

Newsletter

Summer 2005

THE CRA'S CHANGING APPROACH TO VERIFICATION

Author: Bruce Johnston, CA, CFP, TEP

The Canada Revenue Agency (CRA) recently changed its approach to using special purpose audits where each audit has a focus, i.e. payroll, GST, etc.



A typical approach includes:

- a phone call 30-60 days before starting the audit.
- a detailed questionnaire and list to be completed by the start date.
- a review of the issues.
- a proposed assessment, followed by an assessment notice in 30 days.

Common assessments include disallowance of:

- Car allowances without a supporting automobile log, resulting in taxable benefits to employees, and GST on allowances.
- All golf, personal meals and entertainment, and personal benefit for events without a documented guest list.
- Bonus payments within 183 days do not include monthly payments considered normal salary.
- Convention costs for spouses, resulting in a taxable benefit to shareholder.
- Bad debt reserves/write offs where no written settlement agreement exists/no pursuit of collection occurred.
- Deductions where proper source documents/receipts do not exist with proper GST numbers, etc. (a cancelled cheque/credit card receipt is not acceptable).
- Rental losses where **any** personal use is involved.

The CRA's approach in issuing assessment notices is

rather aggressive. They prepare to assess immediately and make the taxpayer support their claim properly. No argument of reasonableness or extra time required is acceptable. The CRA's assessments are based on **their** interpretation of the law and less on historical assessments.

Local newspaper reports and discussions with auditors indicate the change in practice was brought about by:

- The lack of a wage contract.
- The fact that the CRA evaluates its people based on the amount of the increase in initial assessments generated. The fact that the increase reduces future years' income, or that they are overturned by appeal, has no impact on the evaluation criteria.

So, get ready to file your Notices of Objection (form T400A)!

Recent changes are the result of an aggressive hiring policy and a change to the use of special purpose audits.

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"Never mistake knowledge for wisdom. One helps you make a living; the other helps you make a life."
— Sandra Carey

Special points of interest:

- **Next personal tax instalments:**
- Sept. 15, 2005
- Dec. 15, 2005
- **GGFL adds search feature to web site (www.ggfl.ca)!**
- **We're growing and looking to recruit the best accountants at every level (see P4).**



UNITED STATES' RIGHT TO TAX NORTH OF THE BORDER

Author: Hugh Faloon, CA, CFP, TEP



Protect yourself against a “downpour” of taxes on employment income earned in the US or on real estate owned in the US!



Business owners involved in cross-border transactions beware! There are thousands of tax jurisdictions in the US.

Do you occasionally work in the United States (US), or own real estate in the US? If so, you may be subject to tax in the US, and possibly in more than one State.

If you are subject to tax in the US, Canada’s tax system allows you to reduce your Canadian taxes by claiming a foreign tax credit for the tax that is legally payable to the other country. In most cases, the total tax paid to both countries on the foreign income should not exceed the highest taxes payable to one of the countries. The foreign tax reduces the federal taxes payable, then the provincial taxes.

It is important to review the Canada/US Tax Treaty to determine which country has the right to tax the income. In many cases, the Tax Treaty also reduces the amount of tax the US can charge Canadian residents, and vice versa.

You can’t always rely on the Treaty when determining if you are taxable in a State of the US. For example, California and New Jersey do not recognize the Treaty.

If you work in the US, you should track your duty days (number of days you are physically in the US) in the US and the particular State. The Treaty exempts the first US \$10,000 of income earned in the US; therefore, if you earned US \$120,000 a year, and worked in the US just over 30 days, you could be subject to US tax.

If you own a rental property in the US, you must file a US tax return to report the rental income or loss. This return is necessary to claim the foreign tax credit in Canada. Also, any losses can reduce the future capital gain when the property is sold.

When you sell a US property, the IRS requires 10% of the proceeds to be deducted as a deposit on the potential taxes payable on the gain. The State may also require withholding tax. You have to file a US tax return to calculate the appropriate taxes owing and, hopefully, get your refund. The US tax return will be used to claim the foreign tax credit in Canada.

If you are a business owner involved in cross-border transactions, there are several issues that must be explored. There are 50 states in the US; therefore, one would think you may be subject to tax in 50 jurisdictions. Not so! In the US, cities, counties, etc., have the right to charge sales and income taxes. There are thousands of tax jurisdictions in the US. More details on this will appear in a future newsletter.

What to do? File your US tax returns on time, and do not forget to use them to reduce your Canadian tax liability.

It is important to review the Canada//US Tax Treaty to determine which country has the right to tax the income.

THE BONUS ROUND:

Maximize 2005 Small Business Corporate Tax Savings in Ontario ("Bonusing down" to \$400,000 vs. \$300,000)

Author: Paul Morton, CA, CFP, TEP

A common practice for corporate taxpayers to minimize their income taxes on business income has been to pay a bonus to the business owner, equal to the corporate taxable income in excess of the federal small business tax rate threshold (currently \$300,000). However, the "eventual personal tax payable on dividend" (see table below) may be deferred until a dividend is paid to an individual shareholder.

Subsequently, income retained in the corporation can be reinvested. Therefore, it may be worthwhile to leave more income in the corporation — if the benefit exceeds the additional future tax cost.

In particular, this article considers the costs and benefits of "bonusing down" to Ontario's current small business corporate tax rate threshold of \$400,000.

"Bonusing Down" to \$400,000

If most of the corporate income is required for immediate personal use by the owner(s), they would be better off if the corporate taxable income were reduced to \$300,000 (or less) in 2005. If the income is not required immediately, the table below shows that the total tax cost is only slightly higher on corporate income between \$300,000 and \$400,000, (50.31% versus 46.41%), while the immediate 2005 tax cost is much lower (27.62% versus 46.41%).

The income could be retained at the corporate level for any of the following reasons:

- To defer the personal tax on the future dividend by investing money at the corporate level.
- To pay dividends to other shareholders of the corporation, such as other family members or a family trust.
- To use the money to pay off corporate debt.
- To provide more equity for the company to meet bank covenants.

Other Matters

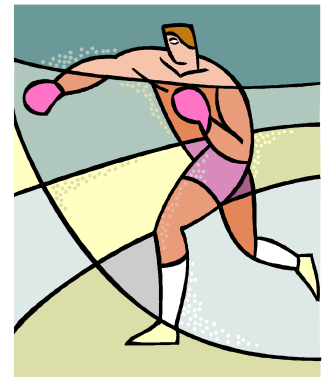
Many factors need to be considered when determining whether to "bonus down," including:

- The use of family trusts.
- The balance due date for income taxes.
- Scientific Research & Experimental Development ("SR&ED") claims.
- The effect of excess cash on the \$500,000 capital gains exemption.
- Payroll taxes.
- RRSP contribution limits.

For a more detailed version of this article, refer to our web site publication: "The Bonus Round: Maximize 2005 Small Business Corporate Tax Savings ("Bonusing down" to \$400,000 vs. \$300,000)."

	Corporate Taxes Payable in 2005	Eventual Personal Tax Payable on Dividend	Total Tax	Personal Tax Rate on Bonus in 2005
\$1 - \$300,000	18.62%	25.51%	44.13%	46.41%
\$300,001 - \$400,000	27.62%	22.69%	50.31%	46.41%
\$400,000 - \$1,128,520	40.79%	18.56%	59.35%	46.41%
Over \$1,128,520	36.12%	20.02%	56.14%	46.41%

This article considers the costs and benefits of "bonusing down" to Ontario's current small business corporate tax rate threshold of \$400,000.



"Bonusing down" to make the most of corporate profits in 2005.



TAX PLANNING FOR SECOND RESIDENCE

Author: Hugh Faloon, CA, CFP, TEP

If you own a cottage or a ski chalet, you should start planning for the future sale or transfer of the property to your children. Depending on location, the value could be increasing more than your primary home.

Prior to 1982, married couples could own two tax-free principal residences, provided that the husband owned one property and the wife owned the other. Our current tax system allows a tax-free gain only when you sell your “principal residence,” meaning married, common-law, and same-sex couples can only allocate the principal residence election to **one** residence per year (<http://www.cra-arc.gc.ca/E/pub/tp/it120r6/it120r6-01-e.html>).

The CRA’s Interpretation Bulletin IT-120R6 explains how the calculation works. In simple terms, you calculate the gain for both properties and divide the gain by the number of years you owned the property to determine which

property has the largest average gain per year. From this calculation, you can determine how many years you will allocate as the “tax free” years to the property sold. The calculation also includes a bonus year for each property; therefore, if you owned the cottage for ten years, you would only have to allocate nine years to get ten years tax free. Make sure to retain a copy of the principal election form (T2091) for your home or cottage.

Although you may not be planning on selling your residences for years, most likely you have been making improvements to both. I’m betting you haven’t kept receipts to prove the cost of the cottage furniture, dock, or improvements! The CRA may request proof of the cost of the property; so, if you don’t have the receipt for your \$15,000 dock, the CRA could disallow it. We recommend keeping separate files for each residence to keep your receipts for all improvements. It is important to keep receipts for



Keep receipts to prove the cost of the furniture, dock, or improvements. CRA may request proof!

furniture, appliances, boats, etc., for your cottage or chalet, since these items are usually sold with the property. Keep in mind, \$1,000 of missing receipts could cost you \$250 in taxes!

Finally, if you used the 1994 capital gains election to increase the value of one of your residences, please keep a copy of the election form. You will need it when the property is sold.

Annual Westboro Community Festival Huge Success! GGFL—Sponsor and Participant in WESTfest Festival



Come grow with us!

GGFL is growing nicely and is continually *seeking* enthusiastic, career-minded *accountants, at all levels*, to join our firm.

Please visit our web site – www.ggfl.ca – to see if GGFL would be the “perfect fit” for you. If so, please *submit your resume* to employment@ggfl.ca.

GGF&L
Chartered Accountants

Accounting For Your Future™

287 Richmond Road
Ottawa, ON K1Z 6X4

Phone: 613-728-5831; Fax: 613-728-8085
www.ggfl.ca