

REPORT ON RECENT DEVELOPMENTS

September 2009

Voluntary Disclosures

The legal battle between UBS and the U.S. tax authorities, and the recent settlement whereby UBS agreed to disclose names of certain account holders that committed “tax fraud” has attracted much publicity in recent months, as has the partial amnesty program introduced by the IRS.

Canada has long had a voluntary disclosure program in effect, but recent policy changes have had a drastic effect on the cost of disclosures involving offshore accounts. Although in the past, repatriation of capital cases were generally settled on a percentage basis (approximately 38% total cost, taxes and interest, federal and Quebec combined), now the CRA is looking to tax opening capital and up to the last ten years of real income. This is an attempt at regularizing the treatment of such cases at the national level. It was perceived that Revenue Quebec’s practice (which the CRA followed) whereby each government collected a maximum amount of 19% of the current value of the offshore portfolio (adjusted for withdrawals in the previous 6 years and any tax paid component of the capital) as tax and interest was much more beneficial than the treatment accorded to similar cases in other provinces.

Prior to this change, repatriation cases were treated in such a way that actual earned income (interest, dividends, distributions, gains, etc.) for each of the previous 6 years was taxed and an amount of the opening capital was added as other income in the 7th oldest year in order to collect the agreed

amount of 19% of the adjusted current value of the portfolio as both taxes and interest for each level of government.

Now, there is no backing into the 19% return sought by each of the two levels of government but rather a simple and straightforward tax on the income earned during a minimum of each of the previous 6 years up to a maximum of 10 years and tax on the value of the portfolio at the start of the period. It is possible to limit the disclosure to only 6 years in cases where the information is only available for 6 years (since certain offshore financial institutions only keep records for 6 years). But beware: the CRA generally knows which institutions keep records for longer periods and may insist on full disclosure for the previous 10 years. Also, if any of the capital in the offshore portfolio is tax paid, it will not be taxed a second time if adequate proof is provided of its tax paid status. Finally, if the portfolio has historically earned capital gains, it may be possible to have only 50% of the capital taxed in recognition of the fact that the portfolio’s value is derived from capital gains and that Canada only taxes 50% of capital gains.

The following example will highlight the change in approach:

1. Mr. X has an offshore portfolio now worth \$770,000.
2. On December 31, 2008, the portfolio was worth \$750,000.

3. The portfolio has consistently earned an average of \$25,000 of income per year over the last 10 years.
4. On December 31, 2002, the portfolio was worth \$600,000.
5. On December 31, 1998, the portfolio was worth \$500,000.
6. A total amount of \$25,000 was withdrawn from the portfolio during the last 6 years.
7. There is no tax paid component to the initial investment capital.

Under the old system, both the CRA and Revenue Quebec sought 19% each of the December 31, 2008 value of the portfolio with all withdrawals during the previous 6 years being added back and any tax paid capital being removed. With no tax paid capital and adding back the withdrawals of \$25,000, the final total liability, taxes and interest, would have been \$147,250 to each of Revenue Quebec and the CRA (19% of (\$750,000 + \$25,000)), or \$294,500 in the aggregate. Once this liability was established, actual income figures were used to determine how much of the capital at December 31, 2002 was to be added as "other income" in order to arrive at the 19% total liability for each level of government. In other words, the maximum liability was generally the greater of 38% of the adjusted December 31, 2008 value or tax and interest on actual income earned.

Under the new system, assuming the entire 10-year period is covered by the disclosure, tax is payable on every dollar of income earned, as well as on the entire value of the portfolio on December 31, 1998 as either ordinary investment income or capital gain depending on the portfolio's income history, unless a portion of the portfolio is already tax paid. Assuming there is no tax paid capital, the entire value as at December 31, 1998 is added as other income and taxed at the applicable marginal rate. For the income earned during 1999 through to 2008, it is

included in income as earned and taxed at the taxpayer's marginal rate for each year. The only concession offered is on interest, whereby for statute-barred years, the prescribed rate of interest will be reduced by 4%. Assuming the financial institution(s) holding the portfolio have records for the past 10 years and an average combined marginal tax rate of 50% over the last ten years, the minimum tax liability in the above example under the new system is \$375,000 (50% of the \$500,000 portfolio value on December 31, 1998 + 10 years x \$25,000 of annual income) plus interest at the prescribed rate for the previous 3 years and at the prescribed rate less 4% for older years.

In discussions with the CRA, it was stressed that the 4% reduction of the interest rate is a real interest rate reduction, whereas before it was notional since the CRA would simply increase the "other income" capital inclusion amount in order to obtain their desired 19% of the adjusted value of the portfolio in taxes and interest. This is of little comfort to those who are now faced with the prospect of paying much more than the combined 38% under the previous policy. One can only hope that the CRA's position which imposes a very substantial tax burden upfront will be short-lived and instead the CRA and Revenue Quebec will focus on the benefit of having the capital repatriated to Canada so that the future payment of taxes becomes the driving force of the voluntary disclosure program.

GAAR Update

The last year has seen a proliferation of court cases dealing with the general anti-avoidance rule known as GAAR.

In January the Supreme Court of Canada released its long awaited decision in the *Lipson* case. Although the Court approved the so-called Singleton plan to make non-deductible interest deductible, in a divided decision the majority held that GAAR applied to deny the interest deduction because of the

misuse and abuse of the spousal attribution rules.

Given the contradictory findings of the different Supreme court justices, the *Lipson* decision may have done more to muddy the waters, rather than to provide guidance as to the type of transactions where GAAR will be applicable. Indeed, subsequent to *Lipson* the GAAR cases have gone in both directions. Without going into a technical analysis, here is a summary of the outcome in the following post-*Lipson* GAAR cases:

Cases where GAAR was held to apply:

OGT Holdings: Quebec Court of Appeal applied GAAR to a Quebec shuffle transaction whereby a capital gain triggered for federal purposes was avoided in Quebec and realized on a tax-free basis in Ontario.

Copthorne: Federal Court of Appeal applied GAAR to series of transactions that preserved and, according to the Court, improperly increased paid-up capital of shares.

Lehigh Cement: Tax Court applied GAAR to transaction structured to avoid non-resident withholding tax.

Cases where GAAR was held not to apply:

Landrus: Federal Court of Appeal held that GAAR did not apply to transactions which allowed partnerships to realize terminal losses which were then allocated to partners under partnership rules.

Collins & Aikman: Tax Court refused to apply GAAR to transactions involving distributions to a non-resident shareholder, rejecting the

Crown's assertion that the PUC increase was artificial and abusive.

Our firm had applied for leave to appeal the *OGT Holdings* decision to the Supreme Court of Canada. Even though the Quebec legislation has since been amended to prevent shuffle transactions, it was hoped that the high Court would address the application of GAAR in the inter-provincial context. Unfortunately, on September 10, 2009, the Supreme Court dismissed the application without reasons. This leaves the Court of Appeal decision as the final authority (for now) on the application of the Quebec GAAR.

Making Jurisprudence – Sanction for Abusive Proceedings

Denis A. Lapierre of our firm was successful in obtaining a recent judgment on the newly adopted Article 54 of the Quebec *Civil Code of Procedure*, condemning the opposing party to pay all extrajudicial and judicial fees. The purpose of new Article 54, which came into force in June 2009, is to prevent the improper use of the Courts and discourage abusive judicial proceedings. Pursuant to the new provision, once a party establishes that an action or pleading may be an improper use of procedure, the Court may dismiss the action or other pleading and may order costs to be reimbursed. The Court may also condemn a party to pay, in addition to judicial costs, damages for the prejudice suffered by the other party, including the fees and extrajudicial costs incurred by that party, and may also award punitive damages. Prior to the adoption of Article 54, it was quite rare and extremely difficult to obtain an order for payment of extrajudicial fees.

Sweibel Novek News

We are delighted to announce two new additions to the Sweibel Novek team:

Erica Stermer joined our firm earlier this year after articling with us and being called to the Quebec Bar in 2008. Erica works primarily in the areas of tax and commercial litigation.

Ryan Rotchin, who previously worked with us as a law student, returned in September after completing his articles as a law clerk at the Tax Court of Canada and his call to the Quebec Bar. Ryan will be working primarily in the tax planning field.

At Sweibel Novek we always strive to provide the highest quality of service and expertise. While we don't go looking for awards, we are proud that members of our firm continue to be recognized for excellence in their fields. Congratulations to Sydney Sweibel and Barbara Novek who have both been included in Law Day's Top 60 Leading Lawyers in Canada in the practice area of Trusts and Estates for 2009, and to Barbara Novek who will again be recognized in the 2010 edition of The Best Lawyers in Canada in the practice areas of Taxation Law as well as Trusts and Estates.

We are in the process of revamping our website and invite you to visit us soon at www.sweibelnovek.com.

WE WOULD LIKE TO TAKE THIS OPPORTUNITY TO WISH OUR JEWISH CLIENTS AND FRIENDS A HEALTHY, HAPPY AND PROSPEROUS NEW YEAR.

The material contained herein is necessarily of a general nature and cannot be regarded as legal advice. The members of our firm would be pleased to provide additional information. You may reach us at (514) 849-1188 or by e-mail as follows:

<i>Sydney Sweibel</i>	<i>ssweibel@sweibelnovek.com</i>	<i>Barbara L. Novek</i>	<i>bnovek@sweibelnovek.com</i>
<i>Douglas Yip</i>	<i>dyip@sweibelnovek.com</i>	<i>Jack Boidman</i>	<i>jboidman@sweibelnovek.com</i>
<i>Denis A. Lapierre</i>	<i>dlapierre@sweibelnovek.com</i>	<i>Konstantinos Voggas</i>	<i>kvoggas@sweibelnovek.com</i>
<i>Carol Rabbat</i>	<i>crabbat@sweibelnovek.com</i>	<i>Marcie Akerman</i>	<i>makerman@sweibelnovek.com</i>
<i>Erica Stermer</i>	<i>estermer@sweibelnovek.com</i>	<i>Ryan Rotchin</i>	<i>rrotchin@sweibelnovek.com</i>

or visit our website at www.sweibelnovek.com

