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TAX LETTER

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US CITIZENS BEWARE! YOUR BANK IS TELLING ON YOU

On February 5, 2014, Canada and the United States signed an "information exchange" agreement under which Canadian banks, brokerages and other financial institutions will report information to the CRA, which in turn will start sharing this information with the IRS beginning in 2015. The government also introduced amendments to the (Canadian) *Income Tax Act* to require this reporting.

The information being reported is of "U.S. persons" who own (or have any interest in) accounts at these institutions. A "U.S. person" includes any U.S. citizen (even if the person is also a Canadian citizen) and anyone who holds a U.S. green card (permanent residency card), even if they no longer live in the U.S. It also includes U.S.-incorporated companies, and various other entities.

This information exchange is being done to comply with the U.S. *Foreign Account Tax Compliance Act* (FATCA). The U.S. requires its citizens to file tax returns and pay tax even if they are not resident in the United States. (The U.S. is the only country in the world that does this, except for Eritrea.) Although U.S. citizens in Canada have a variety of mechanisms to avoid double tax on most of their income, there are many situations where they have to pay some amount of U.S. tax.

In order to "find" U.S. citizens living outside the United States, the U.S. has introduced FATCA. If Canada had not signed the information exchange agreement, Canadian financial institutions would have been required to report information about U.S. persons directly to the IRS, and if any institution did not comply, all payments from the U.S. to accounts at that institution would be subject to a 30% withholding tax. With the information exchange agreement, the withholding tax will not apply (except in some cases of serious long-term non-compliance).

So what does this mean?

If you were born in the U.S. or if you were born in Canada but had an American parent, you may be a U.S. citizen, even if you have never had a U.S. passport. Under the new agreement, your bank (and brokerage, etc.) will now be required to identify whether you are a "U.S. person". If you are, your bank will report this to the CRA, and the CRA will report this to the U.S. Internal Revenue Service. In due course you can expect the IRS to start demanding tax returns from you. Even if no tax is payable, you may be subject to severe penalties for not filing the returns. You may also be subject to very severe penalties, such as $10,000 *per account*, for not reporting all your Canadian bank and brokerage accounts to the U.S. government under the *Bank Secrecy Act*. These rules were introduced to catching hidden Swiss bank accounts, but they apply equally to your regular Canadian chequing or savings account.

If you are a Canadian citizen and live in Canada, the IRS may not be able to enforce collection of any tax or penalties that you owe. However, if you have any assets in the U.S., or if you ever travel to the U.S., having a large tax debt to the IRS will cause you a lot of trouble. (If your Canadian passport shows that you were born in the U.S., American immigration officials at the border will tell you to get a U.S. passport or you will not be allowed in next time. And of course, when you apply for a U.S. passport, the IRS is notified that you exist.

U.S. persons who have not been filing U.S. tax returns and reporting their financial accounts to the American government should get professional advice as soon as possible on how best to comply voluntarily before the IRS catches up with you.

DEDUCTING INTEREST EXPENSE

Under the *Income Tax Act*, interest expense can be deducted from business income or property income if certain conditions are satisfied:

- There must be a **legal obligation** to pay interest. (In most cases this ensures that the recipient of the interest is required to report it as income.) An obligation to pay interest that is contingent or uncertain is disallowed.

- The interest is paid on **borrowed money used to earn income** that is subject to tax. The CRA and Courts generally require that the borrowed money can be traced this way. It is normally not enough to say that if you had not borrowed the money, you would have had to sell other assets that generate income. You need to show that the money you borrowed was directly used to invest in a business or in property that can generate taxable income.

- Alternatively, the interest can be paid on the **unpaid purchase price** of property that is **used to earn income from business** or property (e.g., a vendor takeback mortgage on a rental property). Again there needs to be a direct link between the property and the earning of income. (There are some other special cases where interest deduction is allowed as well.)

- The amount deducted must be **reasonable**.

- The borrowed money, or the property, does not have to actually *generate* income, nor need it generate a profit after expenses. It has to be used with the ***intention* of earning income**. The Supreme Court of Canada ruled in the 2001 *Ludco* case that for shares, earning dividends need not be the primary purpose of the investment; an ancillary purpose is sufficient. The Court also ruled that an intention to earn some amount of income was sufficient, even though it was at a lower rate than was being paid out in interest.

- Traditionally, interest paid on borrowed money used to buy shares in a company was always considered to qualify, since shares can always pay dividends. However, in the 2013 *Swirsky* case, the Tax Court denied a deduction for interest on a loan used to buy family company shares, since the company had no history of paying dividends, so there was no “reasonable expectation of income”. (This case is under appeal and was heard by the Federal Court of Appeal on February 4, so a decision may be issued soon.)

There have been many decisions from the Courts on interest deductibility, on a wide range of fact situations. For example, even if the property acquired goes down in value, the interest deduction can continue: *Tennant* (Supreme Court of Canada, 1996). However, a taxpayer borrowing money to lend at no interest to his own company may not qualify (*Scragg*, 2009). In *Penn Ventilator* (2002), the Tax Court allowed a company to deduct interest paid on a note it issued to repurchase its own stock; and in *Trans-Prairie Pipelines* (1970), interest borrowed to redeem preferred shares was deductible. On the other hand, in the 2013 *A.P. Toldo Holding Corp.* case, interest on borrowed money used to redeem common shares to resolve a shareholder dispute was not deductible, as the company was a holding company and did not have a “financing and banking” business. So the *Penn Ventilator* rule may be quite restricted.

As you can see, while the rules may sound straightforward, they can be hard to apply in practice. If you are seeking to deduct interest, make sure that the funds you borrow are used directly to earn income that is reported on your tax return, and your deduction will normally be allowed.

Special rules in the Income Tax Act prohibit deduction of interest on loans taken out for certain purposes, such as to make RRSP, RESP or TFSA contributions. As well, rules introduced in 2013 prevent interest from being deduction on a “leveraged annuity” or a “10/8” life insurance policy. These are structures that were used before 2013 to take advantage of the interest-deductibility rules.

THE TFSA COMES INTO ITS OWN

Every taxpayer can contribute up to $5,000 to a **Tax-Free Savings Account (TFSA)** for each year since 2009, and $5,500 for 2013 and 2014. Income earned on the funds in a TFSA is tax-free.

If you were at least 18 by 2009 when the TFSA began (i.e., you were born in 1991 or earlier), and you have been resident in Canada since 2009, then you now have a total of $31,000 in contribution room. It’s well worth it to have that $31,000 earning income in a TFSA where it is completely tax-free, even if you take the income out and spend it.

Each taxpayer has the same limit, so you and your spouse can each contribute the maximum.

TFSA contributions are not deductible for tax purposes, but income earned in the TFSA is tax-free and you can withdraw the funds at any time (subject to any restrictions on your investments — for example, if you have bought a two-year GIC, you might have to wait out the two years before you can access the funds, or pay a penalty to the bank for early withdrawal).

If you have investments that are earning interest or dividends that are subject to tax, make sure to max out your Tax-Free Savings Account.

A few TFSA tips and traps to be aware of:

- You can withdraw funds from your TFSA at any time, but you must **wait until the next year to replace those funds**, once you have hit the contribution limit. Otherwise the funds you replace will be subject to a 1% penalty tax *per month*.

  <u>Example:</u> suppose you have already contributed $31,000 by March 2014. In April 2014 you need some cash and withdraw $3,000. If you replace any of that $3,000 by recontributing to the TFSA later in 2014, you will be subject to the penalty tax. You have to wait until January 2015 to replace the $3,000. (Once January 2015 comes, you will also have additional contribution room of $5,500 as you do every year.)

- The Income Tax Act provides "attribution rules" to prevent income splitting that can reduce tax. For example, if you give or lend money or property to your spouse, income earned from that money or property is generally "attributed" back to you and taxed in your hands rather than in your spouse's hands. However, **income earned in a TFSA is not subject to the attribution rules** as long as it stays in the TFSA.

INNOCENT UNDER-REPORTING OF INCOME: HUGE PENALTIES

In recent years, the CRA has taken to assessing very harsh penalties on under-reported income, often in circumstances that are very unfair. Unfortunately, the Courts have upheld these penalties as valid.

Subsection 163(1) of the *Income Tax Act* provides that if you file you return and fail to report some amount of income, and had failed to report some other amount in a return you filed for any of the three preceding years, then there will be a penalty of 10% of that income.

This doesn't sound too harsh, but each province's *Income Tax Act* provides the same rule. The CRA now assesses this penalty under both the federal and the provincial Act (in Quebec, Revenu Québec assesses the provincial penalty), so the penalty becomes 20%.

Doesn't sound too bad? Consider the following case, which is a very real example:

John files his tax return on time every year. On his 2010 return, he gave his accountant all his information slips, but missed one slip that reported $100 of income. So he under-reported his 2010 income by $100.

Then, early in 2013, John got a $50,000 lump sum pension settlement. Tax of 30% was withheld at source, so he only actually received $35,000. When he gave his accountant his papers to file his 2013 return early in 2014, he forgot about this amount. But since tax was withheld at source, no harm done, right? Wrong.

The CRA will likely discover both mistakes via its “matching” program, which identifies non-reporting of income that was reported on information slips using the Social Insurance Number.

Since John had an amount of unreported income on his 2010 return, the penalty kicks in on his under-reporting for 2013. The CRA will assess a penalty of 20% of the $50,000, even though $15,000 was already withheld. John will have to pay a $10,000 penalty.

This penalty is very onerous. It ends up being more costly than the “gross negligence” penalty for wilful failure to report, which applies as 50% of the unreported *tax*. This is not fair, but it is how the rule applies. Making an innocent mistake is no defence. Only if you can show active “due diligence” in trying to comply with your tax obligations will the Tax Court cancel the penalty — and you will normally have to appeal to the Tax Court to even have a chance of that.

AROUND THE COURTS

Wrong information from CRA but company still liable for not collecting GST

The recent Tax Court decision in *Smart Net Systems Ltd.*, is an unfortunate case of a company that was given wrong information by the CRA and did not collect GST on sales of goods that turned out to be taxable.

Smart Net, located in Comox, BC (on Vancouver Island), imported and sold various agricultural and fish netting products. The fish nets were zero-rated (i.e., free of GST) because commercial fish nets are listed in the GST Regulations that apply for this purpose. Agricultural netting, however, is not listed in the Regulations and is not zero-rated.

When Smart Net began importing agricultural netting (used to protect crops), its owner contacted the CRA and was assured, wrongly, that this netting was zero-rated. As a result, Smart Net did not collect GST on these sales.

Eventually Smart Net was audited, and the CRA assessed it for some $17,000 of GST not remitted on the netting. The CRA waived all interest and penalty on the assessment, evidently believing Smart Net’s accountant that it had asked the CRA for direction and been given wrong advice. However, it would not back down from the assessment of the GST itself. Smart Net appealed to the Tax Court of Canada, but the Tax Court dismissed the appeal.

As the Courts have established in many such cases, wrong information received from the CRA does not affect the correctness of a tax assessment. Smart Net might be able to sue the CRA for damages (for negligence in providing wrong advice), but it could not escape the assessment for failing to collect GST on its sales of agricultural netting.

(In this situation, Smart Net should also identify whether it can bill the GST to its customers. To the extent it made large sales to GST-registered customers who can claim input tax credits, the customers should not mind paying the GST to Smart Net since they will recover it. However, if Smart Net has many small customers, this approach will not be practical.)

This is a case where the CRA auditor should have acted more reasonably and simply instructed Smart Net to start collecting and remitting GST on agricultural netting in the future. Once the assessment was issued, neither the CRA Appeals Officer nor the Tax Court judge had the legal authority to cancel it, but the auditor could have simply not assessed in the first place. Unfortunately, the CRA in recent years has become much less reasonable in such situations.

Suing the taxman sometimes works

Many taxpayers who are upset by the way they are treated by the CRA ask if they can sue the government for damages. Almost always the answer is no. As long as CRA auditors or collections officers are acting within the scope of their duties, it will be almost impossible to win a lawsuit.

However, in one particularly egregious case, a company and its owner were recently awarded $4 million in damages against Revenu Québec (RQ), which administers the GST and Quebec Sales Tax in Quebec, for abusive assessment and collection action.

Archambault ran Group Enico Inc. a company in the business of automation control and robotics. Enico was engaged in extensive research and development. It was financially successful and had a good reputation. By 2007 it had 38 employees and over $5 million in annual sales, and was involved in several major projects. It had arrangements in place for bank financing, as well as pending financing from Business Development Bank of Canada (BDC), Export Development Canada (EDC), Investissement Québec (IQ) and R&D Capital. It was also in line to receive several hundred thousand dollars in SR&ED (scientific research and experimental development) tax credits, both federal and provincial. It was current with its tax obligations and had passed an audit in 2000 with no problems.

In 2006-2007, RQ audited Enico, due to a complaint from a disgruntled former employee whom Enico had fired and who was now a competitor. The RQ auditor initially identified some $80,000 in adjustments which Archambault agreed were correct. Suddenly, however, RQ assessed Enico for some $450,000. Based on the tip RQ had received, the auditor believed that deposits to Enico's bank accounts, which were actually monies Archambault had injected into the company, were unreported revenues that included GST and QST that had to be remitted. The assessment included gross-negligence penalties. RQ also assessed Archambault for personal income tax on the basis that he had appropriated $430,000 of Enico's funds.

RQ also proceeded to lose Enico's payroll remittances for one month, and assessed Enico to seize those amounts. This problem was resolved after more than a year, but in the meantime RQ officials labelled Enico as a "delinquent" taxpayer and indicated to Collections that recovering the amounts assessed was "urgent". Collections then proceeded to seize Enico's SR&ED refunds and its bank accounts, even though the audit manager had by then advised Collections that, based on submissions from Enico, the debt would be reduced to a minimal amount.

Enico's business fell apart and it made a bankruptcy proposal to its creditors of 80 cents on the dollar. RQ, quite unreasonably, refused to accept anything less than full payment unless Enico dropped its appeals of the assessments — even though, by this time, RQ had seized so much of Enico's money that RQ owed $290,000 to Enico!

Eventually, the assessments exceeding $600,000 were reduced to about $30,000. The audit manager had confirmed to Collections that this reduction was coming, but Collections still proceeded to collect the amounts showing on the bogus assessments. Not until 2012 did RQ provide Archambault with a meaningful explanation and reconciliation showing how

Enico's supposed debt was calculated — and which had numerous errors.

Enico and Archambault sued RQ and the Attorney General of Quebec in Quebec Superior Court for abusive assessment, unreasonable behaviour by Collections in enforcing collection despite being told by the audit manager that reductions were coming, delay in correcting the incorrect assessments, and wrongful seizure of Enico's bank accounts. They sought total damages of some $12.8 million.

The judge agreed with many of the claims, found RQ liable, and awarded $2 million in actual damages (mostly the loss of Enico's value as a company) and $2 million in punitive damages.

The evidence showed that the auditor had created fictitious entries in his working papers when calculating Enico's supposedly overclaimed expenses. The auditor also lost a year of Enico's expense documentation.

The evidence also showed that RQ collection agents were given targets, or quotas, for revenue collections, and were evaluated based on their performance in collecting revenues. Auditors were also given unofficial targets of raising $1,000 of revenue per hour worked, and could get bonuses for meeting these targets. This was clearly wrong; officials who can issue assessments of taxpayers should not get bonuses for higher assessments!

Overall, the judge ruled that RQ acted in bad faith.

The story is not over yet. Not surprisingly, RQ has appealed this decision to the Quebec Court of Appeal. It remains to be seen what happens with the appeal. So far the Court of Appeal has ordered RQ to cough up $450,000 right away, so that Archambault and Enico can cover their legal fees and defend against the appeal.

ERRATUM — TAX-DEFERRED TRANSFERS TO CORPORATION

In our February Tax Letter, we described the rules for electing an amount to be treated as the proceeds of disposition on transferring property to your corporation in exchange for shares. There was a typo in the paragraph describing the restrictions on the elected amount: it *cannot be less than* the fair market value of any non-share consideration you receive back from the corporation (not "cannot exceed").

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