Davidson & Company
CHARTERED PROFESSIONAL ACCOUNTANTS

TAX UPDATE

A member of Nexia International

March 2017

"RECTIFICATION" TO FIX TAX MISTAKES WILL NOW BE RARE

A recent decision of the Supreme Court of Canada has seriously restricted the use of "rectification" to fix tax problems.

Here's the background:

Tax planning sometimes goes wrong.

Transactions executed for tax purposes often involve corporate reorganizations, contracts, issuing new classes of shares, mergers, transfers, etc. What happens if someone forgets to sign the right document, or the lawyers do not draft the right documents to make the transaction work?

Or worse yet, what happens if you or your corporation engage in some transaction, such as a real estate deal, setting up a trust, or a transfer of property within a family group, and aren't properly advised about the tax consequences, and a huge tax problem results?

Until recently, it was frequently possible to fix the problem by seeking "rectification" from a Court. Not the Tax Court of Canada, which is the only Court that can hear your tax appeal, but the superior court of the province whose law governs the corporation or the transaction.

The reason rectification works is that the province's superior court has the sole right under the Constitution Act, 1867 to determine matters of "property and civil rights in the province". The Tax Court of Canada, on a tax appeal, is required to apply provincial law to determine the status and meaning of such things as contracts and corporate documents; and if the province's superior court has issued a formal Order deeming a contract to have included a particular provision or deeming a corporation to have issued a particular class of shares, the Tax Court is required to accept that ruling as determining those matters.

One can apply to the superior court for a retroactive order "rectifying" a contract or document. The Court may be quite sympathetic, as long as you are simply trying to fix a mistake and get the effect you intended.

In some cases in recent years, the concept of rectification was expanded to include situations along the lines of, "if we'd known the tax consequences of this arrangement, we wouldn't have done it".

This changed on December 9, 2016. That was the day the Supreme Court of Canada released its decision in Fairmont Hotels.

In essence, rather than being available where "we would have done the transaction differently", rectification is now available only where "we clearly agreed to do X but mistakenly wrote down Y".

As the Supreme Court explained, rectification is "limited to cases where the agreement between the parties was not correctly recorded", and "it may not change the agreement in order to salvage what a party hoped to achieve". A party seeking rectification must bring "clear, convincing and cogent" evidence "that the true substance of its unilateral intention or agreement with another party was not accurately recorded" in the documents signed.

The rules for rectification in Quebec are the same as for the rest of Canada, per the Supreme Court's parallel decision in Jean Coutu Group, released at the same time.

REQUEST A DETERMINATION IF YOU HAVE A LOSS

If you have a business or property loss that wipes out all of your income for the year, you report taxable income on your income tax return as zero.

What happens if the CRA audits you some years later and decides that you claimed too much loss?

For a regular assessment of tax, there is a "three-year clock" that starts running as soon as the CRA issues your original assessment for the year.

Thus, for example, if you filed your 2014 return on April 6, 2015 and you received a Notice of Assessment dated April 22, 2015, then the CRA cannot reassess you to change your 2014 taxable income after April 22, 2018. (This limitation does not apply in cases of fraud, carelessness, neglect or wilful default, or if you sign a waiver before the deadline.)

But what if you had a business loss in 2014, reported zero taxable income and zero tax, but also had a $50,000 loss carryforward to claim in a later year? And suppose the CRA decides, many years later, that the $50,000 loss shouldn't be allowed?

The three-year clock will not start running for a loss, since your "assessment" — i.e., zero tax for 2014 — does not change. Thus, for example, if you try to use the $50,000 loss from 2014 on your 2017 return, the CRA can reassess you to deny the claim, any time up to the reassessment deadline for your 2017 return (sometime in 2021), rather than only until April 2018, as would be the case for your 2014 return.

There is a way to prevent this, however, and to start the clock running. Once you receive your "nil assessment" for a year in which you pay no tax, write to the CRA and request a determination of loss under Income Tax Act subsection 152(1.1). The CRA will usually comply and issue the determination fairly quickly. Once it is issued, the date on the Notice of Determination starts a three-year clock running for any redetermination. If the three years run out, then your loss is guaranteed and (subject to exceptions for fraud etc. as mentioned above) you can be sure of being able to carry it forward and claim it in a future year. Business losses can now be carried forward up to 20 years.

So, if you have nil taxable income for the year and a loss carryforward, request a "determination of loss".

RRSP, RRIF AND TFSA FEES WILL HAVE TO BE PAID FROM THE PLAN

If you have a self-directed Registered Retirement Savings Plan (RRSP), Registered Retirement Income

Fund (RRIF) or Tax-Free Savings Account (TFSA), your financial institution likely charges you an annual administration fee — perhaps something like $125 per year plus GST or HST. If you have a "fee-based" account where your investment advisor charges you a percentage of the plan's value in exchange for investment advice and in place of commissions, your annual fees may be much higher.

Until now, these management fees and investment counsel fees for an RRSP, RRIF or TFSA could be paid either from the plan or from your personal, "non-registered" accounts. Paying the fees from your personal account would in effect give you a small addition to the funds in the plan that grow tax-free — or, put another way, would avoid reducing the value of the plan by the amount of the fees. (The fees are not deductible to you for income tax purposes, regardless of whether they are paid from the plan or from your personal account.)

As of June 2018, the CRA will not permit these fees to be paid by you personally. They must be paid from the registered plan. If you pay them from your personal account, the CRA will consider this an "advantage" that you have received from the plan. An "advantage" from an RRSP, RRIF or TFSA is a technical term defined in the Income Tax Act, and is considered a very BAD THING. In general, the Act imposes a 100% tax on an "advantage", effectively confiscating it.

The CRA has given the public a year's notice of this change, to allow financial institutions to adapt. You can expect a letter from your financial institution within the coming year, telling you that from now on the fee will be charged to the plan, and you will no longer be given the option of paying the fee from your personal account.

TFSA CONTRIBUTION LIMITS

Tax-Free Savings Accounts, or TFSAs, have now been around for over eight years. One can easily lose track of the available contribution room, as the maximum that can be contributed has changed over the years.

Contribution room is cumulative. Once you are 18 or older in a year, you can contribute the maximum for that year, and if you do not, you can carry forward the excess room and contribute that amount in any later year.

All investment income earned in a TFSA, such as interest and dividends, as well as capital gains, is tax-free. This makes TFSAs more and more useful as the years go by.

Of course, you can withdraw any amount from the TFSA at any time, tax-free. Doing so re-creates that amount of contribution room, but only on the next January 1, not immediately.

So the limit for each year is:

2009	$ 5,000
2010	5,000
2011	5,000
2012	5,000
2013	5,500
2014	5,500
2015	10,000
2016	5,500
2017	5,500

The total of the above amounts is $52,000.

Since TFSA eligibility starts at age 18 and TFSAs started in 2009, the cumulative TFSA contribution limit during 2017 is, based on your birthdate:

Born before	1992 (2009-2017)	$52,000
	1992 (2010-2017)	$47,000
	1993 (2011-2017)	$42,000
	1994 (2012-2017)	$37,000
	1995 (2013-2017)	$32,000
	1996 (2014-2017)	$26,500
	1997 (2015-2017)	$21,000
	1998 (2016, 2017)	$11,000
	1999 (2017 only)	$5,500
	2000 or later (age 17 and under)	Nil

MAKE MONEY VOLUNTEERING FOR A CHARITY

If you volunteer for a charity, you may be able to make a little money at no cost to the charity.

The charity cannot give you a donation receipt for the services that you provide for free. A valid donation receipt for tax purposes can only be issued for a donation of money or property.

However, suppose the charity pays you for your services and you donate the money back?

If you are not in a high tax bracket (taxable income over $142,353 in 2017), this will pay off. Donations over $200 per year will give you a 29% federal credit plus a provincial credit, for a total savings of 35-50% depending on the province. If you are in a lower bracket, the income you report from the charity will be taxed at a lower rate than the credit you receive. The lower your tax bracket, the higher the differential and thus the more profitable it will be to have the charity pay you.

If you are in Alberta or Nova Scotia, the benefit is even larger. Both of these provinces provide a special 21% provincial tax credit for charitable donations over $200. This makes the total federal/provincial credit worth 50%, even for someone paying a much lower marginal rate of tax.

Of course, the amount the charity pays you for your services must be reasonable, or the charity can run into problems if it is audited by the CRA. Also, if you are a director of the charity (or related to a director), you might not be permitted to be paid by the charity for your services. There are numerous rules, both federal and provincial, that govern charities and their activities.

WATCH OUT FOR SHORT TAXATION YEARS

A corporation can be deemed to have a year-end for income tax purposes, in the middle of its fiscal year, for a number of reasons.

One common reason is a change in control (or of 75% ownership) of the corporation (now called a "loss restriction event" in the Income Tax Act). If the corporation is sold to new owners, it will be deemed to have a year-end and start a new taxation year. (Business losses from previous years will then generally not be claimable unless the corporation continues to carry on the same or a similar business. Capital losses from previous years will not be claimable at all after the change in control.)

Another trigger for a year-end is if the corporation becomes or ceases to be a Canadian-controlled private corporation. Thus, for example, if the majority shareholder becomes non-resident, the corporation will be deemed to start a new taxation year.

There are several other such triggers, including becoming or ceasing to be exempt from tax, and becoming or ceasing to be a "financial institution".

What happens when the corporation has a new taxation year and a resulting "short" year (or two)? Many things change, and there can be numerous negative side effects. For example:

- A corporate tax return must be filed for the "short" year, within 6 months of the deemed year-end.

- The due date for the current year's tax balance is moved earlier (two or three months after the deemed year-end).

- A loss carryforward year will usually vanish due to the extra taxation year, as can other carryforward years such as for foreign tax credits, investment tax credits and certain reserves. This means that the carryforwards will expire sooner than they otherwise would. (Most business losses can now be carried forward for 20 years, but many other carryforwards are much shorter).

- A loan to a shareholder may have to be repaid sooner to avoid being included in the shareholder's income.

- Certain reserves, and certain accrued amounts that were deducted but have not been paid out, may be reincluded in income sooner than would otherwise be required.

As well, certain calculations that are based on the presumption that a taxation year has 365 days will now be different. A corporation's monthly instalment requirements are based, for example, on the previous year's tax payable, but prorated based on the length of that taxation year. Suppose a corporation has $100,000 of tax payable for the year but all of it was earned in the first three months of the year, and the corporation was sold after 3 months. The "instalment base" for the next year will be $100,000 but prorated to a 12-month year, so the corporation might have to remit instalments of $400,000 the next year (though it can pay lower instalments if it knows that its tax will be lower).

Similarly, most capital cost allowance claims will be prorated to the short taxation year, as will various other claims including those for the small business deduction, and limitations on investment tax credits for small corporations.

Any change to a taxation year-end must be very carefully analyzed for all the unexpected fallout.

AROUND THE COURTS

Former director still involved in running company was not a "de facto" director

The recent Tax Court of Canada decision in Koskocan has potentially changed the law on de facto directors.

The question of "who is a director of a corporation" is very important in tax disputes, when a corporation goes out of business owing either GST/HST net tax, or payroll deductions (income tax source withholdings), or both. In most cases, the directors of the corporation are fully liable for its unremitted payroll deductions and GST/HST.

Over the past 18 years, the CRA and Revenu Québec (RQ) have often assessed a person on the grounds that the person was a de facto director even if not legally a director. A 1999 Federal Court of Appeal decision (Wheeliker and Corsano) confirmed that someone who thought he was a director, but had not properly been appointed, was liable as a de facto director.

The concept of de facto director has gradually expanded over the years, to effectively include anyone who is managing a company.

In this case, Koskocan founded a company in 1997 that operated a pizzeria in Montreal. In 2003 he turned the business over to his son and resigned as director, but he continued to help out with the business in various ways, including being the person who signed its cheques. RQ decided the company had under-reported its revenues and assessed it for a large amount of GST and Quebec Sales Tax. When the company could not pay the debt, RQ assessed Koskocan for the debt as a de facto director.

Koskocan appealed his GST assessment to the Tax Court of Canada, which allowed his appeal and cancelled the assessment. The Court strongly rejected the recent trend of treating anyone involved in running a company as a de facto director.

The judge engaged in a lengthy review of the meaning of "director", and explained that directors are supposed to provide direction to a company through board decisions, to pass resolutions and to take certain major actions. It is the officers of a corporation who run it on a day-to-day basis.

When a person takes actions such as signing cheques or routine contracts on behalf of a corporation, those are not the actions of a director but of an officer or manager. Koskocan's actions were, if anything, those of a manager. He was not a de facto director and so he was not liable for the company's GST debt.

For good measure, the Tax Court also ruled that RQ's method of calculating the restaurant's revenues, based on its use of utilities and industry averages, was unreliable, so there was no GST debt of the corporation for Koskocan to be liable for, even if he had been a director.

This decision is refreshing. If the other judges of the Tax Court follow it, it will greatly restrict the number of cases where a person can be assessed as a de facto director.

RQ did not appeal this decision to the Federal Court of Appeal, so as of now it stands as the latest word on de facto directors.

Lawyer liable for not giving tax advice

The Ontario Superior Court of Justice issued an interesting ruling in January 2017, in Ozerdinc Family Trust v. Gowling Lafleur Henderson LLP. A lawyer who set up a family trust was found liable for not advising about the tax consequences.

The parents in question were doing trust and estate planning, and retained S as their lawyer in 1990. S set up a trust for their children, with a final distribution date of all the trust assets once the youngest child turned 22. In 2007, the parents decided this meant the children would get their money too early (perhaps they thought the children would not yet be mature enough), and they came back to S for assistance. He created a new trust for them, to which the old trust transferred its assets tax-free. The trust assets included property with substantial accrued capital gains that had not yet been taxed.

Unfortunately, in 1990 S failed to tell the parents about a key rule that applies to trusts: every 21 years there is a "deemed disposition", and the trust must recognize and pay tax on all accrued capital gains. Since a trust usually pays tax at the highest marginal tax rate, this is often much more expensive than if the gains were taxed in the beneficiaries' hands.

S's failure to tell the parents about the "21-year deemed disposition rule" continued in 2007 when he designed the new trust. While it was possible to transfer the old trust's assets tax-free to the new trust, S did not realize that the Income Tax Act provides that the 21 years would still expire in 2011, on the 21st anniversary of the old trust. The new trust had to pay substantial tax on the deemed gains for its 2011 taxation year.

Had S warned the parents about this problem, there was a fairly simple tax solution: the assets could have been "rolled out" tax-free to the children in 2011, before the 21 years were up, and the tax on the capital gains could have been deferred further and likely reduced.

The Court ruled that S's law firm was liable in negligence to the trust. However, determination of the amount of damages to be awarded was left for another day.

As can be seen, there are many income tax traps that can catch an unwary taxpayer who is planning their financial affairs.

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 Update, which are appropriate to your own specific requirements.

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