Everyone's guide to tax shelters

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Paying taxes is kind of like buying gas for your car. No matter how hard you look for the best deal, you always have a nagging feeling that somewhere someone else is paying less than you. Certainly that's the sensation I had when my friend Dave told me, with no little amount of pride, that he'd pulled one over on the taxman. "Guess what? I finally got my own tax shelter," Dave crowed last spring. "I made a donation of $7,500 to some charity and got a tax receipt for $30,000. What do you think about that?"

What did I think about that? How about: "Who left me off the invite list for the tax avoidance party?"

Most Canadians regard avoiding taxes as something between a duty and an obsession. Certainly I don't want to be paying any more than I absolutely have to. Paying nothing at all sounds even better to me. But is getting out of your taxes really as easy as Dave made it seem? And if so, why isn't everybody doing it?

One of the first people I talk to in search of an answer is Shy Kurtz, a tax-shelter promoter with Freedman, Kurtz & Kron Financial in Montreal. He stresses that he's not trying to peddle anything that's against the law. He draws a distinction between tax avoidance(where you take advantage of the rules to minimize your tax bill)and tax evasion(where you deliberately try to hide income or deceive the taxman). "Tax avoidance is perfectly legal," he says. "Tax evasion, on the other hand, is not."

There are two major strategies you can use to legally sidestep taxes. The first is to put your money into certain types of investments that government wants to encourage. Government deliberately equips these "tax-assisted investments" with generous tax breaks precisely because it wants to help them attract investors. The second way you can give the taxman the miss is to exploit loopholes in tax laws in order to earn outsized tax deductions. Manoeuvres like this are termed tax shelters. They're the work of sharp-eyed lawyers and accountants who spot unexpected ways to legally beat the system set up by legislators and bureaucrats.

While the two types of tax avoidance are quite different, they both involve risk. Consider, for instance, the sad history of MURBs — a bureaucratic designation for Multiple Unit Residential Buildings, or what most of us would call apartment buildings. Back in the 1970s, Ottawa decided to encourage investment in this sector by allowing investors in new apartment buildings to claim their annual depreciation against other income for tax purposes. Promoters quickly took advantage of that offer and constructed leveraged deals that allowed MURB investors to put down as little as 10% of their total investment while giving them an immediate tax break almost as big as their initial cash outlay.

All of which was fine until the real estate market crashed in the late 1980s, vacancy rates soared and a lot of clever taxpayers found they couldn't sell those lovely tax-assisted MURBs for love or money. The lesson? "The prospects of immediate tax savings blinded people to the economic reality of the underlying investment," says Robert Brown, former CEO of PriceWaterhouse Canada, former head of the Canadian Tax Foundation and a long-time observer of the tax planning industry. "Investors weren't thinking about the long-term implications."

That lesson went unheeded in the 1990s when investors flocked to Labour-Sponsored Investment Funds(LSIFs). These are essentially mutual funds that invest in small start-up firms. Investing in such businesses has always been notoriously risky, so federal and provincial governments decided to offer tax credits worth 30% or more of your initial investment to encourage as many investors as possible to take the plunge.

Unfortunately, most labour funds have turned out to be dogs. Even the 10 best funds with a minimum five-year track record have lost an average of 1.2% a year, according to the fund tracker Morningstar. Many LSIFs have done far worse. Adding misery to discontent, those who invest in labour funds have to hold these poorly performing investments for a minimum of eight years or pay back all the tax credits they have already claimed.

The dismal track records of MURBs and LSIFs demonstrate that no tax advantage can compensate for a fundamentally lousy investment. "Any investment you make should stand up on its own investment merits," says Adrian Mastracci, portfolio manager of KCM Wealth Management in Vancouver, a fee-only advisory service. "You should ask yourself: 'Would I want to own this without the tax goodies?' If not, you should move on." That brings us to tax shelters. While government approves of tax-assisted investing, it's no fan of tax shelters. These shelters are the work of tax planners who build their businesses on their ability to dream up clever shortcuts through the Income Tax Act. In doing so, they often incur the wrath of the Canada Revenue Agency, which wants to collect as much tax as it can and views fancy tax avoidance schemes with deep suspicion.

This battle of wits between the government's revenue agency and tax planners is something akin to the spy vs. spy clashes of the KGB and MI5 during the Cold War: a fascinating struggle between unseen foes who are constantly challenging the rules. To keep track of all the tax shelters in operation, the Canada Revenue Agency requires that promoters register with the government. Anyone claiming a shelter tax reduction must include an assigned tax shelter number on their tax returns.

Hard-working minds are constantly dreaming up new kinds of tax shelters. Something known as the "Little Egypt Bump" took advantage of depreciation charges during mergers and raised eyebrows at the federal Auditor-General's office as far back as 1986. Around the same time, other tax shelters packaged the tax credits that were doled out to encourage Canadian movie production and scientific research and resold them to investors looking for a break on their taxes. More recently "buy low, donate high" schemes bought art at low prices, then used questionable valuation techniques to donate it

to charity in return for a tax receipt based upon values as much as three times the original purchase price.

The advantage of tax shelters like these is that they can't wipe out your capital the way a tax-assisted investment can. On the other hand, you run the risk that the Canada Revenue Agency will decide your shelter runs afoul of the law and challenge it in tax court. In fact, all the above tax shelters — from the Little Egypt Bump to the film tax credit to the art flip — were shut down when the government took action to either clarify or change its laws. "The Canada Revenue Agency has become very aggressive about tax shelters, particularly those that have an underlying component of charitable donations," says David W. Chodikoff, a tax litigation specialist at law firm Goodman and Carr in Toronto.

If your tax shelter is successfully challenged by the Canada Revenue Agency, you can lose your deduction for that year. You may also face a penalty, depending upon your involvement in choosing the shelter. And that's not to mention the stress, says Chodikoff, who spent 15 years working for the federal government, trying to shut down questionable tax shelters, before entering private practice: "One of the biggest things I see, having been on both sides of the fence, is what I call the worry factor. It's not just about the dollars and cents saved on your taxes, but about your mental health. A long and difficult reassessment can take years off your life and you really have to ask yourself: 'Is it worth it?'" In shutting down the art flip shelters, for instance, the Canada Revenue Agency reassessed approximately 10,000 tax returns, creating massive headaches for the people who had taken advantage of those shelters.

So should you play the tax avoidance game? The answer depends upon how you define your terms. The most popular tax-avoidance tool is the humble Registered Retirement Savings Plan(RRSP). You should definitely take advantage of this tax dodge.

But tax avoidance doesn't end there. If you're a high-income earner who doesn't mind rolling the dice in search of some tax-assisted investing, you may want to consider investing in flow-through shares, which are issued by some oil, gas and mining companies. A flow-through share gives the investor, rather than the originating company, the right to claim various tax deductions.

Consider an oil and gas company that issues $1 million in flow-through shares. It commits to using that money exclusively for exploration expenses, which gives it the right to deduct that amount from its corporate taxes. However, rather than use the deduction itself, the company passes it along to people who buy the flow-through shares. The shareholders can then write off the entire amount against their taxes, usually in the first two years.

Sounds good, doesn't it? But there is a catch. Because the exploration company is giving up its right to the deductions, it tends to price its shares higher than a normal common share. This means the underlying investment can decline in value. For example, shares in the 2005 EnerVest Flow-Through Shares Limited Partnership, a mutual fund of flow-through shares popular with oil and gas investors, were sold to investors at $25 apiece. A

year later they are worth only $14, a loss which offsets much of the tax saving. Bottom line: before you invest in any flow-through stock, do your homework to ensure that you're buying a promising company as well as a promising tax write-off.

If you have the stomach for extreme tax avoidance, an innovation called gifted trust arrangements has replaced the nowbanned art flip deals as the tax shelter du jour. These shelters, such as the Donations for Canada program offered by ParkLane Financial of Burlington, Ont., use a mind-boggling series of trusts and sub-trusts and offshore firms located in exotic locales such as Bermuda to swell the original value of your donation. In 2005, its first full year of operation, the Donations for Canada program helped 6,000 taxpayers get $175 million in donation receipts.

It doesn't take a tax lawyer to spot the attraction. The essence of the deal is that ParkLane's parent company will quadruple the size of any charitable donation you make, thus boosting the size of your tax receipt. Depending on your province and tax bracket, a $1 donation can provide about $1.80 in tax credits.(This is how my friend Dave got his envy-inducing tax deduction.)

Yes, there are strings attached. To benefit from the donation, you select a charity — only a few are eligible — and that charity has to enter into a complex repayment agreement with ParkLane's parent company. The result is that for every $2,500 in cash you donate, the charity gets a much smaller amount deposited in a hedge fund account. Over the next 20 years it receives 80% of the monthly profits from this leveraged sum. ParkLane's parent company keeps the principal. While the program thus delivers less to charities, it could also give donors more than they bargained for.

"Certainly there are risks with our program," admits Ron Olsthoorn, president of ParkLane. The biggest risk, of course, is that the Canada Revenue Agency may decide it is too good to be true, as it did with the art flip deals, and challenge it in tax court. However, Olsthoorn argues his scheme is fully protected against any possible objections from the taxman. "Since we are dealing only with cash donations, there are no valuation problems with our program and nothing for the Canada Revenue Agency to challenge. We think we've built a better mousetrap here," he says. Just in case, Olsthoorn has set up a $500,000 legal defence fund that clients may access if the government does decide to test his plan in court.

While the revenue agency has not yet taken the Donations for Canada tax shelter to court, some tax experts expect it to be just a matter of time. Financial adviser Mastracci refuses to recommend the deal to his clients. "Anyone who puts their money into one of these charitable donation schemes is just asking CRA to put a red flag on their return," he says. Jacqueline Couture, a spokesperson for Canada Revenue Agency, suggests as much: "It is our position that the 2003 legislation [which was used to shut down the art-flip deals] will apply to all types of donation arrangements to limit the allowable donation to the amount of the donor's cash." Donations for Canada participants recently got a terse letter from the Canada Revenue Agency saying the program was being investigated. If the government acts on this stated position, Olsthoorn may soon get a chance to put his legal defence fund

to work. But for now, it is one of the more aggressive, and inventive, tax shelters available.

Despite the fact that a tax break would look pretty good on my next tax return, I'll be steering clear of anything racier than an RRSP. I'm the conservative type, I guess. But after talking to countless taxpayers, tax lawyers and tax planners, I've learned one thing. Even if the Canada Revenue Agency bulldozes the Donations for Canada gambit, another dodge will quickly take its place. Like Hockey Night in Canada or a Tim Hortons coffee, a tax shelter seems like one of life's necessities for many Canadians. Or as my friend Dave put it: "I pay plenty of taxes as it is. If I can find a way to legally save on them, I'll take it."

When less truly is more

Here are the key terms any tax-phobic Canadian needs to know.

Tax avoidance: this is the perfectly legal practice of trying to arrange your affairs so that you pay the least tax possible. Do you contribute to an RRSP? Then you're a tax avoider.