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TAX LETTER

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THE TAX IMPLICATIONS OF YOUR SIDE-HUSTLE

Nowadays, a lot of people are using a side business or additional source of income to augment their primary income. The tax implications of these extra sources of income are frequently misunderstood or overlooked entirely.

The side-hustle could involve earning money via the gig economy, selling goods online, renting out assets like cars and apartments, or earning money as a social media "influencer."

In order to remind taxpayers of their tax responsibilities with regard to "platform economy" income — that is, income obtained through online platforms like Kijiji, Uber, and Instagram — the CRA has recently published several news releases to offer guidance.

The CRA advises that “whether the earnings you make from online platforms are your main source of income, or a small part of it, you are considered to be a platform economy participant. When it’s time to file your taxes, you must report all sources of your income, including gifts and donations”.

A lot of people are unaware that they could have to pay taxes on this kind of income. Maybe they view such activities as a hobby, rather than a business. This is a very important distinction when it comes to tax, as hobby income is usually not taxable.

Income is usually not taxable if your hobby generates some extra cash for you. For example, it is likely that you won’t have to pay tax on that unwanted Christmas present that you sold on Kijiji! Similarly, if you paint for fun and someone wants to purchase one of your creations, this probably wouldn't be taxable as a one-off sale.

But as a hobby gets more serious, time-consuming and perhaps even profitable, you might eventually find that your hobby has turned into a business, and business income IS subject to income tax.

Determining when a hobby has actually become a business is a subject often debated between taxpayers and the CRA.

The difference between pursuing a hobby and running a business depends on the facts. Common indicators of a business include the intention to make a profit, a significant investment in time and money, and frequent sales of the fruits of your activity.

You must declare any income from a business in your tax return as self-employment income. Hobby income doesn't have the same requirement.

If you do in fact run a business, you can claim any expenses you have incurred in the running of that business. These expenses may include overheads, materials, and fees for online platforms. If the expenses exceed your income, you will have a loss that you can apply against other sources of income, or carry over to other tax years if you don't have enough other sources of income – but if you claim such a loss, you're likely to be audited by the CRA to verify that you really are carrying on a business.

If your business generates gross revenue of more than $30,000 (from Canadian customers) over the course of four calendar quarters, you will normally also need to register for GST/HST.

One exception to this is ridesharing services (e.g., driving for Uber). This activity requires the driver to register for GST/HST from the first $1 of income earned.

To assist those operating in the platform economy in understanding their tax responsibilities, the CRA has recently provided ten "tips."

1. Know your area of the platform economy

You could be working gig economy, the sharing economy, the peer-to-peer economy (e.g. selling items on Kijiji), or as a social media influencer. Each of these areas of the platform economy has different tax considerations and filing obligations.

2. Report your income and consider all sources

You may work in more than one area of the platform economy and all sources must be reported.

3. Know what applies to you as a non-resident

Even if you are not a resident of Canada, income earned in Canada will usually come with a Canadian tax obligation.

4. Keep records at regular intervals and explore your platform's available documents

Online platforms frequently offer tax forms and summaries that can assist you in meeting your responsibilities.

5. Determine if you are self-employed or not

Remember that you might not be required to report and pay taxes on income if you are merely engaged in a hobby as opposed to running a business.

6. Claim your eligible business expenses

Costs such as advertising, platform fees and software licences may all reduce your business income for tax purposes.

7. Register for GST/HST and collect it if required

It is important to determine if you only have to register for GST/HST upon meeting the $30,000 supply threshold or whether you may have an immediate registration requirement.

If you are required to charge GST/HST, the CRA will demand that you remit the tax, even if you haven't registered and even if you haven't charged tax on your sales or services. The penalties for not remitting GST/HST can be significant.

8. Visit the CRA's Taxes and the platform economy web page here.

9. Get help from the CRA for your taxes

For example, the CRA offers a liaison officer service for small businesses, giving them the opportunity to meet with a CRA officer to discuss reporting requirements and obtain support.

10. Correct your tax affairs voluntarily

If you voluntarily make the required corrections after realizing that you failed to report income or collect GST/HST, you may avoid penalties and interest.

Through the CRA's voluntary disclosure program, taxpayers can request a waiver of penalties and interest, based on their willingness to come forward voluntarily and provide a complete disclosure of their situation (and, of course, upon paying any additional tax that is due).

More information on the CRA tips mentioned above can be found here.

DO YOU OFFER SHORT-TERM PROPERTY RENTALS? MAKE SURE YOU ARE COMPLIANT!

Provinces and territories all over the nation have been tightening regulations for short-term rentals (for example, Airbnb rentals) due to the rising demand for housing, especially in cities like Montreal, Toronto, and Vancouver.

Due to a recent amendment to the Income Tax Act, it is now even more crucial to abide by local laws governing short-term rentals, as failure to do so may prevent expenses from being used to offset the income, and lowering tax!

A "short-term rental" is defined as a residential property that is rented or offered for rent for periods of less than 90 consecutive days.

Therefore, while many rentals advertised on internet platforms will be caught, the majority of "normal" residential rental arrangements will not be subject to these expense denial rules provided they are not month-to-month contracts.

A short-term rental is deemed to be non-compliant under the Income Tax Act if it is situated in a Province or municipality that does not allow these kinds of rentals.

In provinces or municipalities where short-term rentals ARE allowed, a rental is considered non-compliant if it does not meet all local applicable registration, licensing, and permit requirements for short-term rentals.

If found to be non-compliant, the Income Tax Act now states that any otherwise deductible expenses will be denied, although the income will still be subject to tax of course!

If the property is non-compliant for only part of the year, expenses will be denied in a similar proportion.

For example, if the property was non-compliant for 36 out of 365 days in the year (around 10%), then 10% of the total rental expenses for the year would be denied.

The rules take effect from the 2024 tax year. However, in this first year, a property is considered to be compliant for the whole of 2024 if it was compliant at the end of the year.

This provides taxpayers with some time to ensure that all local requirements are complied with, if the property they are renting out is currently non-compliant.

Operating short-term rentals has become more cumbersome when it comes to local compliance over the past few years. It has now potentially also become more costly from a tax point of view!

AMENDED GAAR RULES NOW IN FORCE

In June 2024, changes to the general anti-avoidance rule (GAAR) took effect. These changes strengthened the teeth of this tax anti-avoidance rule, expanding its scope and introducing a penalty for transactions that are found to breach the rule.

The GAAR is a general fallback rule which can apply to transactions which, although complying with the Income Tax Act, are contrary to the spirit of the Act and result in a misuse or abuse of its provisions.

An example of this would be where a transaction results in an outcome which was not intended by the Act, even though the transaction has not technically breached any of the Act's provisions.

When it comes to reorganizations of corporations and personal estates, the GAAR is very significant. These types of reorganizations frequently involve several separate transactions that, when combined, can save or defer taxes, neither of which the CRA likes.

The CRA may use the GAAR as a backup to punish these "abusive" transactions if they believe that any of the transactions result in a misuse or abuse of the Act, especially if they have no other powers to prevent the saving or deferral of tax, but where they believe that an abuse of the Act has occurred.

One of the most significant changes to the GAAR rules is the change in the definition of what an "avoidance transaction" is – a transaction must be an avoidance transaction in order to be caught by the GAAR.

Previously, a transaction could avoid being caught by the GAAR if it could be shown that there were "bona fide purposes" to the transaction, other than the obtaining of a tax benefit, and that these purposes were the primary reason for entering into the transaction.

Therefore, if there were genuine business reasons for the transactions (for example creditor-proofing, restructuring, planning for the entrance or exit of shareholders, etc.), the fact that the transactions also resulted in a tax benefit was not usually enough for the transactions to be caught by the GAAR.

Now, as a result of the recent changes, a transaction can constitute an avoidance

transaction where “one of the main purposes” of the transaction was to obtain a tax benefit.

This may seem like a subtle change in wording, but it significantly widens the net in terms of transactions that may be caught by the GAAR.

Under the new wording, even if there are *bona fide* non-tax purposes for entering into a transaction, if there is also a tax reason for entering into the transaction, the *bona fide* purposes are not enough to fall out of the GAAR net.

To add to this, the consequences of being caught by the GAAR are now far more penal.

Before the changes, the only real repercussion of being caught by the GAAR was that the "tax benefit" that the taxpayer achieved was denied.

Therefore, the taxpayer was essentially placed back in the same financial situation as if they had not entered into the avoidance transaction and obtained a tax benefit.

A financial penalty has been introduced for transactions caught by the GAAR.

This penalty is 25% of the extra tax charged if the GAAR is found to apply (i.e. 25% of the tax benefit that was achieved by the transaction before GAAR denied the benefit).

Even though these two changes are arguably the most important, there are a lot of other changes to the rules that need to be understood because they may also cause a transaction to now be subject to the GAAR.

There are also changes which may mitigate the increased scope of the GAAR. For example, the new penalty may not apply if the taxpayer voluntarily discloses the details of the transaction before the CRA becomes aware if it. This, of course, is what the CRA is hoping to achieve.

It will take many years for the full impact of these changes to become known. Transactions will be taken to court for a judicial analysis of the new GAAR rules and how, and if, they apply.

Until the full extent and range of the updated rules becomes clear, advisors and taxpayers must exercise caution when entering into transactions that result in a “tax benefit”, which includes tax savings, a tax deferral, and an increase to a tax refund, among other things.

For now, the CRA has started to release guidance in relation to situations where it thinks the new GAAR rules will and will not apply.

For example, the CRA have already suggested that common estate plans, such as estate freezes (see the March 2024 Tax Letter) may not be subject to the GAAR in certain circumstances.

For taxpayers entering into any tax planning, it is now more important than ever to work closely with your tax advisor to ensure that the new GAAR rules are considered.

Although the rules are complex, and their interpretation is still largely uncertain at this point, it is very important to try to understand the rules and anticipate how the courts may view any proposed transactions from a GAAR point of view.

AROUND THE COURTS – CORRECT RECORDING OF SHAREHOLDER LOAN PAYMENTS IS CRUCIAL

It is not unusual for a shareholder of a corporation to use company funds to cover personal expenses, particularly in the case of small, owner-managed businesses.

The shareholder may have viewed such a withdrawal as being one of a number of potential things, such as a loan, a loan repayment, a taxable benefit, or the payment of a dividend or salary – or may simply have used the money without paying attention to the form in which it was being extracted.

The tax implications of shareholder corporate withdrawals are typically determined by how the withdrawal is recorded in the company's books and eventually reported on personal and corporate tax returns.

For instance, a company is permitted to lend corporate funds to its shareholders. To maintain track of the amount owed by the shareholder, the loan would need be recorded in the company's "shareholder loan account."

No tax would be due by the shareholder on the loan as long as the loan is paid back to the corporation by the end of the year **after** the year of the loan.

However, the loan amount would be treated as taxable income that belongs to the shareholder if it is still outstanding after this period. Only when the loan is eventually repaid would the shareholder qualify for a tax deduction to reverse this taxable income inclusion.

Where a shareholder takes an amount out of a corporation, and to the extent that this is not recorded as a loan in the shareholder loan account, the withdrawal may be considered taxable income in the shareholder's hands immediately.

Therefore, it is essential to record the corporation's and the shareholder's intentions at the time of any shareholder withdrawals.

The *Kumar* case (2024 TCC 105) serves as a recent example of how important it is to accurately record these types of withdrawals.

In *Kumar,* the taxpayer, now in his 70s, had remortgaged his home on two separate occasions in order to start an automotive business to assist with his son's career development – the son was a qualified auto mechanic and the intention was that he would operate the automotive business through a new company that Mr. Kumar incorporated.

In 2013 and 2014 the corporation paid over $40,000 to the taxpayer. Mr. Kumar testified that these amounts were repayments of loans he made to the company to set it up and fund its operations.

However, the company's shareholder loan account was not updated to record these repayments. Therefore, the CRA reassessed Mr. Kumar's 2013 and 2014 tax years on the basis that the amounts paid by the company were shareholder benefits, rather than repayments of his loan to the company.

Mr. Kumar had prepared the company's tax returns. He had taken a tax course previously but had no corporate tax training and admitted that he didn't know how to correctly record shareholder loan repayments on the corporate side. However, he asserted that the amounts received were shareholder loan repayments.

Although the Tax Court judged found that the taxpayer was a credible witness, this wasn't enough to have the payments classified as

shareholder loan repayments as there were **no entries in the shareholder loan account recording this.**

The Court commented that "to be recognized as shareholder loan repayments, the payments ought to be recorded by the payer corporation as such" and that "the subjective intent of the taxpayer, expressed after the fact, is at best of little relevance".

Although the court accepted that "one off" omissions from the shareholder loan account may sometimes be corrected after the fact, a long-running practice of not recording transactions in the shareholder loan account could not be.

The court concluded that "the choice is to pay for professional assistance to have the corporate records correctly maintained or to learn how to do it oneself. Mr. Kumar elected neither option."

The Tax Court upheld the CRA's reassessment of these amounts as taxable income inclusions, rather than shareholder loan repayments.

The unfortunate result for the taxpayer in *Kumar* serves as a good lesson for business owners. Where shareholder loans are made to, or received by, a company, the correct recording of these transactions is crucial in order to avoid a nasty tax surprise.

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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.