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TAX LETTER

September 2014

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TEN COMMON TAX MISTAKES

What are the most common areas where Canada Revenue Agency auditors find errors that they can assess?

Here are some of the most common tax problems or mistakes that people make, and for which tax assessments or reassessments may be issued. Watch out for them!

1. Meals and entertainment. If you are deducting expenses — whether for a corporation or for yourself if you are self-employed, or as deductible employment expenses where you're an employee — expenses for meals and entertainment are normally limited to **50%** of the amount you pay (although there are some exceptions). If you deduct the full amount of that restaurant meal, you're leaving yourself open for reassessment! Of course, if you cannot show that the restaurant meal was for a business purpose (or qualifies as an allowable employment expense), you will get no deduction at all, rather than 50%.

2. Shareholder appropriations and shareholder loans. If you **take money out of your company** without declaring a (taxable) dividend or paying yourself a (taxable) salary, you will normally be taxed on the value of what you have taken out—even if you just borrowed the money. This is a favourite target of auditors when auditing small owner-managed companies. There are a number of exceptions and ways to avoid the problem, but this can be a dangerous tax trap.

3. Income splitting attribution rules. If you lend or give money, investments or other property to your **spouse or child under 18**, income earned from that property (e.g., interest, dividends, rent) will be "attributed" back to you and taxed in your hands, rather than in the hands of your spouse or child. Note also that if you arrange for your child to get dividends from a corporation, then even if the attribution rules do not apply, the child may have to pay "kiddie tax" at the top marginal rate of tax, for which you may be jointly liable.

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4. GST or HST input tax credit documentation. If you carry on business, you can normally claim an "input tax credit" for all GST or HST that you pay in the course of the business, recovering this tax from the CRA (either deducting it against GST/HST you collect or, if you do not collect enough GST/HST, getting a refund). However, if you do not keep detailed **receipts** that include prescribed information (including the vendor's **GST number** and, in most cases, properly identifying you as the purchaser), your claims may be denied when the auditor comes calling. The same rules apply in Quebec for the Quebec Sales Tax (TVQ).

5. Automobile expenses. CRA auditors love to deny automobile expenses. If you are claiming business expenses or employment expenses for your car, make sure to keep a detailed **logbook** tracking the extent you use it for business or employment. (Driving from home to work doesn't count, unless your home is a place of business for you.) If you can't be bothered to keep a logbook, you run the risk of having your deductions for gas, car washes, oil changes, repairs and insurance denied or severely curtailed.

6. Director's liability. If you are a director of a corporation — anything from your own wholly-owned private corporation to a large public company — you may be on the hook if the company runs out of money. In particular, you can be assessed by the CRA for any unremitted **payroll deductions** (source withholdings for income tax, CPP contributions and EI premiums), and for any **GST, HST or TVQ** the company has failed to remit (or that the company received as a refund). Sometimes you can escape such an assessment via the "due diligence" defence, but this is uncertain and usually requires expensive legal representation. Make sure that any company you're a director of is always up to date in its source deduction and GST remittances! If you are at risk of being assessed, resign as soon as possible, and make sure your resignation is legally recorded. Once you resign, there is a two-year deadline beyond which the CRA cannot assess you as a director.

7. Spousal support. If you are paying support to an ex-spouse, make sure you are aware of the myriad rules and conditions that apply before the amounts you pay are deductible. Child support is not deductible, unless your arrangements predate May 1997 and have not been modified since then. For spousal support to be deductible to you (and taxable to your ex-spouse), it must normally be paid as an "allowance", with the recipient having discretion over its use, on a "periodic basis", pursuant to a Court Order or a written agreement.

8. Transfer of property by a tax debtor. If husband H owes money to the CRA (or Revenu Québec), whether for income tax, GST/HST or some other tax, and transfers his interest in the family home — or anything else including money — to his wife W, then the government can assess W for H's tax debt, up to the value of what was transferred (minus whatever W paid H for it). In most cases, transferring such property makes things worse, because the CRA or RQ can seize other assets from W for her new tax liability, not just the home or other property that was transferred. Another risk along the same lines: if H's bank account has been frozen by the CRA, so he endorses his paycheques over to friend F who puts them into F's bank account and immediately takes out the amount in cash and gives is to H, the CRA will assess F for the *total* deposits into F's account made this way.

9. Capital gain or income? The difference between a **capital gain** (only half taxed) and an income gain (**business profit**) is significant. If you buy property such as real estate, and then sell it down the road for a gain that you report as a capital gain, expect the auditor to examine carefully your intentions. If your primary or even secondary purpose in buying the property was to sell it rather than to earn income *from* it, then your gain may become a fully-taxed business income gain. If you have bought and sold several similar properties, the auditor is likely to treat your gain as income gain no matter what your reasonable explanation, and will likely assess you a 50% "gross negligence" penalty as well. The CRA has become very hard-line about this issue on sales of homes and condos.

10. House hoppers. If you're in the home-building business, and you like to move into the homes you build, watch out! You may think that you don't pay tax on the gain when you sell the home, but that's not always true. If you built the home to sell, then *even if* you live in it for a while, your **profit will be fully taxed** (just like #9 above), and you can't claim the principal-residence exemption, which applies only to *capital* gains, not business income gains. Second, you will likely be hit with a GST or HST assessment for GST or HST on the *full value* of the home including the land, which becomes payable as soon as you move into the property (or rent it out), under the **GST/HST "self-supply" rule**. The CRA vigorously pursues "house hoppers" and has had great success in the Courts. Claiming that you really intended to live in the house for a long time, and only sold it because of unexpected reasons, won't get you very far with the judge if you build homes for a living.

THE TAX COST OF LEAVING

(OR LOSING) YOUR JOB

What happens for tax purposes if you leave your job — voluntarily or by being terminated — and your employer gives you additional money?

Typically, you might receive one or both of the following kinds of payments:

(1) An **extension of your salary** during a period while you are still officially employed. For example, you might be given 3 months' notice of termination, and your salary and benefits continued during that period — whether or not you actually continue coming to the workplace.

(2) A **severance payment**. For example, you might get 12 months' salary. This might come in one of several ways:

- Your employer offers you an "early retirement" package which you accept.

- You are fired and accept an offer for a severance payment.

- You are fired and you do not accept your employer's offer. Instead, you consult a lawyer, who threatens to sue your employer for wrongful dismissal. Perhaps you even start a lawsuit. You eventually reach a settlement, with your lawyer's assistance.

- You actually take your former employer to court and get a court award of 12 months' salary for wrongful dismissal.

Payments of type (1) above, which continue your salary, are treated as regular employment income, and given the same tax treatment as your salary was before you were given notice. The same withholding at source applies as well — tax withholding that is approximately equal to the amount of tax you will have to pay on this income.

Payments of type (2) above — whether simply offered by the employer, paid to settle a wrongful-dismissal lawsuit, or awarded by a court — fall into the definition of what the *Income Tax Act* calls a "**retiring allowance**". This term also covers a payment genuinely made in recognition of long service when you retire.

A "retiring allowance" is taxable, and must be included in income on your tax return. So in some ways it may not matter whether you get a continuation of salary or a severance payment. However, there are a number of important differences between a "retiring allowance" and regular employment income:

- If you began your employment with this employer (or a related employer) before January 1, 1996, then part of the retiring allowance can be **transferred to your RRSP** instead of

being taxed this year. You can transfer up to $2,000 for each calendar year (or part of a year) during which you were employed with that employer (or a related employer) before 1996.

As well, if you were not a member of a pension plan or deferred profit sharing plan to which your rights have vested, you can add an additional $1,500 for each such year during which you were employed before 1989.

If the money is transferred directly by your employer to your RRSP, then no tax will be withheld from the payment. However, if this is not done, you can still do the transfer yourself, provided you do it by 60 days after year-end (the same deadline as for regular RRSP contributions).

- The "retiring allowance" is *not* considered employment income for tax purposes. (Technically, it is taxable under section 56 of the *Income Tax Act*, rather than under the employment-income sections, which are sections 5 to 7.) This means that it does not create RRSP contribution room (except for the pre-1996 employment described above), and does not count as earned income for purposes of the child-care deduction. It also means that you (and your employer) won't have to pay CPP contributions or EI premiums on the "retiring allowance", so if the payment is early in the calendar year when CPP and EI would be payable on employment income, a "retiring allowance" may be better.

- The **withholding tax** on the portion of the retiring allowance that is not transferred directly to your RRSP is 10% for amounts up to $5,000, 20% of the total for $5000.01 to $15,000, and 30% of the total for $15,000.01 and over. (In Quebec, the withholding is 21%, 30% and 35% respectively.) This is only a prepayment of your tax; the actual tax you pay will be calculated on your tax return for the year by including the retiring allowance in your income, and you will receive a credit for the tax withheld. So if you are in a 45% tax bracket, you may need to set aside an additional 15% of the pre-tax amount to cover the tax you will owe next spring.

- If you become **non-resident** before you receive the retiring allowance, the only tax will be a flat 25% withholding tax, rather than the regular tax at rates of up to 48%.

  If you are considering leaving Canada, it may be a good idea to arrange to do so, and "cut your ties" with Canada sufficiently to become non-resident (see CRA Income Tax Folio S5-C1-F1), before you receive the payment.

Is there any way to make the settlement tax-free?

Aside from the RRSP rollover described above, there are other ways in which payments for wrongful dismissal can become at least partially tax-free, but should be planned early in the process.

(A) If you sue your employer for an injury such as **mental distress** or for **defamation** (libel or slander), and the settlement or Court award explicitly allocates some amount to these kinds of damage, that amount can be non-taxable.

(B) Similarly, the CRA normally accepts that if you and your employer classify part of the award as damages for human rights violation, then that portion will be tax-free (up to the maximum that could be awarded under the applicable human rights legislation).

(C) Along the same lines as above, it may be possible, in cases of severe wrongdoing by your employer, to have a Court classify part of your award as "punitive damages" or "exemplary damages", which would be non-taxable.

(D) You can ask your employer to provide you with re-employment or retirement **counselling services** as part of the settlement. These are non-taxable benefits under the *Income Tax Act*.

(E) Amounts paid by the employer to your lawyer to cover your **legal expenses** are not taxable to you. Similarly, if you receive the funds and pay your lawyer yourself, the legal fees are deductible against the settlement, and so can reduce the "retiring allowance" or employment income on which you must pay tax.

WHEN CAN THE CRA NO LONGER REASSESS YOU?

If you have invested in a tax shelter, or claimed some deduction or credit that you think the CRA might disallow, when can you stop worrying?

The normal rule is that the Canada Revenue Agency (CRA) can reassess you up to **three years from your original assessment**. The three-year clock starts running from the date shown on the Notice of Assessment that you receive shortly after filing your return. In most cases, if you haven't been reassessed by the time the clock runs out, you are safe for that year. But not always!

Note, first of all, that the clock is not "restarted" by a reassessment. If the CRA reassesses you at some point during the three-year period, the time limit for any further reassessment is still three years from the *original* assessment date.

There are some exceptions to the three-year rule. The following are the most notable:

- *Fraud.* If you have committed any fraud in filing your return or in supplying any information under the *Income Tax Act*, you can be reassessed **at any time**.

- *Neglect, carelessness or wilful default.* If you have made a misrepresentation that is attributable to "neglect, carelessness or wilful default", you can be reassessed **at any time**.

- *Tax shelters.* If you're involved in a tax shelter where you're required to file an information return with the CRA, and you don't, then you can be reassessed **at any time**. (The deadline is three years after you file the information return, so if you never do, the clock never starts running.)

- *Failing to file an accurate T1135.* If you own foreign property with total cost over $100,000, and you don't properly report *all* of it on Form T1135 with the level of detail the form requires, and you have *any* foreign income that you haven't reported, then you can be reassessed up to **six years** from the original assessment date.
- *Dealings with related non-residents.* If the reassessment relates to a transaction between you and a non-resident with whom you "did not deal at arm's length" (typically a family member, or a corporation or trust controlled by you or a family member), then the reassessment can be issued up to **six years** from the original assessment date.

- *Loss carrybacks.* If you are carrying back a loss, which generally can be done to any of the three years preceding the loss, then your return will have to be reassessed to allow this. A reassessment resulting from any one of a large number of such carryback provisions can be done up to **six years** from the original assessment date. (Normally it's to your benefit to have such a reassessment.)

- *Foreign tax credits.* If your tax payable to another country changes (e.g., due to a reassessment by that country), your foreign tax credits may change. The CRA can reassess you to reflect these changes (which could be good or bad for you) up to **six years** from the original assessment.

- *Consequential assessments.* If a reassessment is made to a return that is still open for reassessment, and as a result a "balance" changes which is carried over (forward or back) to another year, then that other year can be reassessed even if it would otherwise be past the deadline.

- *Waiver.* If you sign a waiver with respect to any taxation year, that year

will remain "open" forever, unless you revoke the waiver (which requires six months' notice). Usually you should only sign a waiver with respect to a particular, identified issue, rather than giving the CRA blanket power to reassess a given year. Also, remember that you are under no obligation to sign a waiver. If the deadline is approaching and you think it will expire before the CRA can get an assessment issued, you might choose not to sign a waiver.

- *Corporations that are not CCPCs.* For a Canadian-controlled private corporation, the limit is three years, as it is for individuals and most trusts. For any other corporation (or a mutual fund trust), the limit is **four years**. This would apply, for example, to a corporation controlled by a non-resident or by a public corporation. For such corporations, the limit is one year more than for individuals; thus, in the examples above where individuals have six years, it is seven years.

AROUND THE COURTS

Costs awarded against taxpayers in Tax Court Informal Procedure

If you are in a dispute with the CRA, and you file an objection but it's turned down, your next recourse is to the Tax Court of Canada. Where the federal tax and penalties in dispute don't exceed $25,000 per year in dispute, you can use the Tax Court's "Informal Procedure". It's still a formal Court hearing with evidence and argument, but you don't need a lawyer; you can argue the case yourself or an accountant or other agent can represent you. (It's still advisable to spend an hour with an expert tax lawyer to determine whether your appeal has any merit, what your chances are and how you should present your case.)

Traditionally, since the Informal Procedure came into operation in 1991, costs would never be awarded against taxpayers. In other words, there was no real downside to appealing, because the worst that would happen would be that you'd lose your appeal and would be left with the same assessment the CRA had already issued to you.

Recently, however, the Tax Court has started awarding costs against taxpayers whose appeals are considered an abuse of process — frivolous appeals, or those where the taxpayer is making false claims. Of course, "frivolous" and "abusive" are from the judge's point of view; some of these taxpayers might have thought they had valid arguments.

Thus, for example, the Court awarded costs (often $600 to $1,000) to be paid by taxpayers to the CRA in the following recent cases in 2014:

- *Yourkin* — taxpayer repeatedly appealed the same issue he'd lost for earlier years
- *Ian E. Brown*, — "tax protestor" making frivolous arguments that he was not liable for tax
- *Hassan* — false claim for charitable donations
- *Amyan* — false statements in a Notice of Appeal claiming child-care expenses
- *Yevzeroff* — attempt to relitigate issue already decided for an earlier year.

So beware of bringing frivolous appeals!

* * *

This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.