjusted cost basis of the policy will increase the "capital dividend account" (CDA) of the beneficiary corporation. The CDA can then be paid out tax-free to the surviving shareholders. CRA also noted that the GAAR could apply if the insurance was structured to increase the capital dividend account.

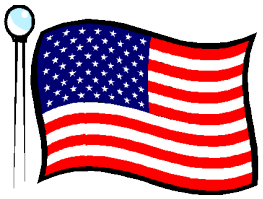
CRA has stated this new assessing position is effective January 1, 2010 for new policies issued after that time. For existing policies, the ownership structure must be amended by January 1, 2011. You should ensure that any existing policies are reviewed with your accountant and your insurance broker. Any applicable shareholder agreements should also be reviewed to ensure that changes to the insurance structure are possible under the agreement.

An unintended loss of an addition to the capital dividend account can occur when a corporation has a life insurance policy pledged as collateral for a loan. CRA's long standing position is that where a corporation is the policyholder and the insured dies, the amount that the corporation can add to its capital dividend account depends on whether the company or the creditor is the beneficiary under the insurance policy. If the corporation remains the beneficiary under the policy, the proceeds less the adjusted cost basis of the policy would be added to the corporation's capital dividend account notwithstanding that the proceeds are paid to the creditor. In the past, where the creditor received the life insurance proceeds directly because there had been an absolute assignment of the policy, there was no addition to the capital dividend account. A recent court case overturned the CRA's assessing practice, and allowed a full addition to the capital dividend account even though part of the proceeds was paid directly to a bank.

Despite the recent victory, extreme care should still be taken as CRA has not yet accepted the result of this Court decision. Future insurance should still be structured, where possible, to ensure that the policy beneficiary is the debtor corporation and not the financial institution. A good practice would be to have the insurance provided by a separate carrier and simply pledged as security for the loan. This will ensure that all proceeds will be paid to the company and leave little for the CRA to challenge.

The Tax-Free Savings Account – What if You Are a US Citizen?

Warren Smith, CA, TEP, Principal, Segal LLP Chartered Accountants



The Tax-Free Savings Account (TFSA) was implemented on January 1, 2009, and is a great vehicle in which to earn tax-free investment income.

We have many clients that are US Citizens and their tax filings are always a bit more complicated because of the need to file a US tax return each year. If you are a US citizen residing in Canada, you likely are not surprised that the IRS is still going to tax you on the investment income earned inside the TFSA.

If you have other Canadian-source investment income, it is unlikely the investment income from the TFSA will create a tax liability in the US in the short term. This is because the maximum contribution to the TFSA for 2010 is $5,000, so the investment income earned will likely not be material unless you have realized a significant capital gain. Furthermore, the tax paid on other investment income in Canada will likely provide sufficient foreign tax credits to offset any US tax liability. In later years, when the balance inside your TFSA has increased, you may need to pay closer attention to this matter.

We do not expect the financial institutions to issue a T5 or other income slip showing the investment income earned in the TFSA, so you need to remember to review your account statements and provide this information to your accountant. Failure to report income from your TFSA on your US tax return may result in penalties.