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Blaney McMurtry
BARRISTERS & SOLICITORS LLP

Blaneys on Business

This newsletter is designed to bring news of changes to the law, new law, interesting deals and other matters of interest to our commercial clients and friends. We hope you will find it interesting, and welcome your comments.

Feel free to contact any of the lawyers who wrote or are quoted in these articles for more information, or call the head of our Corporate/Commercial Group, Stanley Kugelmass at 416.593.3943 or skugelmass@blaney.com.

"The harmonized sales tax will have an impact on all businesses in Ontario, including developers, owners, operators and managers of real property and businesses that buy or sell real property."

HST TAKES EFFECT IN ONTARIO JULY 1, 2010; OWNERS, OPERATORS, MANAGERS OF REAL PROPERTY ARE ADVISED TO REVIEW THEIR AGREEMENTS

Jeffrey Warren

The combination of the Ontario retail sales tax (RST) and the federal goods and services tax (GST) to form a harmonized sales tax (HST) takes effect July 1, 2010. This article briefly examines the application of the HST to transactions involving real property.

The harmonized sales tax will have an impact on all businesses in Ontario, including developers, owners, operators and managers of real property and businesses that buy or sell real property.

Businesses that develop, own, operate and manage real property, and the businesses that work with them, will have to understand the ins and outs of the new HST regime and will have to take a number of steps to integrate the new regime smoothly into their operations. Landlords, to take one example, will have to review their form of lease to ensure that the sales tax definition contained in it is broad enough to include the HST. Businesses that intend to acquire or sell real property after July 1, 2010 will also need to be familiar with the new HST regime.

Generally speaking, the HST will operate much as the existing GST regime does. While the current policies of the Canada Revenue Agency (CRA) regarding the application of the GST and the provisions in the *Excise Tax Act* (the Act) that relate to real property will apply for the most part under the new HST regime, there will be grandparenting provisions, transitional rules and exceptions to which businesses will have to be sensitive.

The following are some particulars:

Purchase and Sale of Commercial Real Property

The HST will apply to the purchase and sale of commercial real property in the same manner that the GST does at present. The HST will apply to a purchase and sale of commercial real property if both ownership and possession of the property are transferred on or after July 1, 2010, regardless of the date on which the agreement of purchase and sale was entered into. A purchaser of commercial real property who is a registrant under the Act will be able to self-assess the HST in the same manner that it now self-assesses the GST.

Leases and Licences of Commercial Real Property

The HST will apply to leases and licences of commercial real property in the same manner

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that the GST currently does, subject to transitional rules.

The HST applies to consideration that becomes due, or is paid without having become due, on or after July 1, 2010, for a supply of property by way of lease, licence or similar arrangement, to the extent that the consideration is for the part of a lease interval that occurs on or after July 1, 2010.

The HST will not, however, apply to a lease or licence of real property, or a similar arrangement, if the lease interval begins before July 1, 2010 and ends before July 31, 2010.

The HST will also apply to consideration that becomes due, or is paid without having become due, between May 1, 2010 and June 30, 2010, for a supply of real property by way of lease, licence or similar arrangement, to the extent that the consideration is for the part of a lease interval that occurs on or after July 1, 2010 (unless the lease interval begins before July 1, 2010 and ends before July 31, 2010). As is mentioned above, landlords will need to review their form of lease to ensure that the sales tax definition in their lease is broad enough to include harmonized sales tax.

Purchase and Sale of Newly Constructed Residential Property

The supply of newly constructed or substantially renovated residential housing that is now subject to the GST will be subject to the HST when both ownership and possession are transferred on or after July 1, 2010, subject to the grandparenting provisions, transitional rules and other exceptions and qualifications implemented by the CRA.

An agreement of purchase and sale between a builder and a purchaser for the purchase and sale of newly constructed or substantially renovated residential housing that was entered into prior to June 18, 2009 will be grandparented and will not be subject to the Ontario component of the HST if ownership and possession are transferred on or after July 1, 2010.

The grandparenting provisions do not apply to newly constructed or substantially renovated homes built by owners or traditional apartment buildings, duplexes, mobile homes and modular homes.

Developers of newly constructed or substantially renovated homes, condominium complexes and residential condominium units that are sold pursuant to grandparented agreements of purchase and sale will be required to pay a transitional tax adjustment to account for the tax that would otherwise have been embedded in the price of the new home under the existing RST regime.

In respect of newly constructed or substantially renovated homes, the amount of the transitional tax adjustment that will be payable will depend on the degree of construction on July 1, 2010. Developers will need to review the Act and the transitional rules implemented by the CRA to determine the amount of the transitional tax adjustment that is payable.

A purchaser of a newly constructed or substantially renovated single detached home, semi-detached home, attached home or duplex may be eligible to receive an RST transitional housing rebate where construction of the home straddles the July 1, 2010 HST implementation date, own-

ership and possession is transferred after July 1, 2010 and the HST is payable on the purchase price.

The purpose of the RST transitional housing rebate is to provide relief from the RST embedded in the purchase price to purchasers of non-grandparented single detached homes, semi-detached homes, attached homes or duplexes that are at least 10 per cent complete on July 1, 2010.

A builder of newly constructed or substantially renovated rental housing such as a single detached house, semi-detached house, attached house, duplex, residential condominium unit, traditional apartment building or an addition to an apartment building may be entitled to claim an RST transitional housing rebate where the construction of the housing straddles the July 1, 2010 HST implementation date and the HST would apply in respect of a self supply of the housing. The construction or substantial renovation of the housing must be at least 10 per cent complete on July 1, 2010 in order to be eligible for the rebate.

A builder of a newly constructed or substantially renovated condominium complex that is at least 10 per cent complete on July 1, 2010 will also be entitled to claim an RST transitional housing rebate if the builder sells the condominium complex, or a unit in the condominium complex, that was subject to the transitional tax adjustment or the HST.

A new housing rebate for the Ontario component of the HST will be provided for the same types of new residential housing in respect of which a rebate is currently available for the GST. The existing GST rebate will remain in place after July 1, 2010 in respect of the federal component of the HST. A rebate will be provided in the amount of 75 per cent of the Ontario component of the HST (in other words, 6 of the 8 percentage points of the Ontario component of the HST) to a maximum of $24,000 for new homes purchased. A similar rebate will be available for new rental housing, including investment properties, to be rented out for use as a primary residence. This rebate now exists for the GST.

Resale of Residential Property

Under the Act, the purchase and sale of a used residential complex is exempt from the GST. After the implementation of the HST, the purchase and sale of a used residential complex will be exempt from the HST. ■

The foregoing is a brief summary of the effect of the implementation of the HST on transactions involving real property. It is only intended as an overview. There are a number of exceptions and qualifications to the general provisions that have been discussed in this article. In addition, a number of matters have not been addressed (e.g. the availability of input tax credits in respect of the HST). Businesses that develop, own, operate and manage real property will have their own particular circumstances that need to be addressed. The Act and the transitional rules implemented by the CRA must be reviewed to determine how the rules apply to those particular circumstances or to anything that has not been discussed in this article.

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"The tax-reporting season has just come to a close for most Canadian businesses and residents. Millions of returns have been filed. Billions of dollars have been paid. And, in probably tens of thousands of cases, crimes have been committed in the process..."

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ECONOMIC HEADWINDS INCREASE PROSPECTS OF TAX EVASION: CRIMINAL OFFENCE CAN CARRY DRACONIAN PENALTIES

Ralph Cuervo-Lorens

The following article is by Blaney McMurtry partner Ralph Cuervo-Lorens. Ralph is a national authority on tax evasion litigation and is co-author of the leading Canadian text on the subject, published by Carswell (Thomson-Reuters), the highly regarded legal publisher. Tax Evasion focuses on the management and defence of tax evasion charges at all levels. It has been cited by Canadian courts and is used by private and public tax advisors across Canada, including Canada Revenue Agency personnel.

The tax-reporting season has just come to a close for most Canadian businesses and residents. Millions of returns have been filed. Billions of dollars have been paid. And, in probably tens of thousands of cases, crimes have been committed in the process — to use the most common example, by "buyers," who are required to pay tax, and by "sellers" who are required to charge tax, or by both.

Much of this crime will have been committed unwittingly. In many instances, the perpetrators will not be aware that they have engaged in a *Criminal Code* offence.

The criminal offence in question is tax evasion. Most ordinary people would consider some of it innocent… almost prankish at the small level. But, in the eyes of international, federal and provincial authorities, it is anything but. It is very serious business with serious consequences for the economy and in particular for the person who is caught. Everybody who is convicted of tax evasion will be subject to draconian penalties and is labelled a criminal for life.

Governments are always attuned to the possibility of tax evasion. They have been particularly sensitive to it in the last few years, however, because of the battering that the global economy has taken and the financial desperation to which this battering has led.

Every year, the Canada Revenue Agency (CRA) decides on the areas of business and commercial life that it will monitor specifically for tax evasion offences. The recent areas of focus are the underground economy, GST/HST payment compliance, contraband tobacco, and over-aggressive tax planning.

Despite the criminal nature of tax evasion, most of us have probably committed it. A recent CTV poll showed that 58 per cent of Canadians would accept an offer to evade taxes when buying goods or services (by paying cash and taking no receipt). A Gallup poll showed that 73 per cent of respondents said they would do so. And this is among otherwise law-abiding citizens. Simply put, tax evasion is the most widespread economic crime in the world.

What Exactly is Tax Evasion?

Tax evasion as defined in the *Income Tax Act* (ITA) is, broadly speaking, any wilful omission to pay tax (or, in the words of an old court case, "the intentional commission of a fraud on the public purse" through some affirmative act or omission that intends to evade or defeat a tax or the payment of a tax.) "Affirmative act(s) or omission(s)" are things such as deceit, subterfuge, camouflage, concealment, attempts to colour or obscure events or make things appear other than they are.

"Tax evasion cases... can range from under-reporting income or failing to report income to failing to file, filing more than a year late if tax is owed, or failing to declare taxable income from any source."

Some aspects of the offence worth noting are that intent is required for the offence to be proved. In addition, all related "conspiring" activity, whether active or passive, direct or indirect, is also considered tax evasion. And while no specific scheme need be proved, the common defence of "due diligence" is not available. There is effectively no limitation period. The CRA has the ability to prosecute no matter when the alleged offence was committed.

Tax evasion cases are limited only by human ingenuity. They can range from under-reporting income or failing to report income to failing to file, filing more than a year late if tax is owed, or failing to declare taxable income from any source.

The list can be very long: concealing sales or income, making false declarations on a return, failing to report income on questionable transactions, failing to accurately record retail sales tax, filing false GST returns as part of a scheme to obtain fraudulent GST refunds, destroying records, making deceptive statements or declarations, evading customs duty by under-invoicing and by mis-declaring quantity and product-description.

At a more mundane level, the list can include a retailer offering to let a customer pay cash and providing a false out-of-province address to avoid paying sales tax. It can also include an accountant who "saves" the client money by inflating business expenses, such as cost of goods, to lower the overall business tax owing.

Another favourite is lowering income by reporting only credit card sales and not cash transactions. A contractor "forgets" to report the $10,000 in cash he receives for building a pool. A business owner tries to deduct $100,000 of personal expenses in the calculation of his business taxes. A person falsely claims that she made charitable contributions, or she significantly overestimates the value of property donated to charity. The executor of a $5 million estate files a tax return omitting property and claiming the estate is only worth $100,000, thus owing much less in tax. Or the owner of a company who uses his corporate credit card to pay for family vacations and then deducts these "corporate" expenses on the company's tax return and fails to report them on the owner's personal income tax return as additional income…

Some common tax evasion *schemes* include the understatement or omission of gross revenues/receipts (including "skimming" money off the top of a sale and declaring only what is left); claiming fictitious or improper deductions (including the "padding" of expense accounts); false allocation of income (including diverting income onto the tax return of someone who had nothing to do with earning the money but who has a lower tax rate); improper claims, credits or exemptions (including fraudulent or bogus applications for tax benefits).

With regard to this last category, we read in the news not long ago about the troubles of Cinar Corp., the Quebec entertainment company. Cinar applied for, and received, nearly $8 million in tax credits and Telefilm funding for a number of its productions. Unfortunately, these had been written by U.S. scriptwriters, which rendered them ineligible for the tax credits. The subsequent investigation disclosed that Cinar

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had asked a former employee to draw up "subcontracts" for the purpose of paying American writers. It was this employee who was credited as the lead writer on the application for the tax credits (No mention was made of the U.S. writers). The thought had been that citizenship was irrelevant in this context.

Many wondered what exactly was so wrong with what Cinar had done. One thing that was wrong was that it received a tax benefit to which it was not otherwise entitled under Canadian tax law. Obtaining a tax benefit through the use of misleading or incomplete information is to commit the criminal offence of tax evasion under Canadian tax law. Severe consequences can follow.

There is certainly nothing wrong with arranging one's personal or corporate tax affairs in the most advantageous manner possible. Tax avoidance (or tax mitigation) is therefore to be distinguished from tax evasion. Similarly, tax evasion is very different from civil non-compliance with the ITA, such as failing to pay taxes on time or claiming, through error or mis-allocation, a deduction (which may, of course, result in more or less tax payable).

Hefty consequences if convicted

The great majority of tax evasion cases referred for prosecution are, in fact, prosecuted. The CRA's 2009 prosecution statistics are impressive: 98 per cent conviction rate, $29.2 million in fines, 81 years in jail terms.

The law wants to make sure that the CRA has every tool at its disposal to make a tax evader pay. If convicted, you have to pay the full amount of the tax owing plus interest. In addition, you will have to pay penalties as high as 50 per cent of the unpaid tax plus, in all likelihood, a fine of between 50 per cent and 200 per cent of the tax evaded. For good measure, a jail term of up to five years on top of the fines could also be part of the punishment.

Consider also that a conviction gives you a criminal record, which will follow you everywhere, and a permanent blight on your credit rating. And you become exposed to seizures, without notice, of assets, wages, RSPs and the like for as long as the tax, penalties or interest remain unpaid.

Common Defences

The procedure and rules of the criminal law and the *Criminal Code of Canada* apply to tax evasion. An accused taxpayer therefore benefits from the presumption of innocence as well as the right to silence and the possibility of invoking *Charter* rights.

There are also "factual" defences. The allegations can be refuted or there may be perfectly reasonable explanations or reconciliations that can be offered. Or a close review of the patterns and history of the matter by a forensic accountant could disprove that there was an intention to evade.

The more "legal" defences are built around proving that the required element of intent was not present, that mere negligence was involved, that reasonable reliance was placed on tax advisors, or that age or infirmity were determining factors.

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There are also some "pre-emptive" defence approaches that can be taken, rather than defences proper. The most common is voluntary disclosure under CRA's Voluntary Disclosure Program. There are also so-called "tax amnesties" that rely on a favourable exercise of discretion by the Minister of National Revenue. But, as the saying goes, the best defence is really not to evade taxes at all.

The Globalization of the Financial World and Tax Evasion

As we have suggested above, times of financial crisis have led to more non-filing and more tax evasion. It has reached a point where the International Monetary Fund (IMF) and other international organizations such as the Organization for Economic Cooperation and Development (OECD) have come to refer to tax evasion as a multi billion dollar problem on a global and unprecedented scale. This in turn has led to a worldwide effort aimed at curbing aggressive tax planning in all its forms.

Some countries have approached the issue as one of civic responsibility: paying tax is a social responsibility, not just a burden to be minimized. Others have drawn linkages between paying taxes and good corporate citizenship and governance. In Quebec, to use one severe example, a tax avoidance transaction that complies with the letter of the law but which violates the spirit of the law is now considered evasion. There are many other examples of this trend. At the corporate level, there are new requirements to certify corporate tax systems and controls working in tandem with new requirements to report "uncertain tax positions". On the risk management side, we are seeing a trend toward tax risk management becoming an integral part of any enterprise's overall risk management system.

Two recent manifestations of these trends have had impacts on Canada. One, involving the LGT Group (Liechtenstein) and UBS, both international banks known and valued for secrecy, has been dubbed "The End of Bank Secrecy." After a series of complex legal proceedings as well as threats from their national governments, both banks were compelled to disclose customer data. And note that the case was originally brought by foreign authorities. Some of these customers were Canadian residents and taxpayers.

Another Canadian result involved the Royal Bank of Canada with its brokers being targeted. The allegation was that RBC helped clients set up offshore accounts which were to be used to hide worldwide income. The "informant" here was a former LGT employee who became a paid German government informant.

And this appears to be just the beginning of a sea change in the area of tax collection. There is a "harmful tax practices" initiative at the international level that seeks to put an end to preferential tax regime jurisdictions, or "tax havens," such as the Turks and Caicos. In addition, investigations into such big scale sport franchises as European soccer teams as vehicles for tax evasion have begun. The internationalization of commerce and finance means that these kinds of developments will affect every major country.

The Impact of Technology

The recent and massive increases in e-commerce and self-employment, both made possible or

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greatly facilitated by advances in technology, have opened another tax evasion front. A celebrated case involving eBay is one example. In this case, a U.S. company was forced by a Canadian court order to release identifying information as well as sales details for its "PowerSellers" (who the CRA suspected were not reporting online income). The data that the Canadian court order forced into the open were held in servers located in the U.S.

There is also the increasing use of complex software of various types designed to enable or hide tax evasion. Some software that works with point-of-sale systems and electronic cash registers, particularly in the hospitality and entertainment industries, for example, is a growing problem.

One type, for instance, allows a business to run two sets of books at the same time. If a business wanted to declare only $39.99 for every $49.99 sale it made, for example, it would instruct the software to create one report of the $49.99 sales and another of the $39.99 sales and then use the $39.99 report for tax purposes.

How might the CRA find out that the fraudulent report had been filed? It is often tipped off by former and often disgruntled employees of the business. ■

NEW TAX MEASURES DESIGNED TO BOOST DIRECT FOREIGN INVESTMENT

Paul L. Schnier

Governments across the world are searching in these early post-recession days for measures that will continue to help create a new era of sustainable economic vigour and the business and personal prosperity that go with it.

It seems clear from the March 4 federal budget that part of the Government of Canada's plan is to promote more foreign direct investment in this country.

Foreign direct investment plays a crucial role in Canadian business. Not only does it provide a significant portion of the capital for economic growth, but it brings in new management expertise, technology and value-added jobs.

At the end of 2007, according to Statistics Canada, foreign direct investment constituted a $501 billion share of a national economic engine that generated $1.2 trillion in goods and services, more than double the $219 billion stake that international investors had held a decade earlier.

This growth seems destined to continue and perhaps even accelerate as Canada's historic social and political stability and its watchful approach to banking regulation continue to help the country stand out in bold relief as a safe haven for international investment.

And in addition to those strengths, we now have a new budget that proposes a number of significant tax changes, one of which will reduce taxes

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collected but should lead to a substantial increase in the venture capital investment that foreigners are prepared to make in Canada.

Until now, non-residents have had to deal with a complex withholding and reporting regime when disposing of their Canadian investments. The Budget loosens these requirements significantly.

Under current legislation, when a non-resident disposes of taxable Canadian property to a Canadian resident, he must first obtain a clearance certificate from the Canada Revenue Agency. This is done through a filing with the CRA and often involves paying an amount or posting security with respect to any applicable taxes, or satisfying the CRA that no tax is payable.

Unless the purchaser receives this clearance certificate, he is obliged to withhold 25 per cent of the purchase price from the sale proceeds on account of the vendor's potential tax liability. One can easily see the distress that would be caused where, for example: the clearance certificate is not produced in time for closing or where the purchase price is not paid in cash.

"Taxable Canadian Property" has, until now, included Canadian real property and items akin to real property, such as resource properties and timber limits. It has also included shares of private companies as well as shares of public companies where 25 per cent or more of any class of shares of the public company are held by one or more members of a family group.

The Budget proposes to amend this definition so that the foregoing types of shares will only constitute taxable Canadian property where they derive more than 50 per cent of their value principally from Canadian real estate, resource properties or timber limits held by the company at any time in the 60 month period preceding the date of sale.

In other words, shares of private companies or shares of a closely held public company will be subject to the old withholding and reporting regime only where the companies are, or have been, involved in the real estate, resource or forestry sectors. This allows for a wide array of companies, such as those in the high tech, manufacturing, and retail sectors (which are intensive in technology and value-added employment), to attract foreign investment without the concern that any gains realized on these investments will be subject to Canadian tax.

Also, it is important to note that this proposal applies to investments by any non-resident. Formerly, certain investors who were resident in a country with which Canada had a tax treaty would have enjoyed some relief from this taxation. The change applies equally to both residents of a treaty jurisdiction, such as the United States or Japan, as well as those resident in jurisdictions with which Canada does not have a tax treaty, such as Hong Kong.

This means everyone is now on a level playing field and there is no reason to engage in complicated investment structures utilizing treaty jurisdictions. This amendment should open up Canadian investment to all comers and thus further enhance our global competitiveness as a place to invest.

The change will also affect distributions to non-residents from Canadian trusts and estates. The clearance certificate requirement will no longer apply to such distributions unless the property distributed meets the new definition. This will ease the administrative burden on trustees and beneficiaries alike.

In a parallel move, the Budget also proposes to make it easier for non-residents to obtain refunds where more funds than necessary have been withheld by a purchaser under the clearance certificate procedure. Both proposals are important moves in the right direction to attract greater international investment to Canada. ■

Blaney McMurtry welcomes our newest Partner

Boris Muchalov

Blaney McMurtry LLP is pleased to announce that Boris Muchalov has joined the firm where he will continue his practice in corporate/commercial law with an emphasis on debt financing, asset-based lending, factoring, project and acquisition financing and equipment financing and leasing. He also acts regularly as corporate counsel to a number of local and foreign manufacturing and technology businesses.

Boris was called to the Bar of Ontario in 1999.

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