# FRUITMAN KATES LLP

CHARTERED PROFESSIONAL ACCOUNTANTS

1055 EGLINTON AVENUE WEST
TORONTO, ONTARIO M6C 2C9
TEL: 416.920.3434
FAX: 416.920.7799
www.fruitman.ca
Email: info@fruitman.ca


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## Tax Newsletter

### Topics for discussion:

- Last chance to get ahead of prescribed rate increase
- Should you file if you can't pay?
- Do you have a large bank account in another country?
- The GST or HST component in settling a business dispute
- Around the courts

### Last chance to get ahead of prescribed rate increase

Under the Income Tax Act and Income Tax Regulations, there are several different "prescribed rates" of interest. The most commonly known ones are the interest rate on overdue tax payments (currently 5% compounded daily), and the rate that needs to be charged on certain loans (currently 1%). These rates are found in section 4301 of the Regulations and are adjusted quarterly based on current Government of Canada Treasury Bill rates.

These 5% and 1% rates have not changed since July 2009, except for the last quarter of 2013 when they were each one percentage point higher.

Due to increases in the Treasury Bill rates, these rates are expected to go to 6% and 2% respectively, starting April 1, 2018.

There’s not much you can do about the increase in the rate on late payments. If you have a tax bill owing to the CRA that you can’t pay, you’ll have to live with paying the higher rate. (And note that interest you pay to the CRA on overdue income tax amounts is non-deductible.)

However, the increase in the prescribed rate for family loans might encourage you to take some action, before April 1, 2018.

Loans to family members can be a useful method of income splitting. Suppose you have a high income and your spouse has a low income. You’re paying tax at, say, 53% on each additional dollar earned, and your spouse is paying, say, 21%. (The rates vary by province and tax bracket, and the brackets increase each year for inflation.)

If you simply give money to your spouse to invest, the income on that money will be “attributed” back to you under the Income Tax Act’s attribution rules, so you’ll pay tax on the income at your high rate.

However, if you lend money to your spouse, then there is no attribution as long as your spouse pays you interest at the prescribed rate by January 30 each year for the previous year. And for this purpose, the prescribed rate is the rate at the time the loan was made, and this can continue forever.

Example (assuming you and your spouse pay tax at the 53% and 21% rates shown above):

- You have the opportunity to earn 6% interest on a $100,000 investment in a mortgage.
- But instead, you lend the $100,000 to your spouse.
- Your spouse pays you 1% interest, or $1,000, each January 15.
- And your spouse, instead of you, makes the mortgage investment and earns $6,000 per year.
- You’ve effectively transferred $5,000 from your annual income (where it would cost you $2,650 in tax) to your spouse’s annual income (where it costs your spouse $1,050 in tax).
- So each year you save $1,600 in after-tax money.

Of course, if you transfer “too much” income this way, your spouse’s marginal tax rate will go up, and the savings per dollar of income transferred will be reduced.

## Should you file if you can’t pay?

Suppose you are (or your corporation is) ready to file your income tax return, or GST/HST return, by the filing deadline (which might be, say, April 30 or June 15). But you don’t have enough money to pay the balance. Should you file anyway?

Of course, we recommend that you always file on time. If you have tax to pay for the year, you're legally required to file by the deadline, and you should do so. This article explains the consequences if you do not.

***Penalty for filing late***

If you file late, there is a late-filing or "failure to file" penalty.

For an income tax return, the penalty (Income Tax Act section 162) is 5% of the balance owing as soon as you're one day late, plus an additional 1% for each complete month you file late to a maximum of 12 months. So, if you are over a year late, the penalty is 17%. (This penalty is doubled if the CRA sends you a demand to file a return, and you fail to file in two out of four consecutive years.)

For a GST/HST return, the penalty (*Excise Tax Act section 280.1*) is 1% of the balance owing as soon as you're one day late, plus an additional 0.25% for each complete month you file late, to a maximum of 12 months. So, if you are over a year late, the penalty is 4%.

Both penalties are non-deductible, so they must be paid out of after-tax income.

So, filing on time and paying the balance later is better for you, financially.

Of course, if you have a balance owing — whether or not you have filed on time — interest will continue to run on your outstanding balance, compounded daily. The prescribed rate of interest, as noted in the first article in this Letter, will be 6% annually for April-June 2018, compounded daily; the rate will continue to be adjusted every quarter based on current treasury bill rates. (The same rate applies for both income tax and GST/HST.) A rate of 6% compounded daily is equivalent to an annual rate of 6.183% over a full year.

***What happens if you file on time and do not pay the balance?***

If you file on time but do not pay, the late-filing penalty will not apply. However, CRA Collections will be after you to pay. Because you've filed, the CRA knows exactly how much to assess you and therefore how much you owe.

For both income tax and GST/HST, one way to slow down the Notice of Assessment, without filing late, is to file your return on paper. Paper returns are processed much more slowly than those filed electronically. For personal income tax returns, for example, the CRA's official "service standard" (tinyurl.com/cra-standards) is to issue a Notice of Assessment within 2 weeks for electronic returns and 8 weeks for paper returns. (If your T1 return is prepared by a tax preparer, there is a $25 penalty for filing on paper, for each paper return above 10 returns per year.)

*What happens if you don't file?*

If you don't file on time, the CRA will send you notices demanding that you file. If you still don't, the CRA may eventually issue a "notional assessment", where they guess how much you owe based on past years and assess that amount.

The CRA might also send you a formal demand that threatens criminal prosecution if you do not file; or obtain a compliance order from the Federal Court ordering you to file. In that case, not filing would be a criminal offence (contempt of Court, if there is a Court Order), and you must comply within the deadline, or you will be subject to fines and even jail.

Either way, you'll be subject to the late filing penalty, but collection action won't start until the CRA has issued a Notice of Assessment.

*How soon can the CRA take legal action to forcibly collect tax?*

For an income tax debt, Collections normally cannot take legal action (such as seizing your bank account or sending a Requirement to Pay to your employer to seize wages) until 90 days have passed from when the Notice of Assessment is issued that establishes your liability. After 90 days, collection enforcement can start, but it will usually be some time before Collections actually takes steps to seize funds from you (depending on the size of the debt and whether the debt is considered to be at risk). Also, if you file a Notice of Objection contesting your assessment — even if the assessment matches what you filed — that stops collection action, although interest will continue to accrue on the unpaid balance.

However, during the 90-day period or the objection or appeal process, if the CRA believes that collection is in jeopardy (because you are dissipating your assets or moving them offshore, or are planning to leave Canada), the CRA can apply to the Federal Court ex parte (without notifying you) for a "jeopardy order" (section 225.2) allowing the CRA to take collection action.

For a GST/HST debt, there are no restrictions on legal action as soon as a Notice of Assessment is issued. Because amounts of GST/HST collected are trust funds (deemed held in trust for the federal government), CRA Collections officials are usually quite prompt in insisting on immediate payment and may take action to seize your bank account or garnish your wages almost immediately after if you are not paying.

## Do you have a large bank account in another country?

If you have a bank account, or a brokerage or other financial account in a country outside Canada, and you have not been reporting the account or income from it on your income tax returns, you need to know about the new "Common Reporting Standard" (CRS) rules.

The CRS represents an unprecedented level of cooperation among tax administrations worldwide. It was developed by the Organisation for Economic Cooperation and Development (OECD) for automatic information exchange between countries to reduce tax evasion and took effect in July 2017.

The CRS works as follows. In each participating country, banks and other financial institutions must collect information about accounts owned by residents of other countries, following "due diligence" rules, and must report this information to the local tax authority. In general, for an existing client, the institution will not be required to inquire as to residence status if all accounts totalled less than US$250,000 as of June 30, 2017. New clients will be required to "self-certify" as to where they are resident for tax purposes. (This description is highly simplified. There are many special rules and exceptions.)

The tax authority will then split up the information by country of residence and will automatically provide that information to each foreign country, without needing a request from that country.

So, suppose you immigrated from Italy and you kept an account at an Italian bank branch, which now has EUR 300,000 in it. The bank will report your name, address, the amount of the account and other identifying information to the Agenzia delle Entrate (the Italian tax authority). The Agenzia will then send this information to the CRA, along with that of other Canadian residents with accounts in Italy. If the CRA finds that you haven't been reporting the income from this account or haven't reported the account as "foreign property", you will be in serious trouble. In addition to being assessed tax, interest and penalties for many years, you may be prosecuted and could be sent to prison.

If you are in this situation, you may wish to make a Voluntary Disclosure to the CRA as soon as possible. The CRA's Information Circular 00-1R6 (tinyurl.com/ic00-1R6) has recently changed the rules for voluntary disclosures, as of March 1, 2018. If the CRA already has information identifying you, such as from the Agenzia delle Entrate in the above example, you will not qualify for a Voluntary Disclosure even if the CRA has not yet told you it has this information. (See the third bullet in para. 29 of the Circular.)

If your disclosure is accepted as a Voluntary Disclosure, the CRA will not prosecute criminally and will not impose the 50% gross-negligence/fraud penalty. However, you will have to pay the tax up front to qualify, and will be subject to interest and other penalties, such as penalties for unpaid instalments and penalties for not reporting foreign property.

So, if you are in this situation, you may wish to act now in the hope that the CRA has not yet received information identifying you and your foreign bank account.

## The GST or HST component in settling a business dispute

If you own or manage a business, you occasionally end up in disputes with customers or suppliers over the terms of a contract or payment. Sometimes these disputes are referred to lawyers, and sometimes they end up in court. Regardless of how far the dispute goes until it's settled, are you aware of the GST or HST consequences of any settlement or damage award? Your lawyer might not be aware of this issue.

A settlement or award for breach of contract will normally be considered tax-included if the following conditions are met:

The payment is made by the "recipient" to the "supplier" rather than the other way around. That is, it is the purchaser, lessee or customer who is making the payment, and the vendor, lessor or supplier who is receiving it. (In other words, money is flowing in the same direction as it would have flowed under the contract.)

The payment is for breach, termination or modification of a contract or agreement. (It need not be a written contract; an oral agreement to buy or lease property, or to provide services, is still a contract.)

GST or HST was payable, or would have been payable, under the contract, if it had been fulfilled as planned.

In these circumstances, any settlement amount is normally deemed by the *Excise Tax Act* to be a total that already includes GST or HST.

The supplier (vendor, lessor) must carve out a fraction of the total and remit it to the Canada Revenue Agency as GST or HST. The fraction depends on the province. In Ontario (where the HST rate is 13%), the fraction is 13/113ths, or just over 11.5%. In the Atlantic provinces (15% HST rate), the fraction is 15/115ths. In non-HST provinces (5% GST rate), the fraction is 5/105ths. In Quebec, the Quebec Sales Tax (QST) is treated the same way.

The recipient (purchaser, lessee) can claim an input tax credit and recover the same amount from the CRA, if the recipient would have been able to claim the credit had the money been paid under the contract.

The same rule applies to an amount that is kept as a forfeited deposit.

> *Example 1*
>
> *Landlord leases office space in Ontario to Tenant for $5,000 per month plus 13% HST, under a one-year lease. Six months into the lease, Tenant wishes to cancel. After some discussions, Landlord agrees to accept a one-time payment of $10,000 to release Tenant from the lease.*

Landlord must treat the amount received as HST-included. If Landlord accepts $10,000, it must calculate 13/113ths of this amount or $1,150.44 and remit this amount to the CRA as HST collected. In other words, Landlord has really settled for $8,849.56 plus 13% HST of $1,150.44.

Similarly, Tenant is paying $8,849.56 plus HST of $1,150.44. If Tenant is a normal business that can claim input tax credits for HST that it pays, Tenant can recover the $1,150.44 as a refund when filing its next HST return — which may be something of a windfall if Tenant made the deal without expecting this. This is so even if the settlement agreement does not mention the HST.

If Landlord really wants to settle for $10,000, Landlord should add 13% for HST and settle for $11,300. Then Landlord keeps $10,000 and sends $1,300 (13/113ths of the $11,300) to the government as HST, and Tenant (if a business) can claim the same $1,300 as an input tax credit.

*Example 2*

*B (a builder) builds a new home for sale in Edmonton. P (the purchaser) offers $300,000 for the home, putting down a $10,000 deposit. P then changes his mind and walks away from the deal, forfeiting the deposit. B decides not to sue and just keeps the $10,000.*

B does not really get to keep $10,000. The $10,000 is GST-included. The GST is calculated as 5/105 of this amount, or $476.19. Thus, B really gets $9,523.81 plus 5% GST of $476.19, and must remit the GST to the government.

This may come as a shock to B and should not have accepted the $10,000 deposit unless B was aware that it was really a deposit of $9,523.81 plus GST.

(Note that in this case the deposit includes the full 5% GST even though, if the home sale had been completed, 1.8 percentage points of that 5% would have been refunded to P via the new housing rebate.)

The moral of the story: whenever you settle a commercial dispute, whether by litigation or otherwise, make sure to “gross up” (increase) the settlement amount by the appropriate GST, HST and/or QST, so that the tax is available to be remitted to the government without eating into the amount of the settlement.

Note that these rules do not apply to payments by a supplier — e.g. payment by a landlord to cancel a tenant’s lease early. They also do not apply to payments that are not related to a contract — for example, payments for damage caused by negligence, such as where someone with whom you have no contractual relationship damages your business’s property.

If your dispute is being handled by a lawyer, do not assume that your lawyer is taking care of this issue.

## Around the courts

***Scientific research not sufficiently documented***

The Income Tax Act provides generous incentives for businesses to undertake scientific research and experimental development (SR&ED). For a Canadian-controlled private corporation that is not large, these incentives include a 35% refundable tax credit, effectively subsidizing over 1/3 of the cost of the SR&ED, even for a business that pays no corporate income tax. Many provinces offer additional incentives.

The definition of SR&ED in the Income Tax Act is “systematic investigation or search that is carried out in a field of science or technology by means of experiment or analysis”, with further specification that the work must be “basic research”, “applied research” or “experimental development”, providing definitions for those terms, and then listing various inclusions and exclusions.

In addition, the Tax Court of Canada and Federal Court of Appeal have developed a set of questions for determining whether SR&ED was conducted:

1. Was there technological risk or uncertainty which could not be removed by routine engineering or standard procedures?
2. Did the person formulate hypotheses specifically aimed at reducing or eliminating that uncertainty?
3. Did the procedure adopted accord with the total discipline of the scientific method including formulation, testing and modification of hypotheses?
4. Did the process result in technological advancement? (There cannot be technological advancement unless there is technological uncertainty.)
5. Was a detailed record kept of the hypotheses tested and results, as work progressed?

There have been many reported cases from the Tax Court in recent years, as businesses have claimed these generous incentives. Every claim is carefully audited by the CRA. As well as regular auditors (accountants examining the financial side of the claim), the CRA uses “Scientific Auditors” with a science background, to determine whether the conditions above have been satisfied.

In a recent case, *Mac & Mac Hydro demolition* (2017 TCC 256), a company was trying to develop techniques for removing lining from pipes transporting bitumen. Its work looked like SR&ED: it was trying to solve a difficult technical problem. However, the CRA denied its claim and it appealed to the Tax Court of Canada, which agreed with CRA since the company's testing notes were vague.

Businesses engaged in SR&ED should be aware of this requirement if they hope to obtain the tax relief.

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This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with us before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.