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TAX LETTER

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AGGRESSIVE TAX PLANNING GETS MORE RISKY

The government has been taking more and more measures in recent years to go after "aggressive tax planning" — that is, the use of tax shelters and other schemes to avoid tax in ways not intended by the designers of the tax system. New rules will make it more dangerous than ever to use such schemes.

We are not talking about tax *evasion* here. Evasion is the criminal offence of falsely reporting (or not reporting) one's income or credits. But until now, legal tax *avoidance* has often been worth trying. If a tax planning scheme was audited and it failed, the cost was usually just that the tax and interest were payable.

Now there are more dangers.

Examples of rules that have recently been introduced or passed by Parliament:

- Mandatory reporting of "**reportable transactions**". If your tax planning carries any one of 3 "hallmarks", it must be reported to the CRA. If it is not, both you and the promoter of the scheme can be liable for **severe penalties**, and the CRA has extra years to find and assess you to deny the tax benefits. The 3 hallmarks:

— **Contingency fees**: The promoter's fee is based on whether the tax planning succeeds. (There is an exception for Scientific Research and Experimental Development consultants; they normally get paid a percentage of the tax savings they obtain for their clients.)

— "**Confidential protection**", meaning you are not permitted to disclose the details of the scheme to others.

— "**Contractual protection**", such as insurance or a promise to defend the scheme if you are reassessed by the CRA to deny its benefits.

Until now, you had to have two of the above "hallmarks" of aggressive tax planning to be required to report. Under amendments to section 237.3 of the *Income Tax Act* that will be passed by Parliament during June — perhaps by the time you read this — **any one of the above** is enough to trigger the "reportable transaction" rules.

- Mandatory reporting of "**notifiable transactions**". The CRA will publish a list of tax planning schemes that it considers offside. If you are involved in one of these schemes, whether as taxpayer, advisor or promoter, you will have to notify the CRA or again be subject to **severe penalties**. The Department of Finance has published an initial list of the notifiable schemes. They include: using bankruptcy to eliminate a debt in a way that prevents the negative tax consequences of the commercial debt forgiveness rules; arranging for a corporation to not be a "Canadian-controlled private corporation" so as to avoid the high tax on investment income; avoiding the "21-year deemed disposition" rule for trusts; and several others.

  These rules (in section 237.4 of the Income Tax Act) will also be passed by Parliament during June.

- The **General Anti-Avoidance Rule** (GAAR) has been around for 35 years. However, new proposals to strengthen it will impose an automatic **25% penalty** whenever GAAR applies. That's in addition to interest and other penalties that may apply. As well, a new "economic substance" test and other changes will make it easier for CRA to apply GAAR; and CRA will have 3 extra years to find and assess you if GAAR applies.

UNDERUSED HOUSING TAX — FIRST DEADLINE EXTENDED

We wrote in our April 2023 issue ("*Residential Property Warning — Huge Penalties!!*") about the dangers of the new Underused Housing Tax (UHT).

If a home, condo or cottage is owned by a corporation, trust or non-resident, there may be filing obligations and a $5,000 or $10,000 penalty for not filing a UHT return. These filing obligations and penalties apply even if the home is rented out so that there's no tax to pay.

Legally, the first UHT returns were due April 30, 2023. However, the Canada Revenue Agency announced on March 27 (tinyurl.com/uht-extend) that no penalty or interest will be imposed as long as the first return is filed and any tax is paid by **October 31, 2023**.

For more on the UHT, see the CRA's web page at canada.ca/cra-uht.

ARE YOU A DIRECTOR OF A CORPORATION? BEWARE!

If you are listed on the provincial or federal public companies register as being a **"director"** of any corporation (including a non-profit or a charity) — or even if you are *not* legally a director but are effectively responsible for an incorporated company — you need to be aware of the tax risks **and of the steps you can take to protect yourself**.

Every year, the Canada Revenue Agency (CRA) and Revenu Québec (RQ) assess hundreds of directors to collect debts owing by their companies. In many of these cases, the director was not aware of this risk and of what they could have done to avoid personal liability. Countless Canadians have had their assets confiscated and their lives ruined by this mistake.

(In the discussion below, references to the CRA apply to RQ as well. In Quebec, RQ administers not only provincial income tax and Quebec Sales Tax, but also the GST.)

What corporate tax liabilities can a director be assessed for?

The main tax liabilities are:

- **payroll deductions** (income tax, CPP and EI) that were withheld and not remitted, *or that should have been withheld*
- **GST or HST** (and in Quebec, QST) that the corporation collected, or should have collected, minus available deductions such as input tax credits (i.e., the corporation's "net tax")
- **interest and penalties** on the above payable by the corporation, plus interest on the amount you are assessed from the time the CRA assesses you as a director.

There are other liabilities as well, such as for provincial retail sales taxes not collected, and certain other federal and provincial taxes.

Notably, a director is *not* liable for a corporation's regular corporate income tax debt. However, in many cases a director (or shareholder) who has received anything from the corporation in any year since the year the tax liability arose, including a dividend, can be assessed under Income Tax Act section 160, the "transfer of property" rule, or the parallel GST rule in *Excise Tax Act* section 325.

What if you're not a legal director?

If you're a director, you're liable for the corporation's payroll deductions and GST/HST net tax, as noted above, and subject to various possible defences explained below. But you can also be liable if you're a ***de facto* director**, i.e., a director in practice even if you're not *legally* a director.

So if you're involved in running a company, or if the company is inactive but you're the person dealing with the CRA on behalf of the company and answering questions about it, you may well be considered a *de facto* director. In such a case, you'll be just as liable as if you had legally been a director.

The 2016 *Koskocan* decision of the Tax Court has limited the definition of *de facto* director somewhat by showing that officers, not directors, normally manage a company's day-to-day affairs. However, whether you're a *de facto* director will depend very much on the facts of your particular situation.

What about other directors?

All directors are **jointly and severally liable** ("solidarily" liable, in Quebec), meaning any one of them can be assessed for 100% of the debt.

In practice, the CRA may go after whoever seems to have the deepest pockets (ability to pay). Directors then have a right to "contribution" from each other, but that requires you to sue the other directors in provincial civil court for their portion of the liability, and those other directors may well be bankrupt or have no assets you can seize, even if your lawsuit succeeds.

What does the CRA need to prove?

Nothing. If you appeal the assessment, the onus is on you to prove that you are *not* liable because one of the defences below applies.

First defence: "I wasn't a director"

If you never consented in writing to being appointed as a director, then perhaps you weren't a director and aren't liable. As noted above, however, you might have been a "*de facto*" director, by doing the things directors do (managing the company, signing documents on its behalf, or representing it).

If you weren't a director or a *de facto* director **when the corporation's liability arose**, you're not liable for that liability. So if you became a director when the company already had a significant payroll or GST/HST liability, you might be able to escape the assessment.

Note however that remittances made while you were a director will normally have been applied by the CRA to the oldest debts (for which you wouldn't have been liable), unless the company specifically told the CRA to apply them to the new debts. You may thus be liable for new remittance obligations even though the company made sufficient remittances while you were a director to cover those obligations.

What if you resigned before the liability arose (that is, before the date the corporation was required to remit the payroll deductions or GST/HST)? You're not liable; but proving that you resigned and didn't continue as a *de facto* director may be difficult. This issue is discussed under "Second defence" below.

Second defence: "I resigned more than 2 years before the assessment"

If you ceased to be a director more than two years before the Notice of Assessment is issued to you to assess you as a director, you're not liable.

However, if your name wasn't removed from the public registry of companies when you resigned, proving that you resigned may be difficult. The CRA is understandably suspicious of people who claim to have resigned more than two years ago but can't really prove that they delivered their resignation letter to the company at the time. You'll need to show from all the surrounding circumstances and other documentation that you really did resign.

Even if you resigned, if you continued to act as a *de facto* director, you'll be out of luck.

If the company was dissolved more than two years before the assessment was issued, you ceased to be a director at that time. However, the CRA sometimes takes steps to

ask a Court to "revive" a company retroactively, so that the directors can be assessed. This step can be opposed, but you'll need professional advice from a lawyer familiar with this issue.

Note that there is no other limitation period. Even if the corporation's failure to remit GST happened 25 years ago, you can be assessed for it, with astronomical compounded interest charges that vastly exceed the original amount of tax.

Third defence: "The assessment of the corporation was wrong"

If you can show that the company wasn't in fact liable for the amount of payroll deductions or GST/HST the CRA claims it owed, then you should be able to get the assessment reduced or eliminated.

The CRA used to reject this defence, saying that if the company didn't appeal its own assessment, that assessment is "deemed to be valid and binding" by the legislation and thus can no longer be challenged. The Tax Court was mixed in whether it accepted this reasoning. However, the Federal Court of Appeal made it clear, in the 2020 *Duque* case, that if you can show the corporation's liability wasn't as high as the CRA claims, you can get the assessment reduced. Doing this is difficult, however, if the supporting documentation has disappeared. Simply claiming that the debt "couldn't possibly have been that high" won't work; you need real proof.

Fourth Defence: "I met the due-diligence test"

This defence will be offered to you by the CRA when it first writes to you to propose assessing you as a director, and asking you if you have anything to say.

This defence is: "A director of a corporation is not liable for a [corporation's] failure [to remit payroll deductions or GST/HST] where the director exercised the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances."

There have been hundreds of reported decisions from the Tax Court and the Federal Court of Appeal on this defence. This is an *objective* test: looking at your actions objectively, did you meet the test above? You have to show that you took active steps to ensure the taxes were being remitted, such as by setting up systems to make sure the remittances were made. Innocent good faith, or not being aware of the liability, will not be enough. As well, if there were "red flags" indicating that the company was in financial trouble, then you had an extra high obligation to make sure it was meeting its payroll and GST/HST obligations.

Note also that having taken active steps to remit the corporation's outstanding liability — even if you put in your own money at that point — is irrelevant. You need to show that you met the due-diligence standard at the time the corporation's remittance obligation arose — when the GST/HST return or payroll remittance was due.

Conclusion

If you are a company director, make sure the company is remitting all payroll and GST or HST it is required to remit. Be proactive: if you're not running the company yourself, take active steps to ensure the remittances are actually being made. **Document what you are doing**, if you're an outside director

and are depending on others: sending your inquiries by email is one way of doing this. If you're not sure the remittances are being made, resign and ensure that your resignation is immediately recorded in the government registry of corporations — and then hope that two years go by without you being assessed.

<u>If you're not sure whether you're a director</u>, find out! A shareholder is not the same as a director; you can be one and not the other. Check the company's minute book, or search the government companies register to find out if you're listed. You need to know.

<u>If you're assessed as a director</u>, or the CRA proposes to assess you, you should obtain professional advice as soon as possible to explore your options. You may be able to raise one of the defences above. Make sure you file a Notice of Objection with the CRA within 90 days of being assessed, or you may lose your right to appeal.

FOREIGN TAX CREDIT — MAKE SURE THE FOREIGN TAX IS MANDATORY

As you may know, Canada provides a **"foreign tax credit"** (FTC) to Canadian residents, to reduce double taxation on foreign-source income.
The FTC rules are complex. In general terms, Canada allows a credit to a Canadian resident for **foreign income tax paid on foreign-source income**, up to a limit of the Canadian tax payable on the same income.

The effect is that you pay total tax equal to the higher of the two rates of tax (Canadian and foreign) on the foreign-source income.

Thus, for example, suppose you earn $1,000 in dividends on a U.S. stock, and the U.S. company withholds $150 as withholding tax. (We'll ignore exchange rate issues for this example; assume all amounts are in Canadian dollars.) Assume you are in a 40% tax bracket, so you pay $400 of Canadian tax on the same $1,000 of dividend income.

In this example, Canada will grant you a foreign tax credit of $150 on your Canadian tax return, so that you only pay $250 of Canadian tax on the dividends. The total tax burden ($150 to the U.S. and $250 to Canada) will thus equal the $400 of Canadian tax you would have paid if there had not been any foreign tax. (Most developed countries have similar rules.)

The FTC has many complexities and traps. One trap you should be aware of is that the **foreign tax must be mandatory**. If you could have avoided paying the foreign tax, or recovered it from the foreign government, then you can't claim it as a foreign tax credit.

Thus, for example, suppose your U.S.-source income is interest rather than dividends, and the interest is exempt from U.S. tax under the Canada-U.S. tax treaty. If the U.S. payor withheld U.S. tax, and you can recover that tax from the U.S. government by claiming relief under the treaty, then the U.S. tax you paid is not eligible for the foreign tax credit, because **Canada will consider it to be a "voluntary" payment** to the U.S. rather than a foreign tax. So instead of claiming a foreign tax credit, your only option may be to claim back the wrongly-charged tax from the U.S. Internal Revenue Service.

Note also that the foreign tax credit applies only to an "income or profits tax". It is not available for social security taxes other than those paid to the U.S. Most U.S. "FICA" (Federal Insurance Contributions Act)

payments do qualify, due to a specific provision in the Canada-U.S. tax treaty.

AROUND THE COURTS

Personal expenses paid by company — double tax whammy

In *1048547 Ontario Inc. v. The King*, 2023 TCC 24, a family-owned company operated a goat farm in eastern Ontario, manufacturing dairy products. The CRA audited the company for its 2015 year, and **reassessed it to disallow a number of expenses**, including over $350,000 in travel and meal expenses that the company paid for its shareholders that year.

The CRA also **assessed the company's shareholders** for 2014 and 2015, adding $370,000 to the President's income and $420,000 to the Treasurer's income, as well as smaller amounts to the income of other family members. The company and the shareholders appealed to the Tax Court of Canada.

The Court did not believe the evidence of the shareholders or the company's Controller, who testified that the expenses in question were business expenses. There was no documentary proof of these being legitimate expenses of the company. Rather, they were personal travel expenses. All the appeals were dismissed.

This case demonstrates a **double-tax danger** in having a company pay a shareholder's personal expenses. Not only is the expense denied to the company, but the shareholder has to pay tax on the shareholder benefit (Income Tax Act subsection 15(1)). It is much better to pay the shareholder extra salary or bonus, so the company gets a deduction, and let the shareholder pay their own personal expenses. Alternatively, pay the shareholder a dividend, which is taxed at preferential rates that recognize that the company is paying the dividend out of after-tax income. The worst option is to do what the company did here, paying shareholders' personal expenses and trying to deduct the cost as a business expense.

ERRATUM

In our May letter, in an article about the new First Home Savings Account (FHSA), we wrote:

> One key point to note about this program is that it is not the RRSP home buyer's plan. Both plans cannot be used simultaneously.

Correction: this was true when the FHSA was first announced. However, under the legislation as it was actually enacted and is now in force, the FHSA and the Home Buyer's Plan can be used together in respect of the same qualifying home purchase.

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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.