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Current Issues in Tax Law

2018 MBA Mid-Winter Conference

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This Panel Session

- **This panel discussion, which is geared towards non-tax specialists interested in gaining a deeper understanding of tax issues affecting their clients and their practices, will cover a variety of tax hot topics, tips and traps, and other items of note. The discussion will focus on applying the material covered in practice and will generally not be technical in nature. This session will be of particular interest for general practitioners, commercial lawyers, and estate planners.**

- **The panel will provide general tax information only and cannot be taken as legal advice. Always consult the applicable taxing legislation.**

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Agenda

Johanna C.C. Caithness and Aron W. Grusko

- **Beneficiary Designations in Wills**
- **Graduated Rate Estates**
- **GST and Real Estate Transactions**
- **Manitoba Tax Credits**
- **Taxation of Stock Options**
- **Taxation of Inter-Corporate Dividends (s. 55(2))**
- **Changes to Taxation of Private Corporations**

Paul K. Grower

- **Rectification**
- **CRA's Audit Powers**
- **New Voluntary Disclosures Program**
- **Director Liability**

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Beneficiary Designations in Wills

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Beneficiary Designations – Brief Overview

- ***The Insurance Act*** **(Manitoba) – an insured may, by declaration (including in a will), designate a beneficiary or his/her estate to receive proceeds**
- ***The Beneficiary Designation Act (Retirement, Savings and Other Plans)*** **– a designation may be made by will or by an instrument signed by a participant in a plan**
- **Revocations may also be made by instrument or will**
- **Where the estate is not the beneficiary, the asset will not form part of the estate (should not be subject to probate fees) and there may be some creditor protection**

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Trap #1 – Minor Children Beneficiaries

- **Minor children cannot own their own property – if insurance proceeds or plan proceeds are payable to the child through a designation or declaration outside a will, there is no opportunity to set up a trust**
- **Because the funds must be held in trust for the minor, the Public Trustee of Manitoba must become involved and administer the trust**
- **There will be no opportunity to keep the funds in trust past the age of 18, this can be undesirable with large sums of money**

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Trap #1 – Minor Children Beneficiaries

SOLUTIONS:

- **for insurance proceeds:**
  - It is recommended to set up an insurance trust (in a will or on its own), since a trustee can be a designated beneficiary of an insurance policy, and to complete the insurer's designation form designating the trustee as beneficiary
  - *The Insurance Act* permits the appointment of a trustee for a beneficiary, but without trust terms this will likely not be a proper trust
- **for RRSPs, unless there are concerns about creditors, generally better to have payable to estate and set up a trust in the will**

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Trap #2 – "Equal Shares"?

- **Situation: Testator has RRSPs worth $500,000 and assets in her estate worth $500,000. She has two children and no spouse, and wants to give each child half of her estate. She designates Child A as the beneficiary of her RRSPs and names Child B as the beneficiary of her estate.**
- **Result: Child A takes the full amount of the RRSPs ($500,000) and the tax payable on the RRSPs by the estate of the testator is paid by the estate, meaning that all tax is borne by Child B. The result is NOT an equal distribution.**
- **Possible solution: Name both children as beneficiaries of the RRSPs and both children as equal beneficiaries of the estate.**

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Trap #3 – Separation and Divorce – Revocation of Designations

- **A beneficiary designation is NOT automatically revoked by either separation or divorce**
- **There are many cases where a beneficiary designation has not been changed after separation or divorce and this may result in the ex-spouse receiving the benefit**
- **Issues on separation and divorce unrelated to beneficiary designations (estate distribution generally)**

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Trap #4 – Separation and Divorce – Family Property

- **Situation: A and B separate. A has designated B as the beneficiary of a life insurance policy worth $1,000,000. A does not change his beneficiary designation and dies.**
- **Result: B will take the entire $1,000,000 insurance proceeds. There will also be an accounting under *The Family Property Act* and B will get an equalization payment from A's estate. The $1,000,000 will not be included in the accounting.**

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Trap #4 – Separation and Divorce – Family Property

- **Change the situation: Before A dies, he changes the beneficiary designation to his estate.**
- **Result: Since A and B separated before A's death, the valuation date for the accounting and equalization under *The Family Property Act* will be the date of separation and the cash surrender value of the life insurance policy at that date will be "shareable" with B.**

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Trap #4 – Separation and Divorce – Family Property

- **Change the situation again: Before A dies, he changes the beneficiary designation to a third party (beneficiary of his estate). The life insurance policy has a cash surrender value of $1,000.**
- **Result: $1,000 will be included in the accounting under *The Family Property Act* and will be "shareable" with B.**

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Trap #5 – Inconsistency between Designation and Will - Timing

- Under *The Beneficiary Designation Act*, a designation or revocation contained in a will is effective from the time of the execution or signing of the will
- Under *The Insurance Act*, a designation in a will is of no effect against a designation made later than the making of the will
- Designations in wills will not apply to plans or policies acquired after the will is made

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Trap #5 – Inconsistency between Designation and Will - Revocation

- Revocation of a will revokes a designation made in the will
- A designation in an invalid will is not invalid only because the will itself is invalid (i.e. designation in an invalid will may still be effective) – this can be revoked by an event that would have revoked the will if it was valid (e.g. marriage or a new valid will)
- It may be unclear whether a designation has been revoked
- Republication of a will by codicil does not revive a designation unless the codicil states as much

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Trap #6 – Deceased Beneficiaries

- Situation: Testator has four children and designates all four children equally as beneficiaries of his life insurance policy by declaration. The declaration does not state what happens if one of the testator's children predeceases him. One of his children predeceases him and leaves children of her own. He wants the grandchildren to get their mother's share of the policy. The testator dies.
- Result: The three surviving children share the life insurance proceeds equally and the children of the deceased child get nothing
- Solution: Provide for the disposition of the share of the deceased child in the will of the testator
- Note that *The Beneficiary Designation Act* is silent regarding deceased beneficiaries

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Trap #7 – TFSAs

- **Can name a beneficiary of a TFSA**
  - The FMV at the date of death is essentially a non-capital receipt of the designated beneficiary and may be withdrawn tax fee
- **Governed by *The Beneficiary Designation Act* and the *Income Tax Act* (Canada)**

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Trap #7 – TFSAs

- **A spouse or common-law partner may be named as a beneficiary**
  - Spouse or common-law partner is entitled to contribute the FMV of the original holder's TFSA (calculated as of the date of death) to his or her own TFSA as an "exempt contribution"
    - Complicated to do so
    - The increase in FMV from the date of death is taxable
- **A spouse or common-law partner should be named as a successor holder of the TFSA**
  - The income earned by the TFSA continues to be tax-free on the death of the original holder (i.e. the spouse or common-law partner can have 2 TFSAs)

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Graduated Rate Estates

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Graduated Rate Estates

- **Prior to 2016, several testamentary trusts could generally be established in a will and each testamentary trust was generally subject to the graduated tax rates applicable to individuals**
  - Subject to exceptions, a testamentary trust, in a taxation year, means a trust that arose on and as a consequence of the death of an individual (per ITA 108(1))
- **This is no longer the case – testamentary trusts are taxed at the highest marginal tax rates**
  - Unless they are a graduated rate estate ("GRE") or a Qualified Disability Trust (not discussed here)!!!
- **The term "graduated rate estate" is defined in ss. 248(1) of the *Income Tax Act***
  - Reproduced on next slide

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Graduated Rate Estates

*"**graduated rate estate**"*, of an individual at any time, means the estate that arose on and as a consequence of the individual's death if

- (a) that time is no more than 36 months after the death,
- (b) the estate is at that time a testamentary trust,
- (c) the individual's Social Insurance Number … is provided in the estate's return of income under Part I for the taxation year that includes that time and for each of its earlier taxation years that ended after 2015,
- (d) the estate designates itself as the graduated rate estate of the individual in its return of income under Part I for its first taxation year that ends after 2015, and
- (e) no other estate designates itself as the graduated rate estate of the individual in a return of income under Part I for a taxation year that ends after 2015

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Graduated Rate Estates

Key issues:

- **Disqualification as a graduated rate estate**
- **Charitable donations**
- **Post-mortem tax planning relating to private corporations**

Other tax advantages (extended objection deadline, non-calendar year-end, refund beyond normal reassessment period) will only be available for GREs

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Graduated Rate Estates

Disqualification as a Graduated Rate Estate

- **Same as rules for disqualification as a testamentary trust**
- **Contribution of property to the estate (i.e. trust) by anyone other than the testator**
- **Incurring a debt to a beneficiary or with any person who is non-arms length to a beneficiary unless the debt is repaid within 12 months and carries a commercial rate of interest (no interest is required if the debt is incurred in the 12 months following death)**
- **Caution re: payment of estate expenses by others (e.g. funeral expenses)**

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Graduated Rate Estates

Charitable Donations

- **As of January 1, 2016, donation made by testator (in will, by the estate, or through beneficiary designation) is deemed to be made by the estate at the time the gift is made to the donee**
- **However, gifts made by GREs are treated differently:**
  - Donation tax credit can be used on deceased's final return or return for the year prior to death, or on an estate return (carryback and carryforward are both available)
  - Gift of marketable securities treated more favourably (i.e. no capital gain and donation tax credit)

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Graduated Rate Estates

Post-Mortem Tax Planning Relating to Private Corporations

- **Subsection 164(6) of the ITA allows the carryback of a capital loss resulting on a redemption of shares to the deceased's final tax year, where the loss occurs in the first year following death**
- **Subsection 164(6) loss carryback is only available to a GRE**
- **Although the federal government has backed off on the July 2017 proposed changes to 84.1 of the ITA and new proposed 246(1) of the ITA, if those changes had gone forward, post-mortem pipeline strategies would no longer be available, leaving 164(6) as the only post-mortem tax planning mechanism**
- **Subsection 112(3.2) of the ITA (stop-loss rule) is relaxed in relation to GREs**

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A Selection of GST Issues in Real Estate Transactions

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In general

- **Governed by the federal *Excise Tax Act* ("ETA")**
- **Need to distinguish between the supply of the real property and the supply of any chattels located at the property (chattels subject to Manitoba PST as well)**

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Residential Property

- **Generally, used residential property is exempt from GST**
  - Determined based on last use of property
- **New residential property is subject to GST**
- **Substantially renovated property is subject to GST**
  - Sometimes overlooked
  - If acting for a purchaser of newly renovated property, get a representation that the property is NOT subject to GST (may protect purchaser from tax liability – s. 194 ETA)

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Section 194 of ETA – Incorrect Statement

… where a supplier makes a taxable supply by way of sale of real property and incorrectly states or certifies in writing to the recipient of the supply that the supply is an exempt supply … , except where the recipient knows or ought to know that the supply is not an exempt supply …. (b) the supplier shall be deemed to have collected, and the recipient shall be deemed to have paid, that tax …

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Commercial Property

- **Generally, commercial property is subject to GST**
  - Exemption for personal use property sold by an individual
  - Caution where land has been subdivided
  - Farmland is subject to GST (generally)
- **Section 221 of the ETA governs the collection of GST**
  - Subsection 221(1) – General Rule – Every person who makes a taxable supply shall, as agent of Her Majesty in right of Canada, collect the tax under Division II payable by the recipient in respect of the supply.
  - Subsection 221(2) – Exception for Real Estate
    - See next slide

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Commercial Property

- **Subsection 221(2) – Exception for Real Estate**

A supplier … who makes a taxable supply of real property by way of sale is <u>not</u> required to collect tax under Division II payable by the recipient in respect of the supply where

(a) **the supplier is a non-resident person** or is resident in Canada by reason only of subsection 132(2) [permanent establishment of non-resident];

(b) the <u>recipient is registered</u> under Subdivision d and, in the case of a recipient who is an individual, the property is neither a residential complex nor supplied as a cemetery plot or place of burial, entombment or deposit of human remains or ashes;

…

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Commercial Property

- **Subsection 221(2) – Exception for Real Estate**

A supplier … who makes a taxable supply of real property by way of sale is not required to collect tax under Division II payable by the recipient in respect of the supply where

…

(b.1) the supplier and the recipient have made an election under section 2 of Part I of Schedule V in respect of the supply [a particular supply by way of sale of a residential complex or an interest in a residential complex made by a particular person who is not a builder of the complex or, if the complex is a multiple unit residential complex, an addition to the complex]; or

(c) the recipient is a prescribed recipient.

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Mixed Use Property

- **Referring to a property that has both a residential and a commercial component**
  - An example is an apartment building where the main floor is leased out as a restaurant
- **Reference must then be made to Subsection 136(2) of the ETA**
  - Deemed to be two properties
  - A reasonable allocation of the sale proceeds must be made as between the two deemed properties
- **But first, the term "residential complex" must be defined**
  - Definition is found in subsection 123(1) of the ETA

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Mixed Use Property – Definition of "Residential Complex"

"In very simplified terms, a residential complex (RC) is just a home, condominium or apartment building. …. Under para. (c), if a home owned by or sold to an individual is primarily used as a residence for that person or their family, the *entire* building is a RC, including any part used commercially such as an office…" (David Sherman, Sherman's Notes to 123(1)).

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Mixed Use Property - Combined Supply of Real Property

136(2) For the purposes of this Part, where a supply of real property includes the provision of

(a) real property that is

(i) a residential complex,

(ii) land, a building or part of a building that forms or is reasonably expected to form part of a residential complex, or

(iii) a residential trailer park, and

(b) other real property that is not part of the property referred to in paragraph (a)

the property referred to in paragraph (a) and the property referred to in paragraph (b) shall each be deemed to be a separate property and the provision of the property referred to in paragraph (a) shall be deemed to be a separate supply from the provision of the property referred to in paragraph (b), and neither supply is incidental to the other.

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Caution: Deemed Sales

- **Not going to go into detail on this**
- **Note that, as explained by the CRA, "[s]everal sections of the Act provide for deemed sales, e.g., a deemed self-supply by a builder of a residential complex, a deemed sale resulting from a change-in-use." (GST/HST memorandum 19.2.1, at para. 2)**

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A Selection of Manitoba Tax Credits

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Employee Share Purchase Tax Credit (Manitoba)

- **A Manitoba-specific tax credit**
- **The purposes of the Employee Share Purchase Tax Credit ("ESPTC") are to:**
  - assist and facilitate succession planning for family businesses in Manitoba;
  - assist and facilitate employee buyouts and takeovers designed to create or maintain employment in Manitoba;
  - foster the growth of worker cooperatives in Manitoba; and
  - facilitate and promote employee participation in business successes in Manitoba.

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ESPTC: Employee Share Ownership Plan

- **In order for an individual to be eligible to receive the ESPTC, a corporation must first register an Employee Share Ownership Plan (an "ESOP") with the Provincial Government**
- **Among other things, an ESOP must:**
  - Set out the minimum and maximum numbers of employees who will be eligible to acquire shares under the plan
  - Set out the proposed use of the share proceeds
  - Give all eligible employees (which may be only one employee) under the plan equal rights and opportunities to acquire shares under the plan
  - The purposes of the plan are consistent with the purposes of the employee share purchase tax credit

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ESPTC: Further Requirements

- **There are requirements with respect to the shares to be issued under the ESOP**
- **Only certain corporations will be eligible to issue shares under an ESOP**
  - Many Manitoba-based corporations carrying on an active business will qualify (or will be able to qualify after some planning)
- **An individual must be resident in Manitoba at the end of the taxation year in which the share was issued under the ESOP**
- **Other technical requirements**

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ESPTC: The Credit

- **Generally, an individual's ESPTC for a year is the total of:**

  (a) the lesser of $202,500 and 45% of the cost to the individual of the shares issued in the year to the individual under a ESOP established for one or more of the following purposes:

  (i) to facilitate succession planning for a family business in Manitoba,

  (ii) to facilitate an employee buyout or takeover designed to create or maintain employment in Manitoba;

  (b) the lesser of $27,000 and 45% of the cost to the individual of the shares issued in the year to the individual under any other ESOP

- **The tax credit reduces the cost of the shares for tax purposes**

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ESPTC: The Credit (Continued)

- **The total ESPTC cannot necessarily be claimed in the year that the individual makes the investment**
- **In the year that the individual makes the investment, the individual can claim a maximum of:**
  - $27,000 refundable tax credit
  - $40,500 non-refundable tax credit
- **Any remainder of the ESPTC can be carried forward 10 years or carried back 3 years**
  - But to a maximum tax credit of $67,500 per year (non-refundable)

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Small Business Venture Capital Tax Credit Program (Manitoba)

- **A Manitoba-specific tax credit**
- **The Small Business Venture Capital ("SBVC") tax credit program is designed to assist small business corporations in issuing new equity to investors within Manitoba**
- **A corporation must obtain approval from the administrator of the SBVC tax credit program in order to issue shares under the program**
  - Shares must be issued within the approval period as set out in the Notice of Approval
- **Under the SBVC program, corporations can issue shares representing new equity investments worth a minimum of $100,000 and a maximum of $10,000,000**

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SBVC Tax Credit Program: The Credit

- **The maximum tax credit that may be earned is $202,500**
  - Based on a maximum investment of $450,000 (discussed later)
- **The maximum tax credit that can be claimed in a tax year is $67,500**
- **Any unused tax credit may be carried forward for up to ten years or carried back for three years**

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SBVC Tax Credit Program: Requirements

- **Only certain corporations are eligible for the SBVC tax credit program**
  - Many Manitoba-based corporations carrying on an active business will qualify
  - However, certain types of businesses are excluded, such as professional or management services businesses, property developers, franchises, restaurants, etc.

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SBVC Tax Credit Program: Requirements (Continued)

- **Only certain investors are eligible to purchase shares that will qualify for the SBVC tax credit; among other things:**
  - The investor cannot have been a "specified shareholder" of the corporation within the 24 month period immediately preceding the issuance of shares
  - Specified Shareholder: a shareholder of a corporation that owns, directly or indirectly, at any time in the year, **35% or more** of the issued shares of **any class** of the capital stock of the corporation

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SBVC Tax Credit Program: Requirements (Continued)

- **Only certain investors are eligible to purchase shares that will qualify for the SBVC tax credit; among other things (continued):**
  - The investor must not have disposed of any capital stock of the corporation within the 24 month period immediately preceding the issuance of shares
  - The investor paid at least $20,000, but not more than $450,000, for the shares
- **There are requirements with respect to the shares being issued by the corporation**

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SBVC Tax Credit Program: Holding Period

- **Subject to exceptions, the shares issued under the SBVC program cannot be transferred during the holding period**
- **The holding period is three years from the date that the shares were issued**

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SBVC Tax Credit Program: Use of Share Proceeds

- **The share proceeds must be used within the holding period for the purposes that were listed in the SBVC tax credit program application**
- **The share proceeds cannot be used, among other things, for investing outside of Manitoba, lending to others, paying a dividend, etc.**

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Taxation of Stock Options

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Taxation of Stock Options

"The rules in the [Income Tax] Act relating to stock options are intended to encourage greater employee involvement in the granting corporation and to allow corporations to offer their employees financial incentives in lieu of higher salaries." – CRA

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Taxation of Stock Options: Tax Benefit

- **There are no tax consequences at the time that the option is granted**
- **There are tax consequences when the option is exercised – employee must include a benefit equal to:**
  - The FMV of the shares; less
  - Any amount paid by the employee for the shares plus any amount paid by the employee for the right to acquire the shares
- **Exception where the corporation is a CCPC dealing at arm's length with the employee – the benefit will be included in the year of disposition of the acquired shares (rather than on their acquisition)**

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Taxation of Stock Options: Deduction

- **Non-CCPC – There is a deduction equal to ½ of the amount of the benefit (in the year the benefit is incurred) if the:**
  - shares acquired are regular common shares
  - value of the shares when the option was granted did not exceed the exercise price (*i.e.* cannot be "in the money")
  - employee dealt with employer at arm's length
- **CCPC – There is a deduction equal to ½ of the amount of the benefit (in the year the benefit is incurred) if the:**
  - employee owned the shares for two years or more prior to their disposition

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Changes to the Taxation of
Inter-Corporate Dividends (2015)

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Changes to the Taxation of Inter-Corporate Dividends

- **Subsection 55(2) of the *Income Tax Act*, where it applies, can re-characterize what would normally be considered tax free inter-corporate dividends as a deemed capital gain.**
  - Inter-corporate dividends done in the normal course were generally not subject to the application of s. 55(2)
- **Subsection 55(2) was amended in 2015 to apply to any corporate dividend where one of the purposes of the payment or receipt of the dividend was to effect a significant reduction in the fair market value of any share**
  - Basically every dividend has this effect

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Changes to the Taxation of Inter-Corporate Dividends

- **Now, after the changes to s. 55(2), the payment of inter-corporate dividends may trigger capital gains taxes whereas the payment of same used to be tax neutral**
- **The tax status of the dividends now depends in part on a corporation's Safe Income on Hand attributable to the shares in question (after-tax retained earnings plus many adjustments, calculated as at a certain time, and specific to the shares/shareholder)**
  - A very complicated and costly calculation!

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Changes to the Taxation of Private Corporations (Announced Summer 2017)

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Background

- **The Federal Government released a consultation paper proposing significant changes to the taxation of private corporations in the summer of 2017**
- **Received major backlash from tax professionals, small business owners, and professionals with professional corporations (e.g. doctors)**
- **Backed off some proposed changes and watered down others**
  - Still waiting on draft legislation relating to passive investments
  - Draft legislation relating to tax on split income ("TOSI") has been released

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Three Major Issues (per the Federal Government)

1. ***"Sprinkling income using private corporations,*** **which can reduce income taxes by causing income that would otherwise be realized by a high-income individual facing a higher personal income tax rate to instead be realized (e.g., via dividends or capital gains) by family members who are subject to lower personal tax rates or who may not be taxable at all."**

- Released draft legislation

2. ***"Holding a passive investment portfolio inside a private corporation,*** **which may be financially advantageous for owners of private corporations compared to other investors. This is mainly due to the fact that corporate income tax rates, which are generally much lower than personal rates, facilitate the accumulation of earnings that can be invested in a passive portfolio."**

- Did not release draft legislation

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Three Major Issues (per the Federal Government)

3. ***"Converting a private corporation's regular income into capital gains,*** **which can reduce income taxes by taking advantage of the lower tax rates on capital gains. Income is normally paid out of a private corporation in the form of salary or dividends to the principals, who are taxed at the recipient's personal income tax rate (subject to a tax credit for dividends reflecting the corporate tax presumed to have been paid). In contrast, only one-half of capital gains are included in income, resulting in a significantly lower tax rate on income that is converted from dividends to capital gains."**

-Released draft legislation

-Consultation Paper, Tax Planning Using Private Corporations, Department of Finance Canada

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Income Sprinkling (TOSI) Proposals

- **"Kiddie Tax" negatively taxes dividends received by minors from private corporations**
- **For everyone else, reasonability tests for the receipt of dividends**

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Income Sprinkling (TOSI) – New Rules

<u>Rules apply to "split income", which is:</u>

- **dividends from private companies**
- **partnership income**
- **trust income**
- **interest on debt**
- **<u>the taxable half of the gains</u> from dispositions of property excluding deemed gains on death and excluding gains on the disposition of qualified farm/fishing property and of QSBC shares, whether or not the exemption is used**
  - **BUT**: 100% of a capital gain realized in a non-arm's length disposition of private company shares by a person who is still under age 18 at the end of the year will be deemed to be a dividend from a private company, even if they are QSBC shares

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Income Sprinkling (TOSI) – New Rules

<u>If person under 18 throughout the year</u>

- **TOSI applies unless split income is from certain inherited property**

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Income Sprinkling (TOSI) – New Rules

<u>If person is 18 or older at some point in the year but is under 25 throughout the year</u>

- **TOSI applies unless:**
  - 1) split income is from certain inherited property
  - 2) split income is not from a "related business" (defined term)
  - 3) split income is from an "excluded business" (defined term based on the individual working in the business certain hours)
  - 4) the "safe harbour capital return" exclusion applies to the split income (defined formula) **OR**
  - 5) the "reasonable return" exclusion applies to the split income (various factors to consider)

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Income Sprinkling (TOSI) – New Rules

<u>If person 25 or older at some point in the year</u>

- **Same exemptions available as for those 18 or older at some point in the year but under 25 throughout the year (see previous slide)**
- **Split income from "excluded shares" is excepted**
  - "excluded shares" – shares in a corporation which earned less than 90% of its business income from provision of services in previous tax year, the corporation is not a professional corporation, and prior to the end of 2018 the individual owns shares with more than 10% of votes and FMV
  - **NOTE:** It appears that a beneficiary of a trust cannot rely on the "excluded shares" exception because the beneficiary does not own shares

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Income Sprinkling (TOSI) – New Rules

<u>Individual with spouse who is 65 at some point in the year</u>

- **TOSI rules will not apply if the amount would be excluded from TOSI in the hands of the 65 year old spouse**

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Income Sprinkling Proposals – Multiplication of LCGE

- **Generally proposed to restrict access to the Lifetime Capital Gains Exemption for shares of private corporations held in family trusts**
- **Very complicated transition rules were proposed**
- **The Federal Government is <u>not proceeding</u> with these proposals**

66 Decisive. Direct.

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Passive Investment Proposals

- **Extremely complicated proposals**
  - No draft legislation
- **Significant negative tax consequences for earning "passive" investment income in private corporations**
  - Grandfathering of existing passive investments
- **The Federal Government is not backing off of these proposed changes, but is going to water them down**
  - There will be an income threshold of $50,000 per year for non-grandfathered passive investments

67 Decisive. Direct.

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Capital Gains Proposals

- **Aimed at plans where (dividend) income is converted into capital gains**
  - Concern over "surplus strip" transactions, where retained earnings are taken out of corporations as capital gains rather than as dividends
  - Tax rate on capital gains is significantly less than the tax rate on dividends
- **The draft legislation was very broad, and caught a wide variety of transactions**
  - Caught "accepted" tax plans, such as post-mortem pipeline transactions
- **The Federal Government is <u>not proceeding</u> with these proposals**
  - May see revised proposals in the future

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Current Cases and Items of Note

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RECTIFICATION – IT AIN'T WHAT IT USED TO BE

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RECTIFICATION – IT AIN'T WHAT IT USED TO BE

Canada v. Fairmont Hotels, 2016 SCC 56

- Rectification relief – especially in Ontario – was quite broad
  - Unanticipated tax issue arose – not the "intention" of parties
- SCC has tightened relief back to, **arguably**, its "original purpose"
  - Does the written document(s) comply with the actual agreement?
  - Errors of judgment no longer justify rectification
    - E.G. – If I had known "X", I would have done "Y"
    - SOL if unintended or unexpected (tax) outcome
  - *Rectification is not equity's version of a mulligan*
  - *It cannot change an agreement to salvage what a party wanted to achieve*
  - *Juliar* (shares for promissory note → shares for shares)
    - Documents reflected agreement – mechanism was the error
    - Court rectified the agreement = WRONG says SCC

Decisive. Direct.

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RECTIFICATION – IT AIN'T WHAT IT USED TO BE

Canada v. Fairmont Hotels, 2016 SCC 56

- Rectification can only correct errors in the recording of terms of a written agreement when compared to the "true" agreement

- You need
  - A prior agreement whose terms are definite and ascertainable
  - The agreement was still in effect when the instrument was executed
  - The instrument fails to record accurately a term or terms
  - The instrument, if rectified, would carry out the prior agreement

Decisive. Direct.

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RECTIFICATION – IT AIN'T WHAT IT USED TO BE
Canada v. Fairmont Hotels, 2016 SCC 56

- ***Harvest Operations Corp. v. Attorney General of Canada***, 2017 ABCA 393
  - Even if parties intended to carry out transaction on a tax-neutral basis
  - *[66] Rectification is not available just because the means the parties adopted to execute their business objective had unanticipated adverse tax consequences.*
  - *[67] The means that the parties utilized in pursuit of their goal of a tax-neutral transaction — and not the goal of tax neutrality — are the primary focus of a rectification application.*

Decisive. Direct.

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RECTIFICATION – IT AIN'T WHAT IT USED TO BE
Canada v. Fairmont Hotels, 2016 SCC 56

- Rectification can only correct errors in the recording of terms of a written agreement when compared to the "true" agreement
- You need
  - For example – land put into the wrong name
    - *Buyting v. Attorney General of Canada,* 2017 NBQB 190
  - For example – step memo says do issue 100 shares – 10 instead
  - Why step memos are so important – clear evidence of the precise terms of the "true" agreement
  - **CRA will demand that the CLIENT know the agreement**

Decisive. Direct.

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RECTIFICATION – IT AIN'T WHAT IT USED TO BE
Canada v. Fairmont Hotels, 2016 SCC 56

- ***Elias et al v Western Financial Group Inc* 2017 MBCA 110**
  - *[97] In summary, the law of rectification in Canada has returned to its traditional roots. It is not available to assist a party who regrets entering into an ill-advised contract or a contract with unanticipated consequences. Nor should it be utilized in situations that would undermine the reasonable expectations of a party to a contract.*

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CRA'S ?BROADENING? AUDIT POWERS

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231.1 –right to inspect, audit or examine

231.1 (1) An authorized person may, at all reasonable times, for any purpose related to the administration or enforcement of this Act,

(a) inspect, audit or examine the books and records of a taxpayer and any document of the taxpayer or of any other person that relates or may relate to the information that is or should be in the books or records of the taxpayer or to any amount payable by the taxpayer under this Act, and

(b) examine property in an inventory of a taxpayer and any property or process of, or matter relating to, the taxpayer or any other person, an examination of which may assist the authorized person in determining the accuracy of the inventory of the taxpayer or in ascertaining the information that is or should be in the books or records of the taxpayer or any amount payable by the taxpayer under this Act,

Decisive. Direct.

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231.1 –right to inspect, audit or examine

and for those purposes the authorized person may

(c) subject to subsection 231.1(2), enter into any premises or place where any business is carried on, any property is kept, anything is done in connection with any business or any books or records are or should be kept, and

(d) require the owner or manager of the property or business and any other person on the premises or place to give the authorized person all reasonable assistance and to answer all proper questions relating to the administration or enforcement of this Act and, for that purpose, require the owner or manager to attend at the premises or place with the authorized person.

Decisive. Direct.

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231.1 –right to inspect, audit or examine

- **CRA's General Audit Power**
- **Recent "highlights" of this power include**
  - CRA requesting personal financial information of not just owner-manager, but ALL members of household, regardless if involved in business
  - CRA says → "internal controls are weak" – **SMALL BUSINESS!**
  - CRA presuming "guilt" without any indicia?
  - CRA looks at these "indirect tests" to see if reporting accurate
    - PROBLEM → deposit tests / listing of personal expenditures
    - Can you identify the source of every deposit?
      - Reimbursements?
      - How do you keep records (keep cheques)? E-transfers?
      - **Tax risk increases as electronic banking increases**

2015-0572151C6 -- 2015 STEP—Q15—Tax audit and net worth statements

Decisive. Direct.

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231.1 –right to inspect, audit or examine

- **CRA's General Audit Power**
- **Recent "highlights" of this power include**
  - CRA questionnaire
  - See handout – from 2016 FC decision in *Plachcinski* (**Tab 1**)
    - Clients will be looking to us for assistance & guidance
    - ALWAYS SCAN WHAT IS SENT TO CRA

Compliance order

231.7 (1) On summary application by the Minister, a judge may, notwithstanding subsection 238(2), order a person to provide any access, assistance, information or document sought by the Minister under section 231.1 or 231.2 if the judge is satisfied that

(a) the person was required under section 231.1 or 231.2 to provide the access, assistance, information or document and did not do so; and

(b) in the case of information or a document, the information or document is not protected from disclosure by solicitor-client privilege (within the meaning of subsection 232(1)).

Decisive. Direct.

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231.1 –right to inspect, audit or examine

Plachcinski

- **CRA likes to use 231.7 as Court makes the order – if you ignore → contempt of Court (easier than a s. 238 conviction)**
- **TP argued that the request was overbroad and unreasonable**
- **We used to be able to argue that CRA cannot go on a "fishing expedition" → *likely* not anymore → CRA has BROAD powers**
- **FCA has ruled that TPs have a low expectation of privacy when it comes to their records!**
- **CRA need not show that there is a serious and genuine inquiry, but rather only that the info is needed for any purpose related to the administration or enforcement of the ITA?**
- **Long story short – unless you can show "bad faith" – may be SOL**
- **ALSO – CRA can demand information about statute barred years (though, it will need to meet the "burden" if assessing)**

Decisive. Direct.

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231.1 –right to inspect, audit or examine

- **CRA's General Audit Power**
- **Recent "highlights" of this power include**
  - CRA interviews
  - Taxpayer Bill of Rights (do not create "true" rights)
    - **15. You have the right to be represented by a person of your choice**
      - **RC59 and T1013 need to be completed**
      - **CRA will often go directly to the TP as best source**
      - **TP may have to say, "speak to my representative"**
      - **?? Better to let TP speak ?? Avoid suspicion**
        - **Depends on the client**
      - **CRA can likely demand an interview despite finding in *Cameco Corp*, 2017 FC 763**
        - **Can still try to answer via written response**
        - **Becoming more common with desk audits**

Decisive. Direct.

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231.2 – Requirements to provide documents or information

Requirement to provide documents or information

231.2 (1) Notwithstanding any other provision of this Act, the Minister may, subject to subsection (2), for any purpose related to the administration or enforcement of this Act (including the collection of any amount payable under this Act by any person), of a listed international agreement or, for greater certainty, of a tax treaty with another country, by notice served personally or by registered or certified mail, require that any person provide, within such reasonable time as is stipulated in the notice,

- (a) any information or additional information, including a return of income or a supplementary return; or
- (b) any document.

Decisive. Direct.

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CRA Audit Powers: Requirements

- **Requirements can be served requiring a wide array of information**
  - BIG PAIN
  - Often short period of time to respond (7 days)
  - Try to avoid – often arises due to non-responsiveness
  - May be used if risk of privilege – as there is a procedure to protect
  - Often served on the advisor → **Duties to client arise**
  - To challenge (reasonableness / privilege) → off to Federal Court
  - Not always clear what they can ask for – explanations / bases for filing?
  - **Need to deal with promptly or face 231.7 or 238**
  - Notify other party? Customer of your client is the subject?
  - **SOMETIMES YOU NEED TO ASK CRA WHAT SECTION(S) ARE THEY RELYING UPON TO SEE IF A TRUE REQUIREMENT**
  - *KPMG*, 2016 FC 1322 – Code of Professional Conduct is no defence

Decisive. Direct.

FillmoreRiley

CRA "pokes" – scaring Taxpayers into compliance

- **In 2010, the Canada Revenue Agency (CRA) began yearly letter campaigns to inform selected taxpayers about their tax obligations and to encourage them to correct any inaccuracies in their past income tax and benefit returns.**
- **These educational letters are mailed to individuals each year in selected activity groups where taxpayers are at risk of misunderstanding their tax obligations.**
- **The CRA anticipated sending approximately 30,000 letters to selected taxpayers in early 2017.**
- **For example, CRA advises you of a potential "situation" and suggests you fix it**
- **KEY → CRA CANNOT AUDIT EVERYONE**

Decisive. Direct.

FillmoreRiley

CRA "pokes" – scaring Taxpayers into compliance

Dear Sir,

Re: Offshore Transactions

You are receiving this letter because you have sent out of Canada or received from outside Canada electronic funds transfer(s) of $10,000 or more that we want to understand in relation to your recent tax filings.

The CRA knows that Canadians often interact internationally in circumstances that have no tax implications or in full compliance with tax rules.

The CRA also takes tax avoidance and tax evasion seriously and we have a number of new tools that help us identify taxpayers that may not have reported all their worldwide income or disclosed offshore assets.

For example, financial institutions and others are now required to report all international electronic funds transfers (EFTs) over $10,000 directly to the CRA. For more information on EFT reporting please visit http://www.cra-arc.gc.ca/gncy/cmplnc/eft-ti/.

To ensure taxpayers report their worldwide income and assets, the CRA has adopted a risk-based approach seeking to identify which interactions are low-risk for tax compliance and which ones will require more detailed audit work.

Decisive. Direct.

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CRA "pokes" – scaring Taxpayers into compliance

You may wish to contact us in these circumstances:

- If you need clarification on your reporting obligations concerning your international transactions.
- If there are tax implications or you are unsure, we strongly suggest that you review the information site indicated below set up to assist taxpayers, then as applicable review your current and previous income tax filings to make sure that certain assets owned or held by you have been reported and any foreign income and gains have been properly reported. If you need to amend your filings, working through the CRA via the contact information below may avoid the need for additional audit work.

For more information about your foreign reporting requirements or any other issues involving your income tax filing requirements, please visit the CRA's website at www.cra-arc.gc.ca.

The specialised contact number set up for this project is 1-888-333-2033. Please contact us with any questions or additional information as outlined above.

Thank you for your attention to this matter.

Voluntary Disclosure ***appears*** to still be available (for now)

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231.2(3) – unnamed persons

Judicial authorization

(3) A judge of the Federal Court may, on application by the Minister and subject to any conditions that the judge considers appropriate, authorize the Minister to impose on a third party a requirement under subsection (1) relating to an unnamed person or more than one unnamed person (in this section referred to as the "group") if the judge is satisfied by information on oath that

(a) the person or group is ascertainable; and

(b) the requirement is made to verify compliance by the person or persons in the group with any duty or obligation under this Act.

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231.2(3) – unnamed persons

- **Thanks to VERY unhelpful tax law, CRA is truly able to go fishing for taxpayer data**
- **Seen most recently, in *Rona Inc. v. The Queen*, 2017 FCA 118**
  - CRA "sneakily" obtained a contractor credit application form from Rona
  - CRA sought order to compel 57 Rona stores to disclose all sales to contractors between 2012 and 2015 – no names of contractors provided by CRA
  - Rona fought hard at both FC and FCA – no luck!
  - CRA will most certainly use this again (reward programs?)

SEE PAYPAL HANDOUT – Tab 2

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231.2(3) – unnamed persons

Winnipeg Free Press (11/13/17) OTTAWA - The Canada Revenue Agency is seeking information from three Canadian banks about customer transactions linked to a major Israeli financial institution as part of a federal crackdown on offshore tax evaders.

Newly filed court records reveal the agency wants to see account records associated with Bank Hapoalim to determine whether Canadians are hiding income or assets.

The Federal Court of Canada filings come amid renewed public pressure on the government to show it is taking steps to find and penalize Canadians who improperly use offshore accounts to avoid taxes.

Like many foreign banks, Bank Hapoalim has correspondent accounts in Canada to conduct Canadian dollar transactions on behalf of its customers, the revenue agency says. The bank operates in Israel and is affiliated with other financial services companies in Switzerland, Luxembourg, the United States and the Cayman Islands.

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231.2(3) – unnamed persons

The agency is asking the Bank of Montreal, Royal Bank and Toronto-Dominion Bank for records of deposits, cheques and electronic funds transfers associated with Bank Hapoalim's correspondent accounts from April 1, 2011, to Sept. 30, 2017.

The records will be reviewed and analyzed under the direction of the agency's offshore compliance section and, where warranted, lead to formal audits.

Stephanie Henderson, manager of the section, says in an affidavit the agency is aware of Canadian taxpayers who have previously used Bank Hapoalim "to conceal income and assets," shielding offshore activities from the taxman.

Through one audit, the agency became aware of a Canadian taxpayer who maintained bank and investment accounts for over 10 years at Bank Hapoalim in U.S., Canadian and Israeli currencies, Henderson says. "This taxpayer failed to report the interest income earned on account balances and neglected to disclose assets held offshore totalling approximately $11 million."

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231.2(3) – unnamed persons

In another case, a Canadian had bank and investment accounts with Bank Hapoalim and failed to report $1.5 million in income and approximately $5 million in reportable offshore assets.

The agency has also learned of offshore activities in Bank Hapoalim through the federal voluntary disclosure program, which gives people a second chance to file a tax return and ask for relief from penalties.

From April 1, 2015, through March 31 of this year, 114 Canadian taxpayers made voluntary disclosures involving the Israeli bank, Henderson says. The disclosures covered $59 million in unreported income — such as interest, dividends and capital gains — resulting in $17 million in federal taxes.

Since January 2015, the agency has been able to tap into a new stream of information through mandatory reporting of international electronic funds transfers of $10,000 or more.

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231.2(3) – unnamed persons

Some of these transactions entailed Canadian taxpayers closing their accounts at Bank Hapoalim's subsidiary in Switzerland and transferring the funds to other financial institutions outside Canada, Henderson's affidavit says. Other dealings involved Canadians moving funds from the bank in Israel to accounts in Canada or other Bank Hapoalim branches internationally.

In a number of these instances, the individuals "may not have reported sufficient income or disclosed sufficient offshore assets in Canada" to justify the size of the transactions, she adds.

The revenue agency wants to see whether other, as yet unidentified, Canadian taxpayers have similarly used Bank Hapoalim's correspondent accounts to transfer funds to or from Canada.

Last year, the Federal Court approved the revenue agency's requests for seven years' worth of transaction information from the Royal Bank and Citibank, N.A., related to accounts in the name of Cayman National Bank Ltd.

Henderson's affidavit says the information led to audits that uncovered attempts to avoid paying tax in Canada.

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CRA'S NEW VOLUNTARY DISCLOSURE PROGRAM EFFECTIVE MARCH 1, 2018

SPEAK NOW OR FOREVER HOLD YOUR PEACE?

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CRA's New Voluntary Disclosure Regime

- **Changes to the Voluntary Disclosure Program**
  - CRA has offered, for a number of years now, a "Voluntary Disclosures Program" which allows taxpayers to "come clean" in respect of their tax "sins".
  - Needed: (1) penalty, (2) voluntariness, (3) information more than one-year due; and (4) completeness
  - If accepted, no penalties and reduced interest
- **CRA moving away from a processing model to a true application**
  - Judicial Review of a discretionary process? Pre-discussions with CRA?
- **CRA concerned that people were using VD to their benefit**
  - Earning more interest off-shore than what CRA charges – so ahead
- **CRA now comfortable they will find the off-shore??!!??**
  - They have a "Watson" computer, new agreements and requirements
- **CRA does not appear to have considered the "in-shore" taxpayer**
- **Off shore bank accounts and real property = concern**

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CRA's New Voluntary Disclosure Regime

- **Now a 2 track program**
  - General – old relief (all pens and some interest)
  - Limited – only relief from gross negligence/evasion
    - BUT administrative penalties can be huge!
    - Bases for limited relief include (where "intentional conduct"):
      - Active efforts to avoid deduction, e.g. offshore vehicles
      - Large dollar amounts (corps > $250 million gross also SOL)
      - Multiple years of non-compliance
      - Sophisticated taxpayer
      - After CRA campaigns / announcements (caution letter)
      - High degree of high taxpayer culpability
  - Pay tax at time of application
  - Lose voluntariness and any VD if CRA aware of you through a leak
  - CRA no longer allow implicitly limited disclosure to 10 years back?
  - **Disclose name of the advisor!**

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DIRECTOR LIABILITY – PROTECTING THE CLIENT

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Director Liability – Protecting the Client

- **A number of provisions in the relevant tax legislation (ITA, GST, CPP and EI) provide for personal liability being imposed on directors of corporations as a result of certain corporate tax liabilities.**
- **Thankfully, all of the Acts noted above provide for a time limit on the liability of a director.**
  - any assessment or proceedings against a director may only be made, or commenced, within two years after the person last ceased to be a director of the corporation.

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Director Liability – Protecting the Client

- **When do you "cease" to be a director?**

Ceasing to hold office

103(1) A director of a corporation ceases to hold office when he
(a) dies or resigns; or
(b) is removed from office in accordance with section 104; or
(c) becomes disqualified under subsection 100(1).

Effective date of resignation

103(2) A resignation of a director becomes effective at the time a written resignation is sent to the corporation, or at the time specified in the resignation, whichever is later.

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Director Liability – Protecting the Client

- **BUT …**

  Notice of change of directors
  <u>108(1)</u> Within 15 days after a change is made among its directors, a corporation shall send to the Director a notice, in the form the Director requires, setting out the change, and the Director shall file the notice.

- **While this is likely the corporation's responsibility, given the availability of these government records years later, the prudent director will make sure that such a notification is filed.**

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Director Liability – Protecting the Client

- **TRY TO AVOID**
  - *Gariepy v. The Queen*, 2014 TCC 254
    - directors argued that they were not liable under subsection 227.1(1) of the ITA for $500,000 in unremitted source deductions on the basis that they had resigned as directors more than two years prior to the assessment
    - **10 day trial of testimony and evidence**
  - *Bekesinski v. The Queen*, 2014 TCC 245
    - Fact that the appellant only revealed his resignation shortly after the director's liability assessment made the CRA suspicious that the document had been backdated. **The CRA had a forensic document chemist test the authenticity of the resignation by ink date testing.**

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