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OFFSHORE BANKING AND THE CRA: POLITICS AND THE VOLUNTARY DISCLOSURE PROGRAM (PART II)

David H. Sohmer

Editor's note: This is the second of a two-part article, the first of which appeared in our immediately preceding issue.

In a June 2010 speech to the Society of Trust & Estate Practitioners, Kevin Pratt, Director, Policy, Planning and Disclosure Division of the CRA said that the CRA would issue clarification of VDP procedures and policies in the coming weeks. "Our objective is to have a process that will be consistent across the country, so whether you make a disclosure in Saint John, New Brunswick, or Vancouver, you get equal and fair treatment."¹ Shortly after Mr. Pratt made the statement there were leaks from the CRA to the effect that the VDP policy would provide for taxation of income earned in the 10-year period preceding the year

¹ It should be noted that in her 2004 November Report, the Auditor General recommended that the CRA "implement its February 2004 action plan, with particular emphasis on aspects designed to ensure that the program is administered consistently across the country". The CRA agreed with the recommendation and stated that it has started "implementing the February 2004 action plan that will address consistency issues".

of disclosure with penalty relief but no relief for interest. The tax community waited with bated breath for the CRA to issue the official clarification. At the October 2010 Annual Conference of the Association de Planification Fiscale et Financière, Mr. Pratt delivered an address entitled "Les modifications au programme de divulgation volontaire". Unfortunately, Mr. Pratt simply stated that there would be no change in procedure and policies, and that income would be taxed for all years for which there were business records.

Of particular concern is the fact that the CRA and the Ministry of Revenue of Quebec ("MRQ") have not attempted to harmonize their positions with respect to voluntary disclosures. The MRQ has indicated that it will not abandon its approach pursuant to which capital at the beginning of the 10th year will be treated as if it was earned in the

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10th year.² The fact that there is no statutory authority for taxing income in one year where that income was earned in a different year is not regarded as an obstacle by the MRQ. Taxpayers disclosing to both the CRA and the MRQ may, accordingly, pay less tax federally than they will to Quebec. This will, no doubt, make the CRA vulnerable to attack by the media and the political opposition. It will also encourage Quebec residents to consider other options.

The only explanation for Mr. Pratt having replaced clarification with obfuscation is that political considerations required a policy with more wiggle room. The approach of the CRA should be contrasted with the American settlement initiative introduced by IRS Commissioner Doug Shulman on March 26, 2009:

2 The MRQ has informally indicated that as of November 8, 2010, it will only require records for six years. In some cases, the MRQ may agree to assess in a later year in order to reduce interest charges. Taxing opening capital appears to have been a reaction by the MRQ to a unilateral change in VDP policy by the CRA effective January 1, 2009. Prior to then, there was an informal policy that each jurisdiction would assess total tax and interest of approximately 19 percent of the closing capital (and six years of withdrawals where applicable). The increase by Quebec to 24 percent from 19 percent appears to have been a visceral response to the unilateral change of policy by the CRA.

My goal has always been clear – to get those taxpayers hiding assets offshore back into the system. We recently provided guidance to our examination personnel who are addressing voluntary disclosure requests involving unreported offshore income. We believe the guidance represents a firm but fair resolution of these cases and will provide consistent treatment for taxpayers. The goal is to have a predictable set of outcomes to encourage people to come forward and take advantage of our voluntary disclosure practice while they still can.

The IRS settlement initiative has been described as ranking “in the upper tier of tax compliance successes ever implemented”.³ If Canada is to follow the American lead, the voluntary disclosure program must meet the following criteria:⁴

- 1) It must provide for a predictable set of outcomes.
- 2) It must find a balance between what taxpayers are willing to pay and what should be paid to be fair to compliant taxpayers.
- 3) It must be based on a sound legislative foundation.

The American experience indicates that as long as the politicians and the media sheath their swords, the first two criteria are easy to meet. Meeting the third is the challenge.

The CRA maintains that the legislative authority for the voluntary disclosure program is [subsection 220\(3.1\)](#) of the *Income Tax Act* which permits the Minister to waive all or a portion of penalties and interest for the 10-year period preceding the year in which relief is requested. The May 1991 Technical Notes with respect to [subsection 220\(3.1\)](#) indicate

3 Mark E. Matthews and Scott D. Michel, “IRS’s Voluntary Disclosure Program for Offshore Accounts: A Critical Assessment After One Year.” Source: Daily Tax Report: News Archive > 2010 > September > 09/21/2010 > BNA Insights > Tax Evasion: IRS’s Voluntary Disclosure Program for Offshore Accounts: A Critical Assessment after one year.

4 In its September 2010 publication “Offshore Voluntary Disclosure, Comparative Analysis, Guidance and Policy Advice”, the OECD states that a successful program:

- (a) Will be clear about its aims and its terms;
- (b) Will have a demonstrable and cost-effective increase in short-term revenues;
- (c) Will be consistent with the generally applicable compliance and enforcement regime;
- (d) Needs specifically to improve levels of compliance among the population eligible for the program;
- (e) Will place the short-term boost to revenues in the context of improving compliance across the taxpayer population as a whole by complementing it with measures that improve compliance in the medium term.

See <http://www.oecd.org/dataoecd/38/50/46022680.pdf>.

that the legislative purpose was to grant relief to taxpayers in cases of “extraordinary circumstances beyond their control ...”.⁵ Failing to report income relating to an offshore account is rarely attributable to extraordinary circumstances beyond the taxpayer’s control. Put bluntly, it is arguable that by granting relief to tax evaders, the Minister acts illegally.

The key to resolving this dilemma without legislation may be found in the following statement by the Supreme Court in *Canada Trustco Mortgage Co. v. R.*:

When the words of a provision are precise and unequivocal, the ordinary meaning of the words play a dominant role.⁶

Since the Act is silent on the criteria to be used in exercising the discretion conferred under the subsection, a textual interpretation would remove the restrictions. As long as procedural fairness is exercised, the Minister would be authorized to grant relief as part of the voluntary disclosure program. The CRA could announce that it has concluded that the “words are precise and unequivocal” and that the Supreme Court decisions in *Shell Canada Ltd. v. R.*⁷ and *Canada Trustco* require clear words to trump “an unexpressed legislative intention”.

Subsection 152(4) ITA provides that the Minister may at any time make a reassessment if the taxpayer has made any misrepresentation that is attributable to neglect, carelessness or willful default or has committed any fraud in filing a return. While this provides the Minister with the legislative authority to tax only years for which business records exist, the policy encourages taxpayers to destroy or lie about the existence of such records. Even a “don’t ask, don’t tell” policy with respect to older business records is inconsistent

with a program that should encourage honesty. Rather than taxing years for which business records exist, the policy should be to tax years for which business records must be retained.⁸

There is no legislative authority for taxing income in one year where that income was earned in another year. A “don’t ask, don’t tell policy” whereby the Minister assumes that opening capital in the 10th year was earned in that year in order to permit the waiver of interest and penalties is also inconsistent with a program that should encourage honesty. Only amounts that properly belong to the years being assessed should be included as adjustments for those years.⁹

Matthews and Michel, observing that the U.S. settlement initiative is foundering in the audit and review phase, make the following comments which indicate what the impact will be of a failure by the CRA and the MRQ to clarify and harmonize their programs:

Ethically obligated to advise clients of their various options to deal with a previously undeclared account, many practitioners find that when they explain what is happening to participants in the OVDI (i.e. the offshore voluntary disclosure initiative), particularly in the penalty context, recent potential clients are opting not to come forward, with many walking out of law and accounting offices to mull over their other options.

In transitioning these cases to the civil side, IRS may be snatching defeat from the stunning set of results obtained last year, potentially burdening the IRS for a generation to come with a sense of uncertainty, if not distrust, from the community of tax practitioners who operate as the initial gatekeepers to clients that are seeking a way out of a tough situation.

5 The legislative intention reflected in the Technical Notes resulted in the refusal to grant relief in situations such as those described in the decision of *Case v. Canada (Attorney General)*, [2004] 4 C.T.C. 71 (F.C.) in which the following explanation of the refusal is contained: “The documentation you provided from your doctor verified that you were under her care from August 15, 2000 to August 16, 2001 for treatment and therapy of emotional distress. While we acknowledge your medical condition and the difficulties associated with it, the letter you submitted from your doctor dated March 7, 2003 still does not explain how this condition affected your ability to comply with your tax obligations.”

6 [2005] 2 S.C.R. 601 at para. 10.

7 [1999] 3 S.C.R. 622.

8 **Subsection 230(4)** and **Regulation 5800(1)** provide the limitation period for keeping records. Bank statements with respect to an individual who does not carry on a business must be retained for six years following the year to which the statements relate. In Switzerland every company listed in the Commercial Register is required by law to retain books and records for a period of 10 years (Article 962 of the Swiss Code of Obligations). This applies to transactions in bank and brokerage accounts. Because records for 10 years are readily provided by Swiss banks, there is a basis for taxing 10 years of income related to such accounts. Section 3.3.6 of the Voluntary Disclosure Program Guidelines, 2008-06 states:

“In order to assess years beyond the statutory record-keeping period, the CRA must have enough information to justify its assessment, which may mean relying heavily on what the taxpayer provides with the disclosure.”

9 See Section 3.3.5.4 of the Voluntary Disclosure Program Guidelines.

More important, if the situation is not remedied, the service may do lasting damage to an important component of its tax compliance function, the decades old voluntary disclosure policy (VDP).¹⁰

A successful voluntary disclosure program can dramatically increase short-term revenues and significantly improve the level of compliance by taxpayers who are hiding assets offshore. While tax evaders should not be candidates for sainthood, neither should politicians who undermine the program for political gain.

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¹⁰ *Supra*, note 2.

TAXPAYERS LOSE CUTS AS CAMPBELL LOSES GRIP

It now appears that the twin decisions by Premier Gordon Campbell of British Columbia to resign but also to hold on until a leadership convention is held has produced political chaos in British Columbia. He has lost control of his cabinet and likely the caucus who seem to be panicked about the hostile reaction of voters to the recent performance of the government. Potential strong candidates for Campbell's job are thin on the ground because of the almost certain ultimate defeat of the Liberals (as perceived now) and so far attempts to recruit a leader from outside the Legislature who is not personally tainted by the HST introduction don't seem to be going anywhere.

Given that the tax cut announced by Campbell in late October¹ seems to have had no impact on public opinion, it is perhaps not surprising that the rebellious cabinet cancelled the move. In a November 17th press release, Campbell was effectively forced to eat crow:

In order to ensure the Executive Council has maximum flexibility to set government's economic and fiscal agenda,

¹ See page 181 of this volume of *The Canadian Taxpayer*.

Cabinet has decided to suspend the planned tax reduction. The Cabinet has decided that during this period of transition it is important that decisions are not made that would unnecessarily limit Executive Council's ability to set priorities and implement their agenda for government.

The 15-percent personal income tax rate reduction was subject to legislative approval and would have applied to earnings up to \$72,293. It was announced October 27 and would have taken effect January 1, 2011.

Executive Council also decided, in consultation with the B.C. government caucus, that the 2011 Speech from the Throne would proceed on February 14, 2011 and would be limited to outlining the transition period between February 14th and when a new premier is sworn in.

Executive Council also directed that the budget be tabled in accordance with statutory requirements on February 15, 2011. The budget will be a status quo budget, with no new initiatives beyond what is statutorily required.

A picture of the infighting also appeared when the cabinet meeting commenced with the firing Energy Minister Bill Bennett for suggesting Mr. Campbell needs to make way for an interim leader.

"It was absolutely a group decision by cabinet," Finance Minister Colin Hansen told reporters. "There was nobody in cabinet that disagreed with the request put to Bill that he leave."²

Bennett subsequently fired back with some hugely provocative comments about Campbell generally and his "management style". Two days later he was ousted from the Liberal caucus. There was immediate speculation that he might run for the Liberal leadership.

The political situation in B.C. mesmerises because it has become a paradigm of how things can go wrong when politicians (and presumably bureaucrats) decide that the best way to handle key policy initiatives is to bull ahead without warning or

² Interestingly in the speculation about a new leader, Hansen's name has been conspicuously absent...presumably because of his role in the HST fiasco.

consultation, confident in their power in a majority situation with a weak opposition.

We figure there will be a lot of interesting developments coming with recall petitions floating around, a leadership campaign, and what will be a desperate attempt to woo back voters during a year that will include a referendum on the HST in September – unless the new premier runs up a white flag of surrender.

TAXPAYERS' OMBUDSMAN EARNS HIS KEEP

First, a *mea culpa*.

When the office of the Taxpayers' Ombudsman was created a couple of years ago, we were both sceptical and cynical, viewing it as essentially a PR exercise which would have little practical use.

We began to hear contrary views from several lawyers for whom we have the greatest respect. So we decided to take another look at the office and the role of the Ombudsman,¹ J. Paul Dubé. And we have to admit that based on his reports and again positive comments from people we respect, our view has changed significantly.

For example, we looked at his most recent report, "The Right to Know".² The report has taken a very critical (and in our view, unbiased) look at some of the CRA's practices:

Taxpayers have complained that the CRA's Appeals Branch is being unfair in failing to give reasons for its decisions. The complaints we received from taxpayers suggested to us that the failure to provide reasons for decisions was a systemic issue worth examining since it could be having a negative effect on many other taxpayers.

This statement is followed by examples with a high degree of specificity with name changes to protect confidentiality:

1 <http://www.taxpayersrights.gc.ca/menu-eng.html>.

2 <http://www.taxpayersrights.gc.ca/rprts/rgh/rgh-eng.html>.

Our systemic review of the sufficiency of the information in appeal decision letters considered the following questions:

- When the CRA's Appeals Branch makes a decision that affects the interests and rights of a taxpayer, should it give that taxpayer written reasons for the decision?
- Is a refusal to give written reasons for such a decision inconsistent with a taxpayer's right to complete and timely information (Taxpayer Bill of Rights; Article 6)?
- Is a refusal to give written reasons for such a decision inconsistent with a taxpayer's right to expect the CRA to be accountable (Taxpayer Bill of Rights; Article 11)?
- Is requiring taxpayers to obtain such information through an Access to Information request inconsistent with a taxpayer's right to complete and timely information (Taxpayer Bill of Rights; Article 6)?

After a lengthy discussion which balances both the CRA's administrative requirements and taxpayer needs, the report says:

In light of the foregoing research and analysis, the Ombudsman makes the following recommendation:

Once the Appeals Branch has reviewed a taxpayer's objection or appeal and made a decision to confirm, vary, or reverse the CRA's original decision, it should provide the taxpayer with the reasons for its decision in writing. These reasons need not refer to every factor or conclusion in the process of reaching the decision, but should be sufficient, when read in context, to show why the Appeals Branch made the decision it did.

Providing reasons means providing basic information about the decision, including a description of the decision, the authority under which the decision was made, a description of the main steps in the decision-making process, and reference to the main factual basis for the decision.

We recommend that CRA either provide these reasons in the body of the decision letter to the taxpayer, or institute a policy that the Report on an Appeals or Summary Report is enclosed with every decision letter.

Immediately after the report was issued, Keith Ashfield, Minister of National Revenue, issued a press release.

As Minister for National Revenue, I accept the recommendation made by the Taxpayers' Ombudsman in his report released today: *The Right to Know*.

The recommendation made by the Ombudsman is fair and appropriate. I have already asked the Canada Revenue Agency to develop a plan of action and make the necessary changes in order to accommodate his recommendation.

The report isn't going to change the world unless those in authority at the CRA take steps to implement the recommendations. But we are more than happy to say that it seems that our earlier cynicism may well have been misplaced. We strongly suggest that practitioners who regularly deal with the CRA and find themselves frustrated read some of the material on the Web site and give serious consideration in the appropriate cases (see the "mandate" section of the site) to contacting the Ombudsman's office when all else fails when trying to deal with an obdurate tax bureaucrat.

LEVONIAN PROMOTED AT FINANCE

In mid-November, the Prime Minister announced some changes in personnel which include a few names well known in the tax community.

Stephen Richardson recently retired from the Public Service as Associate Deputy Minister of Finance and has been replaced by Louise Levonian. She has had a quick rise in the department, starting in 2007 as a special adviser in the Tax Policy Branch. She quickly became general director in the branch and in 2008 was Assistant Deputy Minister, Tax Policy.

She now becomes Associate Deputy Minister of Finance.

Two other people known to the tax community also were involved in the moves.

Steve Rigby, who was President of the Canada Border Services Agency, becomes National Security Advisor to the Prime Minister. Most readers will remember him from his tenure at Revenue Canada before the department was split.

Luc Portelance, currently Executive Vice-President of the Canada Border Services Agency, becomes President of the Canada Border Services Agency. His career background has always been in intelligence-related jobs.

All the moves were effective November 15.

EMPLOYMENT INSURANCE LIMITS SET

As we noted a few issues ago, Finance Minister Flaherty made a big to-do about announcing that EI rates going forward will be less than they might have been, thus avoiding charges that the government was bent on killing jobs.¹ For 2011, the employee rate is \$1.78 per \$100 of insurable earnings, with the employer paying another 1.4 times the employee payment.

The second part of the equation, the maximum contribution level, was announced in mid-November by the Canada Employment Insurance Commission which said that the Maximum Insurable Earnings (MIE) for 2011 will increase to \$44,200 from \$43,200.

The MIE is indexed on an annual basis and represents the ceiling up to which Employment Insurance premiums are collected. It is therefore also the maximum amount considered in applications for EI benefits.

The EI Commission is responsible for determining the annual MIE in accordance with the *Employment Insurance Act and Regulations*. The calculations for determining the 2011 MIE have been performed by the Chief Actuary at the request of the EI Commission.

¹ See page 161 of the current volume of *The Canadian Taxpayer*.

ONTARIO ECONOMIC STATEMENT OFFERS SOME RELIEF

Economic updates are usually limited to interim reporting on how a government's financial plan is developing between budgets. But more and more often they are being used to make significant tax or economic announcements which are supposed to cheer taxpayers until the next budget date.

This was the case in Ontario where Treasurer Dwight Duncan offered some pre-winter relief on

electricity prices which were rising so quickly that they threatened to become the Ontario version of B.C.'s HST imbroglio.

Duncan announced that Ontario will use a \$1-billion windfall from licensing its interest in an electronic land-registry system to reduce its massive debt even as it provides relief to hydro consumers. Electricity consumers, including residential and small business consumers, will receive a 10-percent rebate on their hydro bills. The rebate, which will be in place for five years beginning January 1, will reduce the average residential consumer's bill to \$115.20 a month. But, the good news was outweighed by his prediction that despite the subsidy, hydro costs will rise 46 percent over the next five years.

The rebate will cost the province \$1.1-billion a year when the program is fully implemented in fiscal 2011-12. Despite the added cost – aimed at neutralizing a growing backlash over soaring hydro rates in the lead up to next year's provincial election – Duncan said the government will reduce its borrowing by \$2 billion during the current fiscal year.

Duncan said earlier in the week that the deficit for this year will be \$18.7 billion, \$1 billion less than previously forecast. The rosier (in comparative terms only) outlook is due to a rebound in corporate tax revenues and spending constraints. The economy is growing, Mr. Duncan said.

The windfall money to pay for the electricity subsidy comes from a deal that the government has struck to extend the licence on Teranet Inc., the land registry, for another 50 years. Teranet's owner, Borealis Inc., an arm of giant pension-fund manager OMERS, will pay \$1 billion up front to the province.

Duncan said the Teranet deal will save the province \$50 million in annual interest costs and help the province borrow \$2 billion less.

The hydro rebate, known as the Ontario Clean Energy Benefit, will help more than four million residences and 400,000 small businesses. There is likely a large group of bureaucrats who do nothing but think up cutesy names for government programs where a spade is never called a spade.

Other key data from the statement include:

- The 2010-11 revenue outlook, at \$107.7 billion, is nearly \$800 million more than the 2010 Budget forecast, largely reflecting stronger economic growth in 2010.
- Total expense in 2010-11 is currently projected to be \$125.6 billion – 0.2 per cent lower than the 2010 Budget forecast, due to a lower interest on debt expense projection. This is consistent with the government's approach to controlling the rate of growth in spending while protecting core public services.
- Plan to achieve balance by FY 17-18 appears on track. Medium-term revenue and expenditure outlooks are largely unchanged.
- Real GDP forecasts downgraded to 2.2% and 2.5% in 2011 and 2012 respectively. However, these are 0.3-0.6 percentage points more optimistic than our internal projections.
- Tabled proposed legislation to allow the Ontario Securities Commission to develop a regulatory framework for over-the-counter derivatives' trading.
- In 2010-11, the estimated cost of the proposed OCEB is \$300 million, with an estimated full-year cost of \$1.1 billion next year. These costs are accommodated within the fiscal plan as a result of the government's prudent approach to managing its finances.

The next provincial election is in October, 2011 with a budget of course due in the spring.

FILING PARTNERSHIP RETURNS

A lot of partners are probably unaware of the fact that there is a requirement to file partnership information returns. Of course, a partnership is not a taxable entity and it is the partners rather than the partnership who file income tax returns and pay tax.

But in 1989, a regulation was added to the *Income Tax Regulations* that requires all Canadian partnerships to file an annual information return. Since that time, the CRA has provided, under certain conditions, an exemption from the filing requirement for partnerships with fewer than six partners.

Now, in the light of how the Canadian economy and business landscape have evolved over the last 20 years, the CRA has reviewed the conditions for a partnership filing exemption. The CRA's review showed that the amount of both business activity and assets held by a partnership, as well as the

complexity of a partnership's structure, are of more significance than the number of partners.

As a result, as of January 1, 2011, new filing criteria for the partnership information return will come into effect. The new filing criteria will apply to partnerships with fiscal periods ending on or after January 1, 2011. For partnerships with fiscal periods ending on or before December 31, 2010, the current criteria still apply.

Legislation has always required all partnerships to file partnership information returns. To ease the burden on filers, the CRA developed an administrative policy that draws boundaries on those partnerships that have to file and those that do not have to file. Therefore, the changes to the filing criteria are administrative only. There will be no changes to the legislation.

Interpretation Bulletin [IT-90](#), *What is a Partnership?* defines a partnership as the relation that exists between persons carrying on business in common with a view to profit. Taxpayers can determine whether they are a partner in a partnership by examining the type and extent of their involvement in the business and checking the laws of their province or territory. A partnership can be formed between individuals, corporations, trusts, or other partnerships, in any combination. Partnerships can be formed verbally or by a written contract.

The CRA is replacing the requirement about the number of partners in a partnership with a requirement related to financial thresholds, and clarifying the requirements for the types of partners:

Effective January 1, 2011, a partnership that carries on a business in Canada, or a Canadian partnership with Canadian or foreign operations or investments, has to file a T5013 for each fiscal period of the partnership:

- If, at the end of the fiscal period,
 - the partnership has an absolute value of revenues plus an absolute value of expenses of more than \$2 million, or has more than \$5 million in assets; or
- If, at anytime during the fiscal period,
 - the partnership is a tiered partnership (has another partnership as a partner or is itself a partner in another partnership);

- the partnership has a corporation or a trust as a partner;
- the partnership invested in flow-through shares of a principal-business corporation that incurred Canadian resource expenses and renounced those expenses to the partnership; or
- the Minister of National Revenue requests one in writing.

The absolute value of a number refers to the numerical value of the number without regard to its positive or negative sign. For example, "3" is the absolute value of both 3 (positive 3) and -3 (negative 3). To determine if a partnership exceeds the \$2 million threshold, add total expenses to total revenues rather than subtract expenses from revenues as you would to determine net income. For example, a partnership with revenues of \$1.5 million and expenses of \$1.25 million would have an absolute value of revenues plus an absolute value of expenses of \$2.75 million (\$1.5 million plus \$1.25 million).

The revenues and expenses details come from the financial statement amounts. "Revenues" refers to revenues that have not been netted. For example, you would not use gross profit to represent "revenues" since gross profit is revenues minus the cost of goods sold. Expenses include both current costs and capital costs (e.g. depreciation). Revenues from all sources (revenues that have not been netted) are added to the total of all expenses (expenses are expressed as a positive number), and the total is used to determine whether or not the criterion has been met.

The cost figure of all assets, both tangible and intangible, without taking into account the depreciated amount should be used to determine whether a partnership meets the "more than \$5 million in assets" criterion.

The return is currently being updated for the 2011 tax year and will be available at a later date. Go to www.cra.gc.ca/partnership when it is time to get ready to file the 2011 partnership information return for information about the forms you will need to file.

HOLIDAY WISHES

This is the final issue of our 32nd volume (how time flies!) and as usual we want to take this opportunity to wish all our readers the very best for the holidays and of course our hopes for a happy and prosperous (pending the next budget) New Year.