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TAX LETTER

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UPDATE ON CHARITY DONATION TAX SHELTERS

In past years, various promoters marketed schemes to enable taxpayers to "profit" from the charitable donation credit. (The promoters would also earn huge profits.)

The early schemes were art donations: you would buy art that came with a professional valuation, but you would pay a steeply discounted price, and then donate the art to a charity, which would issue you a tax receipt based on the valuation price. So you might spend $20,000 to buy art supposedly worth $100,000, and claim a charitable donation credit for a donation of $100,000, which would be worth about $50,000 depending on your province of residence.

These shelters expanded to other products, such as software and pharmaceuticals. Some shelters were "leveraged donation" schemes where you donated cash, but most of the cash came in the form of an interest-free loan that you never actually had to pay back. The schemes became more and more complex. Some were outright shams, with no real donation to the charity at all. Most of them resulted in relatively little new charitable work being done.

The federal government reacted with numerous amendments to the Income Tax Act to prevent these schemes from working, and the rules were gradually tightened up. As well, the CRA reassessed all taxpayers it could find who were using these schemes, to deny the tax benefits (other than for simply buying and donating flow-through shares, which is acceptable, though an amendment to the Act made it less attractive).

The resulting appeals to the Tax Court of Canada (and beyond, to the Federal Court of Appeal) have virtually all failed, either on the question of valuation or because the Court concluded that there was no real "gift" to the charity. In many cases the CRA or the Tax Court allowed the actual amount of money paid into the scheme as a donation, but not always.

Some claims were also disallowed because they were not properly registered with the CRA as "tax shelters", with a tax shelter registration number that would have to be shown on the return of each taxpayer claiming the donation credit.

Many charities were hurt by these shelters, because they issued what the CRA concluded were false donation receipts. Dozens of charities had their registrations revoked. Promoters have also been assessed millions of dollars in penalties. Thousands of taxpayers have been seriously impacted or financially ruined by the CRA reassessments, along with interest and sometimes penalties assessed (not to mention legal fees). Numerous class actions and other lawsuits are underway against promoters and law and accounting firms that advised on these shelters; some of them have settled with significant payments.

Marketing of these shelters has pretty much dried up, as the promoters and professional advisers realize that their scheme will not work, and taxpayers are better informed than in the past. The CRA has tried to ensure the public is aware of this on their website.

2019 saw several more Court decisions that continued on the same path of denying taxpayers the claimed credits.

If you took part in a donation scheme years ago and the CRA reassessed you, and the promoters have retained legal counsel to handle your appeal along with everyone else ... don't hold out great hope for your appeal to succeed. The appeals might settle without a Court hearing, but you aren't likely to get the full donation you claimed. (Of course, this is a general comment; we aren't privy to the specifics of every donation scheme or shelter that was used.)

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. However, the legal obligation can be under an oral arrangement — provided the CRA or the Tax Court believes the obligation actually existed (e.g., *Conrad Black v. The Queen*, 2019 TCC 135).

- The amount deducted must be **reasonable**. If the borrowing is not at arm's length (e.g., a loan from a family member) and the rate paid is higher than a commercially available interest rate, the CRA will normally disallow the excess.

- The interest is paid on **borrowed money used for the purpose of earning income** that is subject to tax. The CRA and the Courts generally require that the borrowed money can be traced this way. It is 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 for the purpose of earning income** from business or property (e.g., paying interest on 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 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 *Ludco* case (2001 SCC 62) 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 *Swirsky* case (2014 FCA 36), the Federal Court of Appeal 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".

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, special anti-avoidance rules prevent interest from being deducted on a "leveraged annuity" or a "10/8" life insurance policy. (These were structures that were used before 2013 to take advantage of the interest-deductibility rules.)

As you can see, while the rules may sound straightforward, they can be hard to apply in practice. The above just touches briefly on the complexity of the interest deduction. 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.

LEAP YEAR REMINDER: TRUST RETURN DEADLINE

If you are the trustee of a trust, or otherwise responsible for filing a "T3" trust income tax return, you need to be aware of the effect of 2020 being a leap year.

The **deadline for filing the return** for a trust with a December 31 year-end is often thought to be March 31, but it is not. It is **90 days after the year-end**.

Because 2020 is a leap year, there were 29 days in February. As a result, the deadline is **Monday March 30**, not Tuesday March 31.

Missing the deadline by just one day can result in a 5% penalty for any unpaid tax, and can cause serious problems if certain elections that are required to be filed by the return deadline are not made on time.

DON'T DO TOO MUCH TRADING IN YOUR TFSA

As is well known, the Tax Free Savings Account rules allow you to invest a substantial amount of money in a TFSA, and all interest, dividends and capital gains earned in the account are tax-free.

For 2020, another $6,000 is added to the amount you can contribute.

Since TFSA eligibility starts at age 18 and TFSAs started in 2009 (originally at $5,000 per year, now $6,000), your cumulative TFSA contribution limit as of 2020 is, based on your birthdate:

before 1992	$69,500
1992	64,500
1993	59,500
1994	54,500
1995	49,500
1996	44,000
1997	38,500
1998	28,500
1999	23,000
2000	17,500
2001	12,000
2002	6,000
2003 or later	0

You can withdraw funds from a TFSA at any time with no tax cost, and the amount you withdraw becomes available to re-contribute, but only from the following January 1. If you recontribute too soon, a penalty tax applies.

Do not swap securities in or out of your TFSA, i.e., in exchange for money or securities in other investment accounts. Severe penalties apply to a "swap transaction".

Also, do not do too much active trading in your TFSA. If you buy and sell securities all the time, the TFSA may be considered to be "carrying on business", and then it loses its tax exemption and will have to pay tax, as a trust, at the highest tax rate that applies to individuals (something in the 50% range, depending on your province of residence). And you will be personally liable for that tax, so the CRA can assess you to collect it if the TFSA doesn't have sufficient assets to pay.

The line between owning stocks as capital investments and holding them for trading as a business is not always clear. At one extreme, if you just buy or sell a stock once a month there should be no problem. At the other extreme, if you are trading almost every day and holding stocks for only a few days at a time, that will be considered carrying on business and the TFSA will be taxed.

So be careful about this!

NEW STANDARD FOR THE CRA NEEDING TO BE "REASONABLE"

Most disputes between taxpayers and the Canada Revenue Agency, if not resolved, can be appealed to the Tax Court of Canada (after first filing a Notice of Objection with the CRA). That is the appeal route you use if the CRA issues an "assessment" or "reassessment", and you take the position that the (re)assessment is incorrect.

However, some matters are for CRA discretion: the CRA can *choose* to grant you relief, or not. One example is waiving, or cancelling interest and penalty: the Income Tax Act gives the CRA discretion to do that, and the CRA has "Taxpayer Relief" guidelines that it will apply in deciding whether or not to waive some or all of the interest and penalty.

Another example is a request to open up an old tax year to allow deductions or credits not previously claimed. The Income Tax Act allows this for up to 10 years, but the CRA has discretion as to whether to do so (and again will apply its "Taxpayer Relief" guidelines).

What can you do if the CRA refuses to provide relief?

You can't appeal to the Tax Court. The assessment isn't legally incorrect. You just think

that the CRA was unfair in not providing the relief you asked for.

But you can apply to the **Federal Court** for "judicial review" of the CRA's decision. It has been well understood for decades that, if the CRA decision was "**unreasonable**", the Federal Court can order the CRA to have a different Taxpayer Relief official make a new decision. (The Court cannot substitute its own decision.)

But what does "unreasonable" mean?

In 2019, based on a case, the Supreme Court decided, in a 7-2 ruling, to make new law for a Court to determine whether a government action was "reasonable". The new rules will require the CRA (and other government agencies) to be more transparent and careful in issuing reasons for denying a request. While CRA's Taxpayer Relief letters usually do provide detailed reasons, the *Vavilov* decision may require the CRA to be more thorough.

The *Vavilov* decision is extraordinarily long: 239 pages (though the decision of the majority is summarized in "only" 17 pages). Applying it to future disputes with the CRA will be challenging. Here are some of the key new points to apply from the reasons of the 7-judge majority, in determining whether the CRA has acted reasonably in, say, refusing to waive interest or to allow a late claim for a deduction:

- The CRA must "adopt a culture of justification and demonstrate that their exercise of delegated public power can be justified" (para. 14).

- The Federal Court must ensure that the "decision as a whole is transparent, intelligible and justified" (para. 15).

- The Court does not ask what decision it itself would have made, ascertain the range of possible conclusions, conduct a new analysis or seek the correct solution; but must consider only whether the CRA's decision, *including both rationale and outcome*, was unreasonable (para. 83).

- Two fundamental flaws that can render a decision unreasonable (para. 101) are a "failure of rationality internal to the reasoning process" (e.g. irrational chain of analysis, or if the reasons in conjunction with the record do not make it possible to understand the reasoning on a critical point, or exhibit clear logical fallacies: paras. 103-104) and "when a decision is in some respect untenable in light of the relevant factual and legal constraints", taking into account the governing statutory scheme, other relevant law, the principles of statutory interpretation, the evidence before the CRA and facts of which the CRA may take notice, the parties' submissions, the CRA's past practices and decisions, and the decision's potential impact on the taxpayer (para. 106).

- Furthermore, the CRA must consider the evidentiary record and the general factual matrix, and its decision must be reasonable in light of them (para. 126).

- Whether a particular decision is consistent with past CRA decisions is also a constraint the Court should consider (para. 131).

- Finally, individuals are entitled to greater procedural protection when the decision involves potentially significant personal impact or harm, including threatening one's "livelihood" (para. 133), and if the impact is severe, the CRA's reasons must explain why the decision best reflects Parliament's intention in enacting the rule

that gives the CRA discretion to make a decision.

As you can see, due to the number of factors above, there will be lots of room for arguing in a particular case that a CRA decision was unreasonable. Overall the *Vavilov* case will likely improve the chances of a taxpayer being able to challenge a CRA discretionary decision.

INTERNATIONAL TAX RULES — MASSIVE CHANGES

The international tax law has been subject to massive upheaval in the past few years.

For example, foreign bank secrecy has disappeared. Over 100 countries now exchange financial information with each other, so if you (with a Canadian address) have a significant bank account in, say, France, the French government will send details of that account to the CRA, and of course the CRA does the same for French residents with accounts in Canadian financial institutions. This is done using something called the "Common Reporting Standard", coordinated by the OECD.

Another major change just took place in Canada. The government signed and ratified the "Multilateral Convention to Implement Tax Treaty Related Measures". This convention, known as the "MLI" (multilateral instrument), effectively amends most of Canada's tax treaties to limit how they can be used for "inappropriate" tax planning. It operates to amend the tax treaty between each pair of countries that signs on; so far 94 countries have signed, though the MLI is not yet in force in all of them (each country has to ratify the agreement by passing legislation, and then must notify the OECD that it has done so and how it wants the MLI to apply). For Canada, 24 of its treaties have changes that took effect January 1, 2020. Most of these changes implement various anti-avoidance rules, in ways that can operate differently for each treaty depending on that treaty's terms.

If you are involved in any transactions or investments that make use of tax treaties, you should find out whether the MLI affects you. (Canada's tax treaty with the United States is not affected, as the U.S. decided that its treaties already contain the necessary anti-avoidance provisions.)

AROUND THE COURTS

Lawn and garden care allowed as home office deduction

In the recent case of *Hébert v. The Queen*, 2019 TCC 266, Mr. Hébert was a civil engineer who had sold his business and provided consulting services from his home. He used the basement of his home as his office (with a separate entrance), and he had clients in the office. He also conducted arbitration session at his home.

As part of his deductible "home office" expenses, Mr. Hébert claimed 35% of the expenses that he paid to have the lawn mowed and annual flowers planted. This fraction was the same 35% as for his other home office expenses, based on the proportion of the home that he used for his business.

The CRA reassessed him to deny various expense claims including the lawn and garden care, and Mr. Hébert appealed to the Tax Court of Canada.

The Tax Court judge allowed the lawn and garden care expenses. She concluded that these expenses were intended to insure that

the home was in perfect condition to receive clients. (For certain other expenses, the Tax Court upheld the CRA's position.)

This decision is significant because CRA auditors often deny these expenses, although nothing in the CRA's publications specifically addresses this issue. The *Hébert* case can be cited in support of such claims. However, as an "Informal Procedure" decision of the Tax Court, it is not binding on the CRA.

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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.