JOHNSEN ARCHER LLP
TAXATION · ACCOUNTING · ASSURANCE

30 years of original thinking

TAX LETTER

March 2015

MAJOR CHANGES AFFECT WILL PLANNING
CRA ONLINE SERVICES
REGISTRATION OF TAX PREPARERS TO START IN 2016-2017
GST/HST — RISKS OF DEALING WITH A SHADY SUPPLIER
SEVERE PENALTY FOR REPEATED UNREPORTED INCOME
AROUND THE COURTS

MAJOR CHANGES AFFECT WILL PLANNING

Major changes affecting **estate planning and testamentary trusts** were recently made to the Income Tax Act. These changes were enacted by Bill C-43, the 2014 Budget second bill, passed in December 2014. They take effect **January 1, 2016**, and will apply to all testamentary trusts as of 2016, regardless of when the death occurred.

If you have a Will, and especially if the Will creates a trust (known as a "testamentary trust"), then you need to have it reviewed in light of these changes, as estate planning done before 2014 may no longer "work" for tax purposes.

For over 40 years, and still until the end of 2015, testamentary trusts have been eligible for special tax treatment in a number of ways. For example:

- Most notably, a testamentary trust pays tax at the same "low" graduated rates on low amounts of income as individuals (though the personal credits are not available). An "*inter vivos*" trust (created during one's lifetime), by contrast, must pay tax at the top marginal rate (29% federal tax on all income, plus the top marginal rate for provincial tax).

- A testamentary trust can choose a non-calendar year-end for tax purposes, thus deferring tax for its first year.
- Certain losses in a testamentary trust can be carried back and claimed on the deceased's final return.

- A testamentary trust can "flow out" certain amounts, such as pension benefits, death benefits and deferred profit sharing plan benefits, so that favourable tax treatment of these benefits is available to the beneficiary. For an *inter vivos* trust, these payments are simply trust income and do not keep their character (and associated favourable tax treatment) in the beneficiary's hands.

There are numerous other tax benefits as well, relating to Alternative Minimum Tax, late refund claims, extended deadline for filing a notice of objection, instalment obligations, flow-out of investment tax credits to beneficiaries, and others.

Starting 2016, all these benefits are available only to a **"graduated rate estate"**, which is essentially the deceased's estate for the **first 36 months** after death (provided the estate files a designation with its first tax return).

So if your Will creates any trusts, the tax effects will change substantially starting 2016, and your Will may need review. In some cases it will be better to remove the provisions creating the trust, and let the estate benefit from low tax rates for up to 36 months. Also, if your estate's affairs are tied up for any reason (e.g. due to litigation) so that the estate cannot be wound up within 36 months, the estate's income after that point will be subject to high rates of tax.

There are other changes to the trust rules as well. Advice from a professional familiar with estate planning will normally be required in considering changes to your Will.
Note also that existing testamentary trusts that do not use the calendar year will have two taxation years in 2015 and will be required to file two returns, since they will be forced into a December 31 year-end.

CRA ONLINE SERVICES

Even though your income tax return is prepared professionally and filed electronically, you may wish to check the CRA's online system yourself to review amounts, balances, carryforwards, and other information on your file. The CRA's "My Account" system is now quite sophisticated and can provide you with a lot of information.

To access My Account, at www.cra.gc.ca/myaccount, you can register with the CRA online and receive a password by mail. Alternatively, you can access the CRA system through your online banking, if you bank at BMO, Scotiabank or TD, or have a Choice Rewards MasterCard or use Tangerine Forward Banking (this list will expand over time). The financial institution will not have access to anything in your CRA account and will not even know which government service you are using, but the CRA will have some assurance of who you are since you are logged into your online banking account.

The CRA is also moving towards **electronic notices of assessment** and other communications. To receive communications this way, you provide the CRA with your email address and you will get a notification when there is mail for you. You then log in to the My Account system and get your message or notice. **Note that it can be dangerous to set this up:** if the email doesn't reach you for any reason, you're still deemed by the Income Tax Act (subsection 244(14.1)) to have received the notice that is posted to your My Account. The clock will then be ticking for any action you need to take, such as filing a Notice of Objection within 90 days. You could lose your appeal rights due to a fault in the email system or your computer. So consider carefully whether

you want to risk signing up for electronic notices!

See also www.cra.gc.ca/electronicpayments for payment of tax debts online, including by online banking, debit card (Interac), various third-party service providers, or by credit card (subject to extra fees).

REGISTRATION OF TAX PREPARERS TO START IN 2016-2017

In January 2014, the CRA began consultations on whether to introduce a system that requires tax preparers to be registered with the CRA. Some other countries, including the United States, already have such a requirement.

Although the CRA has not made any broad public announcement, a document issued on November 26, 2014, *Reducing Participation in the Underground Economy*, says:

> "the Registration of Tax Preparers Program, to be implemented in 2016–2017 ... will help to improve compliance by working with tax preparers to reduce errors and to identify high-risk tax preparers associated with deliberate non-compliance".

Note that a form of registration is already effectively required. Any tax preparer who prepares more than 10 individual returns or 10 corporate returns is subject to a penalty if those returns are not filed electronically. And filing electronically requires the preparer to register for the CRA's "E-File"system. So unless training or qualification requirements are introduced, "Registration of Tax Preparers" will not likely change the current state of affairs very much.

Ongoing information about this new initiative is available on the CRA web site at cra.gc.ca/rtpp.

GST/HST — RISKS OF DEALING WITH A SHADY SUPPLIER

If your business purchases goods or services from other businesses, and you think some of them may not be complying with their tax obligations, there is a serious risk that you need to address. The risk is primarily in the GST/HST area.

This comes up in everything from construction services, to agencies that supply temporary personnel, to garment work, scrap metal sales, and many other areas.

Surprisingly, **the risk is primarily where the supplier charges you GST/HST**. If it does not charge you GST or HST that you should be paying, your risk is far lower, because the worst that can normally happen is that you have to pay the GST or HST down the road, and will be able to claim an offsetting input tax credit at that time.

Background

Assuming your business makes "taxable supplies" for GST/HST purposes, you are normally entitled to input tax credits (ITCs) to recover all GST or HST you pay on purchases.

However, as you probably know, these ITCs are available only if the supplier provides you with an invoice or receipt that meets detailed documentation requirements. Those requirements normally include the supplier's name and GST/HST registration number, the price paid, a "description of the supply sufficient to identify it", the amount of GST

or HST, the date, the purchaser's name, the terms of payment and certain other details. (See GST/HST Memorandum 8.4 on www.cra.gc.ca.)

These documentation requirements are mandatory; if they are not met, you cannot claim the ITCs to recover the tax you have paid to your supplier.

The problem

The Canada Revenue Agency has been dealing for many years with the problem of companies that bill GST or HST for goods or services, collect the money and then disappear. Quite apart from not paying corporate income tax on their profits, these companies are literally **stealing the sales taxes**, which they collect on behalf of the government and are supposed to hold in trust for the government.

This problem has also shown up in Quebec, where Revenu Québec (RQ) administers the GST together with the Quebec Sales Tax.

Innocent businesses are being denied ITCs

In recent years, RQ has been very aggressively pursuing businesses that have dealt with these unscrupulous companies. Not being able to find the thieves, RQ has instead gone after the businesses that have *purchased* these suppliers' goods and services, and has denied the ITCs that those innocent businesses have claimed.

In recent months, RQ has had a lot of success in the Courts when the innocent businesses have appealed.

Despite the fact that a business has **no legal obligation to "police" its suppliers** to ensure that they remit GST/HST they have collected, the Courts have been finding ways to make innocent businesses responsible.

The way that Revenu Québec and the Courts have nailed the innocent businesses is by ruling that the **invoice was not from the "real" supplier**. Even though the invoice was from a numbered company that was properly GST-registered, and otherwise met the documentation requirements, the Courts have ruled in some of these cases that the supplier named on the invoice was not the "real" supplier, and thus the documentation requirements were not met.

The CRA has not to date been as aggressive as Revenu Québec in assessing innocent businesses in these situations (at least from the reported cases from the Courts), but it may be headed there. In answers to questions at a conference in October 2014, senior CRA officials indicated they support the approach being taken by Revenu Québec and would deny ITCs for the same reasons. So the CRA may be just as aggressive when they next come to audit your business's GST/HST claims.

How can a business protect itself from this risk?

It is of course preferable to deal only with reputable and established suppliers, so this problem will not come up. However, you might not know whether or not a particular supplier is going to disappear without complying with its tax obligations, and for practical reasons you may not always be able to choose your suppliers.

A way to address this problem is to take steps to document that the business named on the invoice you pay is the **same legal entity** that you are dealing with, and is

properly registered with the CRA (or RQ) for GST/HST (and, in Quebec, for QST).

(1) To check that a supplier is GST/HST-registered: For any new supplier, go to www.cra.gc.ca/gsthstregistry, before you pay them any HST, and enter their name and the GST/HST registration number they give you. The online registry will tell you if the person is indeed registered under that name as of the current date. (Caution: the system gives a false positive once the first 10 characters match, so if it's a long name and there's a large amount of tax at stake, call the CRA Business line at 1-800-959-5525 to ask the CRA to confirm the full name.)

(2): For identity:

- If the invoice is in a personal name, get a copy of the person's driver's licence or other government-issued photo ID, and check that it's the same name as the GST/HST registration on the registry you checked in (1) above, and that is the name that appears on the invoice you are paying.

- If it's a company name, especially if it's a numbered company, the only way you can ensure that the entity identified on the invoice is the one you're actually contracting with is to ask the supplier for documentation that shows who the directors of the company are (this information is also available online from the provincial government, at a cost); and check the identity of the person you're dealing with as being a director of the company, by getting a copy of their driver's licence or other photo ID. Ideally, you also want a contract or bill of sale showing that you're contracting with the company because a director is signing on its behalf. This will provide a paper trail that shows you really are contracting with this particular company, and even if they disappear without remitting the HST, the CRA or RQ wouldn't be able to say this person wasn't the real supplier but was using a false invoice name provided by the real supplier.

Of course, every business will have to determine whether it's worth going through these procedures, or whether the risk of suppliers being tax-thieves is low enough that these steps are not worth the cost and effort. But for those seriously at risk of being reassessed to have substantial ITCs denied, these steps may prove to be a lifesaver.

SEVERE PENALTY FOR REPEATED UNREPORTED INCOME

The Income Tax Act (subsection 163(1)) provides an innocuous-looking penalty which can prove to be devastating.

The penalty in question applies if you file a return that fails to report some amount of income, and you also filed a return for any of the 3 preceding taxation years that failed to report some other amount of income.

The penalty is 10%, which doesn't sound like much. However:

- The 10% is 10% of the unreported *income* (in the later year), not of the tax.

- The penalty applies regardless of whether there were offsetting deductions so that little or no tax was payable.

- The penalty applies even if tax was withheld on the income, so that there might be little or no additional tax owing.

- Each province has in its provincial Income Tax Act a parallel 10% penalty, so the CRA will actually assess you a combined penalty of 20%. (In Quebec, the CRA will assess you 10% and Revenu Québec will assess you 10% if you failed to report the income on your provincial tax return.)

Here's an example of how punitive the penalty can be:

> When Joe gave his accountant his papers for his 2011 tax return, he misplaced one of the twelve T5 and similar slips he'd received for various kinds of investment income. The slip in question showed he'd earned interest of $75. So that $75 of income was omitted from his return.
>
> In 2014, Joe retired and received a payout of $100,000, from which tax was withheld by his employer. Because of the tax withheld, he did not have to pay any additional tax on the $100,000. Again he misplaced the T-slip and neglected to tell his accountant about this amount, and his 2014 return was filed without showing the $100,000 of additional income or the tax that had been withheld on it.

The CRA will assess penalty of $20,000, even though the 2011 unreported income was trivial and the 2014 amount led to no unpaid tax. Joe's only hope is to appeal to the Tax Court of Canada and seek relief on the basis that he exercised "due diligence". Unfortunately, misplacing T slips usually does not qualify. Joe may be stuck with a $20,000, non-deductible, penalty. This situation has happened many times, and while the Tax Court judges have called the penalty "harsh" and unfair, they have in many cases upheld it because they are require to apply the law.

In some cases, depending on the numbers involved, it may better to tell the CRA that the non-reporting of the income was done knowingly and have the CRA assess a "gross negligence" penalty of 50% of the unpaid tax. That penalty will often be less than 20% of the income.

AROUND THE COURTS

Late Notice of Objection allowed because company did not have full information

Patterson Dental Canada Inc. v. The Queen, was an application for extension of time to file a GST objection. (The rules for GST objections are virtually identical to those for income tax objections.)

Normally an objection must be filed within 90 days of a Notice of Assessment. An extension of up to one year beyond the deadline is available from the Tax Court, provided certain conditions are met. One of those conditions is that the person *either* have been "unable to act" during the 90 days, or have intended to object before the 90 days expired.

Patterson Dental (PDI), based in Montreal, sold dental equipment and products to dentists. One product was an anaesthetic solution containing epinephrine, a drug that is sold free of GST. PDI did not collect GST on these sales from 2005 until December 2008.

In December 2008, PDI became aware that Revenu Québec, which administers the GST in Quebec, had stated that a solution containing epinephrine was not the same as

epinephrine itself, and was taxable. As this statement was clear and definitive, and PDI wanted to comply with its tax obligations, PDI started collecting and remitting GST on its sales of the solution. PDI was audited in 2009-10, and the RQ auditor was again clear that the anaesthetic solution was taxable. The auditor issued an assessment in March 2010 for over $1 million of GST not remitted on the solution from 2005-08.

PDI did not object within the 90-day deadline (by June 2010), because it had no reason to think the anaesthetic solution was not taxable. However, in March 2011, a GST consulting firm that was reviewing PDI's affairs advised PDI that based on a 2007 Court decision on a related (but not identical) issue, the anaesthetic solution might well be free of GST.

PDI obtained a dental expert report on April 21, 2011, confirming that epinephrine was an essential ingredient of the solution, which would seem to make it free of GST based on the related Court case. Six days later, on April 27, 2011, PDI applied for an extension of time to object.

The CRA rejected the request for an extension of time, and PDI applied to the Tax Court for the extension. It was clear that PDI had not intended to object before the 90 days expired. The issue therefore was whether PDI was "unable to act" during the 90 days.

The Tax Court judge allowed the application. In his view, PDI was "unable to act" because it did not have full information. The related Court case had been decided several years earlier, yet the RQ auditor was unaware of it and so did not bring it to PDI's attention. PDI's decision not to object within the 90 days "was not a fully informed one", as it was based on RQ's definitive statements that the anaesthetic solution was taxable.

Furthermore, it would be "just and equitable" to allow the application, meeting another of the conditions for an extension of time. The issue of whether the anaesthetic solution was taxable was clearly a legitimate and serious one, and deserved to be addressed, especially since over $1million was at stake. PDI had "demonstrated a history of willingness to voluntarily comply with its tax obligations", and should not be left without a remedy.

This case breaks new ground in allowing an extension of time even where the taxpayer in question did not actually form an intention to appeal within the 90 days.

* * *