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FOREIGN REPORTING: A COSTLY OVERSIGHT

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Tax authorities have developed various means of verifying international structures. More specifically, these compliance tools take the form of information returns which target operations involving non-residents and foreign property held by certain Canadian taxpayers.

Although the requirement to file these returns has been in existence for many years, taxpayers and sometimes their advisers seem to be unaware of them. However, the applicable penalties for failing to file these returns may be significant. We therefore propose a quick overview of these returns.

T1135 Foreign Income Verification Statement

Form T1135 must be filed by taxpayers who hold foreign property, the total cost of which exceeds one hundred thousand dollars ($100,000) at any time during their fiscal year. If such foreign property is composed of shares of foreign affiliates, taxpayers must rather file form T1134.

T1134-A Information Return Relating to Foreign Affiliates that Are Not Controlled Foreign Affiliates and T1134-B Information Return Relating to Controlled Foreign Affiliates

Taxpayers who hold an interest in a foreign affiliate or a controlled foreign affililiate must file either form T1134-A or T1134-B, according to the case.

A foreign affiliate of a taxpayer is a non-resident corporation in which the taxpayer's equity percentage is not less than 1% and the total of the equity percentage in the corporation of the taxpayer and that of each person related to the taxpayer is not less than 10%.

Very briefly, a controlled foreign affiliate is a non-resident corporation in which the taxpayer holds not less than 50% of the voting stock.

T1141 Information Return in Respect of Transfers or Loans to a Non-Resident Trust

Form T1141 must be filed by taxpayers who transferred or loaned property to a specified foreign trust. Briefly, a specified foreign trust is a non-resident trust with at least one beneficiary who is a Canadian resident.

T1142 Information Return in Respect of Distributions from and Indebtedness to a Non-Resident Trust

This form must be filed by taxpayers who are beneficiaries of a foreign trust and who, at any time during their fiscal year, received property from the trust as part of a distribution or who are indebted to such trust.

T106 Information Return of Non-Arm's Length Transactions with Non-Residents

Form T106 must be filed by taxpayers who enter into transactions, the value of which exceeds one million dollars ($1,000,000) during the course of any fiscal year, with non-residents with whom they do not deal at arm's length. ▸

(*SUITE*)

Beware of the penalties!

The filing deadline for these returns is generally the same date the tax return of the taxpayer is due for the fiscal year, except for form T1135, which must be filed no later than fifteen months from the end of the fiscal year. Failure to file the information returns mentioned above may result in the following penalties being imposed:

- $25 per day of delay up to a maximum of $2,500;
- $500 per month of delay up to $12,000 (application criteria: knowingly omitted or omitted in circumstances amounting to gross negligence);
- if the delay exceeds 24 months, a penalty of 5% of the cost of the foreign property, of the fair market value of the property transferred or loaned, according to the case (same criteria).

In cases where returns were not filed, an application may be made under the Voluntary Disclosures Program. Using this procedure allows the taxpayer to avoid the payment of penalties. However, such a course of action is not available when tax authorities have already undertaken an audit of the taxpayer at fault. ◂

THE *ACT RESPECTING THE LEGAL PUBLICITY OF ENTERPRISES* AND LIMITED PARTNERSHIPS: WE WIN, WE LOSE... MAYBE!

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The new *Act respecting the legal publicity of enterprises* (the « **new Act** »), which came into force on February 14, 2011, imposes new requirements to limited partnerships as to the information that they are expected to disclose to the enterprise registrar.

Indeed, under the regime of the *Act respecting the legal publicity of sole proprietorships, partnerships and legal persons* (the "**former Act**"), the provisions governing the declaration of registration of a limited partnership provided that only the names of the special partners "known at the time the contract is entered into" were required to be named. The former act did not allow for updating the names of the special partners as they appeared in the initial declaration of registration. Thus, when a special partner was added or replaced, it was not possible to modify the information in the registry to reflect the new reality of the limited partnership. In fact, the enterprise registrar was refusing to process declarations which disclosed a change of special partners!

Under articles 2190 and 2239 of the *Civil Code of Québec*, the general partner was required to keep an uptodate register containing the list of the special partners and information concerning their contributions. Following their enactment, these articles were interpreted in such a way as to allow the special partners to access this register. However, the public only had access to the information disclosed to the registrar at the time the limited partnership was registered.

With the new Act, limited partnerships must, as it was already the case for legal persons, update their information contained in the enterprise register when a change occurs respecting the information which the limited partnership is required to disclose under the new Act. As the names and domiciles of the main special partners form part of this information, an update must henceforth be made in the month following the replacement or addition of a special partner.

Article 2190 of the *Civil Code of Québec*, which was allowing special partners to access the internal register which the limited partnership was required to keep, was repealed simultaneously with the coming into force of the new Act, however, article 2239, which provided for the existence of this register is maintained.

The public therefore has easy access to the information concerning the identity and coordinates of the main special partners of a limited partnership registered in Québec, which was not the case under the former Act since the information was not updated or could simply not be accessed. In order to make up for the disappearance of article 2190 of the *Civil Code of Québec* and ensure the exercise of their right to consult the special partners register, special partners would henceforth be well-advised to see that their partnership contract specifically sets out the right to consult the register. ◂

WHAT SHOULD YOU DO WHEN TAX AUTHORITIES PAY A VISIT TO YOUR CLIENT?

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Tax authorities have intensified their audit measures in the past few years and perfected their methods for doing so. Examples include wealth indicators and data linkage of available information from the Land Register and the Société de l'assurance automobile du Québec. As a result, should one of your clients fail to declare income allowing him to justify the purchase of the property he owns, it is increasingly likely that a Revenu Québec auditor will review his tax returns.

When an audit is contemplated, the auditor contacts directly the taxpayer to inform him that he is the subject of an audit and schedule a meeting at the taxpayer's place of business. Obviously, the taxpayer should rely on his adviser to control the audit process. Revenu Québec auditors must have an audit plan and provide copies of it to the taxpayer or his adviser upon request. Obtaining this information allows the taxpayer and his adviser to steer the auditor in the right direction and respond to his requests more expeditiously.

If the audit revealed irregularities in the tax returns, the auditor provides the taxpayer and his adviser with a proposed tax assessment. At this stage, it is possible to make additional submissions and even a settlement proposal to reduce the amount of the proposed assessment. In this respect, each file is unique and must be dealt with according to its own specific facts. After submissions are made to him, the auditor may issue a new notice of assessment and the taxpayer then has 90 days from the date it is issued to file a notice of objection.

The auditor may also transfer the file to the "special investigations" ("**Investigations**") division if the extent of the irregularities discovered during the audit warrant it. As soon as the file is transferred to Investigations, the auditor may no longer contact the taxpayer or his adviser without informing them that the taxpayer under investigation. In fact, since the charges which may stem from the investigation are penal in nature, any employee of Revenu Québec who asks questions to the taxpayer in this context must inform the taxpayer that he is under investigation and has the right to remain silent and to be represented by a lawyer.

Revenu Québec may also decide to conduct a search at the taxpayer's place of business, at his home or his adviser's premises for the purpose of obtaining additional documents. Unlike when performing an audit, Revenu Québec does not notify the taxpayer prior to conducting the search. When conducting a search, Revenu Québec agents are required to exhibit a search warrant, which should state the date, the location where the search is to be conducted, the charges against the taxpayer and the documents or things sought. It is important not to impede the work of Revenu Québec agents as such a course of action may result in legal charges. We suggest that you take notes detailing the actions of the agents as well as anything you might deem relevant. These notes may prove to be very useful later on to contest the way in which the search was conducted.

Although we do not broach the subject in this bulletin, it is to be noted that specific rules apply to a search conducted on law firm premises.

It goes without saying that the taxpayer is entitled to be represented by legal counsel when a search is conducted and we strongly recommend that he be so represented. It is possible to have a seizure by tax authorities quashed, which our firm recently managed to achieve. In this matter, the effective intervention of our tax experts not only resulted in the seizures being set aside, the files, both civil and penal, were closed without any notice of assessment being issued to the taxpayer. ◂

BEWARE OF HYBRID SALES TRANSACTIONS INVOLVING ASSETS AND SHARES!

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When a business operated through a corporation is sold, the transaction between the seller and the purchaser may involve the transfer of the corporation's shares, the sale by the operating corporation of the assets which are necessary to operate the business or both a transfer of shares and assets. Tax authorities have contested certain transfers of shares and assets on the ground that they resulted in a situation of surplus stripping covered under the General Anti-Avoidance Rule ("**GAAR**") and expressed the view that the capital gain generated by the sale of the shares should rather be treated as a dividend.

In the Geransky case[1], the Lafarge corporation wished to acquire assets of a cement factory belonging to a corporation ("**GBC**") held by the Geransky brothers through a holding corporation ("**GH**").

The transaction had been planned in such a way as to have the Lafarge corporation acquiring part of the assets and shares, thus allowing the Geransky brothers to claim the capital gain exemption. The Tax Court of Canada concluded that the transactions entered into as part of the transfer of the business did not constitute avoidance transactions because they may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit and that they did not result in an abuse in the application of tax provisions. However, we must note that in this case, the funds distributed to the Geransky brothers came from the purchaser, the Lafarge corporation, and not from the GBC or GH corporations.

Following this judgment, federal tax authorities have suggested that they will continue to apply the GAAR in situations of surplus stripping other than those identical to that of the Geransky case[2]. They distinguish between situations where the funds received by the taxpayer who benefits from the capital gain exemption are paid by the purchaser from those where they originate from one of the corporations held by the taxpayer. As an example, it would appear that tax authorities may question a transaction pursuant to which the seller sells shares of a corporation to a joint shareholder if the purchaser pays the purchase price of the shares with the surplus of that corporation[3].

In short, when the parties in a transaction for the transfer of a business anticipate carrying out a hybrid transaction involving the sale of assets and shares they would be well-advised to carefully structure it with their tax advisers in order to limit the risk of tax authorities contesting it. ◂

1 *Geransky v. R.*, 2001 CarswellNat 272, [2001] 2 C.T.C. 2147, 2001 D.T.C. 243.

2 CRA Views, Tech Interp (external) 2002-0156695 – *GAAR surplus stripping post-Geransky*, October 2002.

3 CRA Views, Conference 2004-0086771C6 – *Surplus stripping*, October 2004.

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