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CONTEMPORARY IDEAS FOR BUSINESS MANAGEMENT SPRING/SUMMER 2019

Planning Issues for Taxpayers Owning Two or More "Principal Residences"

Owning more than one residence can be a taxing ordeal. Generally, Canadians are exempt from tax on the capital gains arising on the sale of a "principal residence". Appropriate tax planning can help to manage the tax burden which arises when multiple residences are owned.

A "principal residence" is defined as a housing unit along with surrounding land of up to a maximum of one half hectare (about one acre). In cases where land in excess of one acre is deemed necessary for the use and enjoyment of the residence, it may be considered as part of the principal residence. It should be noted that the property does not have to be situated in Canada to qualify for the principal residence exemption.

For a property to qualify, it must have been ordinarily inhabited "in" the year, not throughout the year. This means, for example, that if a taxpayer sells one house and buys another in the same year, they may be considered to have ordinarily inhabited both of them. Inhabitation on a periodic basis would appear to qualify, even where the total time spent in the property is only a small portion of the year, such as with a family cottage.

Two key considerations in managing the principal residence exemption are:

1. ensuring that you evaluate whether it is best to use the exemption when a particular residence is sold; and
2. that you consider whether shifting future growth in the value of the property to other family members is warranted.

One advantage of transferring the cottage to the next generation now is that your tax liability would be limited, based on the current amount of gain on the property. If you expect the property to appreciate in value over time, a transfer now may be worth considering. This transfer will also have its disadvantages. Having to pay the capital gains tax now and possibly land transfer tax would require a current cash outflow. Issues related to family law and creditor protection also must be considered. You might choose to use your principal residence exemption now to shelter the tax liability and pay tax in the future on the sale of the family home.

If there is reluctance in transferring the direct ownership of the cottage to other family members due to the loss of legal control over the property, you may wish to consider using a family trust to hold the vacation property. This "deemed" disposition on the transfer of the cottage to the trust would still be a taxable event, but you would be able to continue to exercise control over the use of the cottage.

Owning two or more properties can leave your estate with a large tax burden. If there is insufficient cash available, one of the properties may have to be sold to pay the tax bill. One option here could be considering the purchase of life insurance to cover the tax liability which arises on death. This way, the family cottage can remain with the family.

There are numerous tax issues surrounding the ownership of two or more residences. Before buying or selling a secondary residence, it may be prudent to contact your local DJB office to discuss the implications with a tax professional to ensure that the purchase is structured in the most tax effective manner and the sale is less taxing, if possible.

Article written by: **Don Knechtel,** CPA, CA

2 | Annual Financial Statement Preparation - What are My Options?

3 | Structuring Options for Foreign Corporations Doing Business in Canada

4 | Association and HST

Annual Financial Statement Preparation - What are My Options?

All corporations, for-profit and not-for-profit, must prepare annual financial statements to accompany their tax filings with Canada Revenue Agency. However, determining the "type" of financial statements you engage your external accountant to prepare will vary depending on your organization's specific circumstances.

In the not-for-profit world the requirements for financial statement preparation are mandated by the enacted Not-for-profit Corporation's Acts, but directors and shareholders of for-profit corporations have much more flexibility and freedom when making their annual decision on the type of financial statements they wish to have their external accountant prepare.

There are three levels of work that can be performed on a set of annual financial statements. The level of work performed by the corporation's external accountant will vary depending on the shareholder's specific needs and if the financial statements will be relied upon or distributed to external users such as the bank or potential investors or purchasers. Generally, these external users will want to ensure sufficient work has been performed on the financial statements by your independent external accountant to obtain a level of confidence they are relying on accurate and complete information.

Notice to Reader Financial Statements

Notice to Reader, or Compilation, financial statements are generally prepared when there is no intention for the financial statements to be used or relied on by external parties (unless specifically allowed by your lenders/creditors). In these engagements, the external accountant simply takes the balances provided by the corporation's management and formats them into standard financial statement form. Minimal work is done by the external accountant to ensure the figures are accurate and there is no requirement that the balances are reported based on any specific set of accounting rules or framework, such as Accounting Standards for Private Enterprises (ASPE) or International Financial Reporting Standards (IFRS). Since limited work to determine accuracy is performed by the external accountant and no assurance is given, fees for preparation of Notice to Reader financial statements are the lowest compared to the other two options.

When it makes sense for Notice to Reader financial statements:

- No external users
- Typically needed for tax compliance filing
- Desire to keep costs low
- No assurance required on balances reported

Review Engagement Financial Statements

The second type of financial statements provides users with limited assurance that nothing has come to the attention of the external accountant that causes them to believe that the financial statements do not present fairly, in all material respects, the financial position and results of the corporation. The external accountant is able to provide this limited assurance conclusion as the work they perform is more involved than when preparing Notice to Reader financial statements. This includes applying analytical procedures on reported balances and making inquiries of management and others within the entity to corroborate the reported balances. Generally, Review Engagement financial statements are prepared when there will be external users relying on the financial statements. This may be in situations where the corporation has moderate external financing and must report to the lender to ensure any financial covenants of the lending agreement are met. Review Engagement financial statements may also be requested by non-active shareholders to help give them some comfort on the results being reported by management. Unlike Notice to Reader financial statements, Review Engagement financial statements must follow an agreed upon accounting framework, such as ASPE, and will include additional disclosures not typically found in Notice to Reader financial statements. These disclosures give information to the users of the statements and allow them to further assess the reported balances. Additional disclosures would include a Statement of Cash Flows as well as Notes to the Financial Statements. The additional procedures performed by the external accountant along with the additional financial statement disclosures makes a Review Engagement financial statement a more expensive option than a Notice to Reader.

When it makes sense for Review Engagement Financial Statements:

- Statements to be distributed to external users
- Typically required with moderate debt levels
- Non-active shareholders
- Limited assurance on reported balances desired

Audited Financial Statements

An Audited Financial Statement provides users with an opinion that the financial statements present fairly, in all material respects, the financial position and results of the corporation for the period being reported on. In addition to the analytical procedures and inquiries of management performed in a Review Engagement, the external accountant plans and designs audit procedures to test areas where risks of material misstatements specific to the corporation and its industry are significant. Examples of these procedures would include physically inspecting assets and confirming reported balances with third-parties. The auditor also considers the design and implementation of the corporation's internal controls in order to design audit procedures that are appropriate in the circumstances. Similar to Review Engagement Statements, Audited Financial Statements must follow a specific accounting framework. Due to the extensive work required to give an audit opinion, the fees for Audited Financial Statements are the highest of the three options. Generally, owner-managed corporations do not require Audited Financial Statements unless requested by their lender.

When it makes sense for Audited Financial Statements:

- Statements to be distributed to external users
- Typically required with higher external debt levels
- Non-active shareholders
- Required by law or regulation

Determining the appropriate type of financial statement you need in any given year will depend on your specific circumstances. We recommend discussing this with your external accountant as early as possible to ensure appropriate planning steps are taken at/around your corporation's year end date to allow for a cost-effective financial statement preparation process.

Article written by: **Jeff McLean**, CPA, CA

Structuring Options for Foreign Corporations Doing Business in Canada

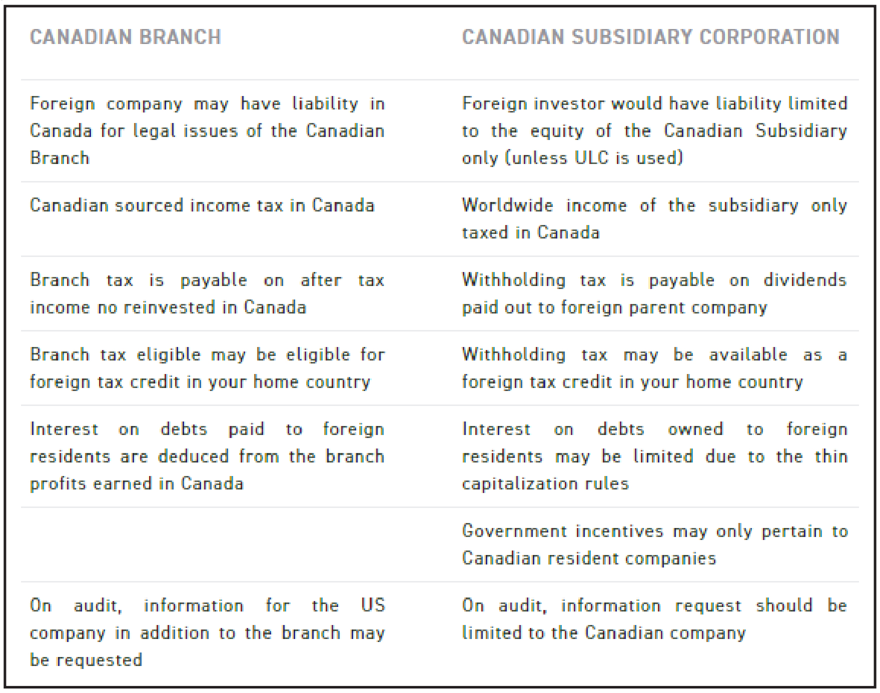
If your company is looking to expand into Canada, there are options as to how you go about structuring your business. The two most common structures are to operate in Canada via a branch or to incorporate a Canadian subsidiary.

There are many considerations to consider when deciding on how to enter the Canadian market, such as legal liability, tax rates, governments access to information upon audit, and ability to access government programs that should factor into your decision.

A branch is not a separate legal entity, but is an extension under an already existing company operating in another jurisdiction. As a result, if you are choosing to operate as a branch in Canada, it would subject the US company to Canadian liability. In addition to this, your company will be subject to filing what can be a complex branch tax return in Canada and will require separate financial statements for said branch to be created.

There are various types of corporations available in Canada, which we will explore in a future post. In Canada, you will have the option of incorporating Federally or Provincially. If you plan on operating in only one province, a provincial company may make the most sense. Certain provinces such as Alberta, Nova Scotia and British Columbia allow for an unlimited liability corporation; which is a common entity for US companies investing into Canada. In addition, only certain provinces allow for all Directors of a corporation to be non-residents of Canada.

Below is a summary of some of the differences between using a branch versus a corporation in Canada:



CANADIAN BRANCH	CANADIAN SUBSIDIARY CORPORATION
Foreign company may have liability in Canada for legal issues of the Canadian Branch	Foreign investor would have liability limited to the equity of the Canadian Subsidiary only (unless ULC is used)
Canadian sourced income tax in Canada	Worldwide income of the subsidiary only taxed in Canada
Branch tax is payable on after tax income no reinvested in Canada	Withholding tax is payable on dividends paid out to foreign parent company
Branch tax eligible may be eligible for foreign tax credit in your home country	Withholding tax may be available as a foreign tax credit in your home country
Interest on debts paid to foreign residents are deduced from the branch profits earned in Canada	Interest on debts owned to foreign residents may be limited due to the thin capitalization rules
	Government incentives may only pertain to Canadian resident companies
On audit, information for the US company in addition to the branch may be requested	On audit, information request should be limited to the Canadian company

Overall, it is relatively straightforward to establish a business in Canada, but their may be unique tax implications beyond the scope of this article. For that reason, we suggest you contact an accounting professional for individual advice.

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Association and HST

In the tax world, association can have a significant impact on your income taxes, but it can also impact your GST/HST as well. When it comes to having to register for GST/HST, the small supplier threshold of $30,000 (or $50,000 for public service bodies) applies to a company and its associates. Association is defined in section 127 of the Excise Tax Act (ETA) and subsections 256 (1) to (6) of the Income Tax Act (ITA). The rules of association for ITA purposes can be found at: http://laws-lois.justice.gc.ca/eng/acts/I-3.3/section-256.html

When it comes to association and GST/HST, a common error is not factoring in all of the taxable sales of all associated parties when looking at the small supplier test. Unlike the ITA definition of association, which applies to corporations only, the ETA extends this definition to apply to other persons (such as individuals). It is common for an individual who controls a corporation to charge management fees or commercial rent to their corporation. Assuming the corporation they control is not a small supplier, due to the association rules, these fees would be taxable for GST/HST. Having the individual registered and charging for these services is often overlooked on the incorrect assumption they are not taxable if under $30,000 of taxable supplies. Please note the appropriateness and income tax consequences of such management fees are beyond the scope of this article.

It should also be noted that, as a trust and a partnership is a person for GST/HST purposes, they should also be factored into association with any corporations with common ownership.

If you have a corporate group with transactions amongst all of the entities and shareholders, it would be prudent to have a GST/HST review done to ensure that all taxes are being charged appropriately.

Article written by: **Greg M. Sawatsky,** MAcc, CPA, CA

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