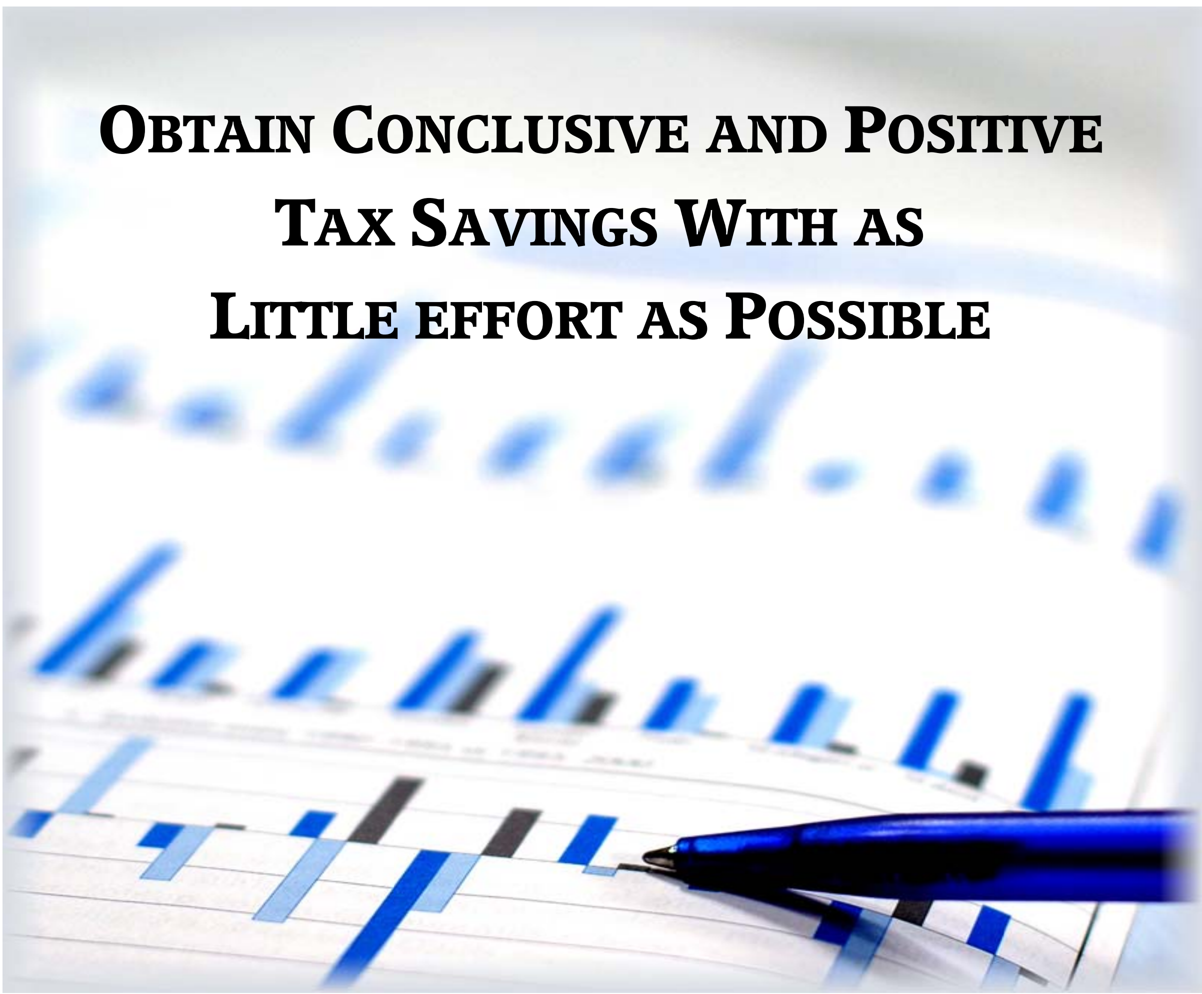
TaxWatch Canada LLP

The Authoritative Guide to Implementing a

Tax Consequences Review©



INCLUDES:
- ACTIVITIES THAT SHOULD TRIGGER A TAX REVIEW
- WHAT COMPLIANCE REALLY MEANS AND WHY THAT IS SO CRUCIAL
- WHERE TO LOOK FOR THE MOST VALUE
- AND MUCH MORE

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Introduction

To reach your most favourable tax position is not always easy. But make no mistake; a habit of reviewing tax consequences will save a lot of money and heartache over the years. This guide gives you what you need to walk down that road. Please be demanding and inquisitive when following the content of this guide. That is what the process of saving taxes should involve - to really hit your tax burden where it hurts. You will view the tax environment and act differently when you have digested what TaxWatch has to say.

What is this Tax Consequences Review useful for?
To assist businesses and professionals to achieve higher after-tax income and cash flow. Reducing taxes has profound positive implications for any business and lifestyle.

What is the risk and tax cost?
The risk works both ways. If you do nothing to save taxes you risk losing the opportunities that may be available. If you do act and choose between alternatives, CRA may not agree (partially or completely) with your chosen filing position. The tax cost would probably be more tax than you have hoped but still less than if you had not been proactive.

Part A: Perspective

Almost every business transaction that occurs that is not strictly of a personal nature has tax consequences. Income tax, GST/HST, sales taxes, hidden or transparent taxes, numerous municipal taxes and the hot new frontiers (last straw?) - user fees and punitive penalties for assumed noncompliance, create an astounding tax burden. Then there are the complexities and costs of compliance which staggers even the most ambitious efforts. However, resistance is not futile. It is quite successful.

Thankfully, our systems of compliance (see Part E) remain mostly self-assessing. The best way to minimize the cost and burden of compliance is to become as aggressive (not more) as the government is. It does not end well for the taxpayer who ignores or underestimates the resolve of tax authorities to procure funds for their treasuries. Neither the tax authorities nor their tax laws are as intimidating as they seem; it is worse than it seems.

All we can say is that there remain many opportunities and alternatives to save tax. Just as in the medical field or any other specialty, there are the best treatments that apply to each situation at the moment in time.

Part B: Some Fundamentals of Tax Consequences

This may appear to be all somewhat theoretical. However, for something as common as acquiring a commercial property or vehicle, just the simple choices about who the owner(s) will be, how the financing will be arranged, and what the personal and business uses of the asset will be all have tax consequences for the actual acquisition, preservation and eventual disposal of the asset. These acquisitions impose GST/HST, transfer taxes, property taxes, sales taxes, special levies, and sometimes professional fees right from the get go. How you treat transactions provides precedents for future tax treatments as well. The complexity and scope of the tax system must be penetrated to your advantage. There are many possible outcomes.

The Canadian tax system is a self-assessing tax system because tax departments are not privy to details of the transaction unless the taxpayer educates them according. Only the taxpayer is in the position to know the facts and is therefore obligated not only to comply (a moving target to be sure) but to convince tax authorities that they have complied. For any disputed tax treatments (penalties for gross negligence excepted) each taxpayer is literally assumed to be guilty until they prove themselves innocent unless they have a prima facie case and go to court. That is the tax law and that is how it is administered.

Part C: Sample of Common Activities That Trigger Tax Consequences

Here are some tax events to consider.

- ✓ Incomes or losses (how calculated, allocated to whom, when declared).
- ✓ Changing ownership (businesses, assets, investments) by sale, transfer,

seizure.

- ✓ Acquisitions and initial ownership that involve choices of who the owners could be and how the ownership is structured (corporate, individual, joint or tenant in common, co-ownership or tenancy, partnership, trusts of all types, etc.)
- ✓ Changes to physical location of assets, residency, and possession of asset.
- ✓ Choosing special options available in law (elections, compliance procedures, disclosures).
- ✓ Special situations with special tax treatments (e.g. small business provisions, non arm's-length valuation issues, price allocations and on and on and on…). Jump while you still can!

Some Elements That Could Change the Tax Amounts:

- ✓ Characterization of transaction (income, capital, previous history).
- ✓ Who pays and receives the funds and why.
- ✓ Timing (closings, possession, changed ownership, receipts and payments).
- ✓ Treatment of the other parties involved and therefore influencing how these other parties want the tax outcomes to be.
- ✓ Time constraints (standard filing and special election requirements, restraints imposed by law, e.g. appeals), carryforwards and carrybacks).
- ✓ Treatment of similar transactions in rulings, tax policy, court cases and preferences of CRA (some of their practices change quite dramatically without notice).
- ✓ Credibility, personality, resources and determination of parties involved.
- ✓ Subsequent events, legislation, litigation outcomes or policy changes.
- ✓ Important- CRA is famous at using hindsight, which is really preposterous and not lawful, so document those transactions to prove intentions and support the facts <u>at the time</u> of the fiscal event and argue like hell CRA should be deciding the tax position base on <u>*at the time*</u> the transaction occurred. Remember that backdating is not acceptable.

Part D: Gathering the Facts and Assumptions

Facts:

The basic fact gathering mission (first step of a tax consequences review) will include the following areas:

- ✓ Residency and tax jurisdiction of taxpayer and those affected (applicable provincial statutes, related or association party rules may apply).
- ✓ Current "structure" of taxpayer (proprietorship/partnership/corp.).
- ✓ Y/E dates (what fiscal year is affected), 'normal' fiscal operating and tax treatments (past and expected).
- ✓ Validation of reality of the transaction, deadlines, closing procedures.
- ✓ Status of the proposed transaction, commitments, legal, timing. Hopefully there is still time to amend the contract terms or transaction characteristics for more favourable tax purposes.
- ✓ Transaction milestones (e.g. payment dates that trigger tax liabilities), third parties involved (how the heck are they treating the transaction?), idiosyncrasies (e.g. is confidentiality a problem – how many are in the loop?), impediments and bottlenecks (the human factor), history of tax filing positions, valuation and allocation of the transaction components (e.g. price allocations for property to land, buildings, paving, leaseholds, repairs...)
- ✓ Prior-year tax positions and carry forward balances (losses, undepreciated capital cost balances that trigger recapture or have special rules), inter-company items, reserves, elections, accounting policies, executive and ownership structure)
- ✓ Non-tax considerations of situation (goals of taxpayer, both personal and business).

See also Part E for more facts that will influence outcome.

Assumptions:

Assumptions definitely need to be given a logical review. List the pertinent and obvious assumptions and continues to assure their validity (or not). Everything from tax rates, achieving deadlines, other influences on taxable income must be assumed or the solutions would never be resolved. This is where professional experience and skepticism can help. Of particular importance is the probable lack of complete information; thus assumptions must be made in order to provide qualified views.

Part E: High-Value Influences on the Best Tax Outcomes

When conducting tax reviews, these areas of indulgence have to receive attention. Tax really does affect the entire business. Here are some of the areas that can establish a high-value outcome for your efforts.

The Technical and Circumstantial Influences on the Best Tax Outcome for Each Taxpayer (TP):	***Activities for the Taxpayer (TP) That are Usually Part of the Review***
* indicates most critical influence These are some of the financial, practical, strategic and technical opportunities and hurdles that require a review to ensure due diligence is exercised when completing a Tax Consequences Review and accompanying tax research - in no particular order.	The items in this column are a sample of some of the specific items that should be reviewed corresponding to the opposite left column.
*Original intentions of TP regarding the transaction(s) itself (non-tax). Is this intention well supported or hindsight?	Normal or unusual activity of TP. Extenuating circumstances. eg. Forced sale or business as usual?

*Tax outcome intention.	Realistic (affordable cost to perform tax review /tax reduction worth the benefits reasonably attainable at first glance)? Is the transaction reality or theory (commitments made, deal conditions to remove)? In other words, is the tax outcome as important to you as to the CRA? Spend the time and effort now or wait until you are in dispute with the CRA and your documentation is lacking?
*Conduct.	How actions support intentions. e.g. are you in the business to flip properties or can you defend long-term asset investment for capital gain?
Other party (to transaction) intentions and actions. Particularly with non arms -length transactions. Sometimes a deal breaker because of conflicting tax treatments and resulting cash flow or risks of tax compliance too uncertain.	Consistency (or not) of other party with TP. Hard to know but could help with negotiations. e.g. classification of asset split (inventory or capital), valuation in agreements of assets sold (land and building), lease vs. purchase, reasonable semblance to market value or special circumstances (needs gains to use up losses, whatever seems possible…) etc.
*Personal liability and loss of personal investment (equity or loans) in business of owners themselves.	Personal guarantees and severity of loss if transaction outcome (e.g. acquisitions) does not meet expectations – creditor involvement and influence on outcome if defaults occur, likely problems among owners with unequal resources, tax deductibility of losses with proper actions and documents before conclusion of transaction. Costs incurred after the failure occurs are harder to claim for tax deduction purposes.

*Impact of substantial profits on tax of business and owners.	After tax profits belong to the owners and need to be maximized for each owner even though they may be in different tax situations. Distribution to owners to be considered (agree in advance for owners expectations for major items such as property disposals). What were past habits or promises?
Additional costs of transaction(s).	Professional, gov't approvals, gov't taxes (transfer, registration, unrecovered sales or HST/GST taxes); put in use costs, carrying initial operating losses, interest charges. Lots of potential extras and if not carefully planned and documented – these extra costs may not be allowable and/or not be considered a current expense. Which extra costs can you expense and what do you definitely have to capitalize? All extra costs and their tax effect must be considered.
*Human Factor	All information available (will staff and outside professionals provide necessary documents swiftly)? Any confidentiality commitments in place? No surprises that could influence outcome (past CRA delinquencies or present actions)? Legal and other professionals capable and independent? Who is the ramrod of the transaction? What are the 'for your eyes only' type of issues and to whom? What personal relationships will influence the process and problem-solving? How can you keep control without the professionals

	charging too much?
Special tax rules for the industry involved or because of the nature of the transaction(s).	Almost every industry has some special tax aspect due to years of tax lobbying. From small business deduction limits to refundable taxes, each transaction has to ensure the opportunities or pitfalls are reviewed and the most current legislation is researched.
*Residency and tax jurisdiction.	Any foreign or extra- provincial element requires special attention concerning withholding taxes, GST/HST, foreign currency risks, reporting, sales and other taxes, gov't approvals or restrictions, legal requirement in different jurisdictions, needing legal support in each jurisdiction for each party could mean many different legal teams involved - the nightmare that can be modified if your legal team practices in the province or country that has the legal issues that affect the transaction.
*Financing and cash flow.	How much and when can tax savings be forthcoming to create additional cash flow for keeping financial commitments? Can some tax liabilities be postponed (how much, how long)? Is there a possibility of a cash shortfall or financing problem? What tax payments can be adjusted accordingly (installments, arrears, and tax refunds)?
Present tax situations and business structure status that will influence the most desirable outcomes.	Inter-company splitting of taxable incomes and use of losses or special charges not normally done but should be looked at in context of the new transactions (interest on inter-company or shareholder loans,

	transfers of assets or business segments, tax collections vulnerabilities). Risks of dealing with CRA; garnishees of inter- co. loans or shared assets, liens on family homes, business or personal partner's liabilities becoming your own, personal charges for corp. liabilities… Special situations for associated or related companies for GST/HST, valuations, elections, debt forgiveness, impediments for eligibility for special treatments or credits. Consideration of initiation of new entity or structure for transaction. Many more situations such as changes to internal operations and procedures could be reviewed because tax (on income, sales, GST/HST, other) and compliance demands flow from most every transaction.
*Timing of transaction(s).	Important to choose timing of outcomes <u>and to allow plenty of time for activating tax treatments.</u> Timing issues included: which year- end is most favourable for the tax actions, when should costs be incurred, deadlines for filing elections or disclosures with CRA.
Affect on financial statements, tax returns and loan covenants.	New accounting treatments and disclosure (reporting) are in effect by professional bodies that more closely considers the tax effect of normal activities and unusual transactions. These booked tax entries will affect the net income (after tax), working capital and shareholder disclosure and will affect loan covenant performances, comparisons (if income not 'normalized' in disclosures) and possibly the value of the

	business in substantial amounts.
*Some major transactions affect the business profoundly from a tax viewpoint.	Change in majority corporate ownership of a small business (defined), change or death of a partner in a partnership, insolvency or changes in the extent of Canadian ownership are business life changing events. These events will create a year-end, terminate the business for tax purposes and involve losses of opportunities (use of losses perhaps) and affect all associated or related businesses (defined). Not to mention serious deemed dispositions, triggering of tax liabilities or deductions and a host of other financial complications and compliance nightmares only a horror show director would enjoy.
*Possible retroactive and future tax implications.	How transactions are treated, adjusted, or amended can provide opportunities for tax refund claims for prior years income, creation of losses to be carried forward, GST/HST payments, and implications for third parties <u>(better tax advantages for Purchasers usually means a higher sales price or asset value).</u>
*Risks of disputes with CRA.	Compare, where applicable, alternative tax outcomes to illustrate the tax savings for the chosen alternative. This comparison also provides the TP with the additional tax costs if CRA eventually succeeds in imposing alternative treatments.
Consideration of CRA's policies, reactions and compliance issues.	Any tax specialist worth their retainer must have intimate know-how of the realities of working with and against CRA. Think Theory

	(fear- mongering, what could happen) vs. Reality (what is likely to happen – or not). Then plunge into the world of CRA indifference to the damage they create. Consider the fine lines between the so-called Compliance (onus of proof) vs. the more Pro-active tax activities (confidence to achieve more thoughtful, supportive and rewarding tax positions). These high-value insights are intriguing and will influence the conclusion and actions to be taken. For a detailed discussion of these issues, see Part F

Part F: The Power of Knowledge and Attitude

Just like in the tax consequences review itself, here is a comparison of the 'Compliant' vs. Pro-active approaches to tax filing situations. Since there is no real definition or description of what 'compliance' really is, and since important terms such as 'personal', 'income', or 'business expense' are not defined or really explained in the legislation, you have to start making your own tax decisions anyway. Tax success depends on what alternatives you choose and your support for those alternate (more favourable) positions. More favourable than what? More favourable than letting CRA decide for you. Here is the real tax environment.

The Real Tax Environment The Finance Department and CRA (Normally Designated as Compliance Requirements)	Taxpayer Compliant Position and Action	Taxpayer Proactive Position and Action
Extremely complex tax legislation.	Assumes tax laws are all encompassing and too restrictive. Uneasy about the self-assessment requirement.	Understands that many times tax laws (or supportable interpretations) can be applied to cover their situation, thereby allowing for self-application of the law (as required) to their advantage. Hopefully.
CRA's interpretation of tax law does not supersede the actual law where the tax courts have the final say. CRA bulletins, circulars, website info, brochures, rulings, and pronouncements are <u>not</u> the law and are not to be depended upon as the law, per CRA's own statements on its many publications.	Believes what CRA says in matters that may not be applicable or are incomplete when it comes to their own situations.	Does not depend on CRA material (because it is not helpful for tax reduction, purposefully incomplete, contradicts actual law and actions of CRA in many instances). Mines for alternative sources of insight for tax reduction.
CRA is inconsistent in their application of tax laws and their own policies among their own	Assume CRA's actions (requests for info, re-assessments, knowledge of tax law) are correct	Performs sufficient due diligence to choose best among alternative tax treatments and has

personnel and different tax offices. CRA will not admit they are first and foremost a large collection agency whose main purpose is to collect as much money as possible interpreting and bending the law as they see fit.	and unassailable.	support for their actions. Takes CRA to task to explain their actions and respond to TP arguments because that is the quid pro quo. Each part of a tax dispute can then be dissected and rearranged, so to speak.
CRA has absolute power and is accountable to no-one.	TP is intimidated by this true statement. Avoids confrontation and leaves matters until CRA has to use its power to resolve issues. May hope their known evasion situations remain undiscovered.	TP understands it is best to be proactive and if so, there is no need for evasion. Maintains semi-cooperation and communication with CRA. Takes every step to modify possible detrimental actions by CRA (in advance and while disputes are in progress). Stays on top of CRA relationship by maintaining communication and insisting on positive reaction to their position.
CRA does not like to explain its actions and reasons for either positive or negative agreement with TP position.	Does not question CRA's reasons and opinions. Let's CRA put the onus on them in too extreme a manner.	Insists on CRA justifying in writing each position it takes. Refutes CRA's wrong assumptions, inadequate diligence (if applicable), unsupported positions and calculations.

CRA has good people who are there to help if possible.	Does not ask CRA personnel for their reasons, assumptions advice or purpose for actions.	Understands that CRA personnel can be helpful and thoughtful, with some exception as in any institution. Takes issues right up the ladder until clarified and resolved properly. Asks for audit or penalty reports that CRA has prepared so facts and assumptions can be refuted, if applicable.
CRA has not been provided adequate authority or resources to perform activities easily (such as amendments to returns), resolve problems or provide a viable fairness platform.	Nominal attempts to achieve action. Assumes no news means something is happening.	Determination to obtain action for requested changes, refunds, tax collection accommodations.
Finance department has chosen to maintain CRA's actions under a cloak of secrecy. The result is the public is not aware of how consistently, fairly, and technically they are being treated compared to others. It's everyone for themselves.	Becomes a casualty of CRA's divide and conquer process.	Locates resources of information and possibly experienced tax specialists to overcome knowledge vacuum.

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