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Tax Newsletter

Topics for discussion:

- Director's liability
- Employee expenses claimed by shareholders – CRA backs down from *Adler*
- Canada child benefit to be indexed starting July 2018
- Finding the law
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Director's liability

If you are listed on the provincial or federal public registry of companies as being a “**director**” of any corporation (including a non-profit or a charity) — or even if you are *not* a director but are effectively responsible for an incorporated company — you ought to be aware of the tax risks **and of the steps you can take to insulate yourself**. Every year, the Canada Revenue Agency (CRA) and Revenu Québec (RQ) assess hundreds of directors to collect debts owing by their companies. In many of these cases, the director was not aware of this risk and of what they could have done to avoid personal liability.

(In the following discussion, references to the CRA apply to RQ as well, in Quebec where RQ administers not only provincial income tax and Quebec Sales Tax (QST), but also the GST/HST.)

What corporate tax liabilities can a director be assessed for?

The main tax liabilities are:

- **payroll deductions for employees** (income tax, CPP and EI) that were withheld and not remitted, or that should have been withheld
- **GST or HST** (and in Quebec, **QST**) that the corporation collected, or should have collected, minus available deductions such as input tax credits (i.e., the corporation's "net tax")
- **interest and penalties** on the above payable by the corporation, plus interest on the amount you are assessed from the time the CRA assesses you as a director.

There are other liabilities as well, such as for provincial retail sales taxes in the western provinces, and certain other federal and provincial taxes.

Notably, a director is *not* liable for a corporation's regular corporate income tax debt. However, in many cases a director who has received anything from the corporation in any year since the year the tax liability arose, including a dividend, can be assessed under *Income Tax Act* section 160, the "transfer of property" rule, or the parallel GST/HST rule in *Excise Tax Act* section 325. We discussed these rules in detail in our September 2016 Tax Letter, under the heading "You Can Be Liable for a Family Member's Tax Debts!". (We will not discuss them further in this article.)

What if you're not a legal director?

If you're a director, you're liable for the corporation's payroll deductions and GST/HST net tax, as noted above, and subject to various possible defences explained below. But you can also be liable if you're a ***de facto* director**, i.e., a director in practice even if you're not *legally* a director.

So if you're involved in running a company, or if the company is inactive but you're the person dealing with the CRA on behalf of the company and answering questions about it, you may well be considered a *de facto* director. In such a case, you'll be just as liable as if you had legally been a director.

The *Koskocan* decision of the Tax Court, discussed in our March 2017 Tax Letter, has limited the definition of *de facto* director somewhat by showing that officers, not directors, normally manage a company's day-to-day affairs. However, whether you're a *de facto* director will depend very much on the facts of your particular situations.

What about other directors?

If there are multiple directors, the CRA can choose whom to assess. It can assess all directors, or any one of them. If you were one of (say) three directors, it is no defence to say that the other directors are just as liable and should be assessed instead of you, or as well as you. All directors

who are liable (i.e., not excused by the defences discussed below) are **jointly and severally liable** (“solidarily” liable, in Quebec), meaning any one of them can be assessed for 100% of the debt.

In practice, the CRA may go after whoever seems to have the deepest pockets (ability to pay). Directors then have a right to “contribution” from each other, but that requires you to sue the other directors in provincial civil court for their portion of the liability, and those other directors may well be bankrupt or have no assets you can seize, even if your lawsuit succeeds.

What does the CRA have to prove?

Nothing. If you appeal the assessment, the onus is on you to prove that you are *not* liable because one of the defences below applies.

Actually, if you appeal to the Tax Court of Canada, the CRA does have to prove some technical things about how it tried to collect the debt from the corporation and there was nothing to collect, and — if the corporation was bankrupt or had been dissolved — that the CRA acted within a certain period of time. You can find these rules in subsection 227.1(2) of the *Income Tax Act* and, for GST or HST, in subsection 323(2) of the *Excise Tax Act*. In practice, these rules are rarely helpful to you because the CRA normally follows the correct steps, but it’s worth checking that they did.

First defence: “I wasn’t a director”

If you never consented in writing to being appointed as a director, then perhaps you weren’t a director and aren’t liable. As noted above, however, you might have been a “*de facto*” director, by doing the things directors do (managing the company, signing documents on its behalf, or representing it).

If you weren’t a director or a *de facto* director **when the corporation’s liability arose**, you’re not liable for that liability. So if you became a director when the company already had a significant payroll or GST/HST liability, you might be able to escape the assessment.

Note however that remittances made while you were a director will normally have been applied by the CRA to the oldest debts (for which you wouldn’t have been liable), unless the company specifically told the CRA to apply them to the new debts. You may thus be liable for new remittance obligations even though the company made sufficient remittances while you were a director to cover those obligations.

What if you resigned before the liability arose (that is, before the date the corporation was required to remit the payroll deductions or GST/HST)? You’re not liable; but proving that you resigned and didn’t continue as a *de facto* director may be difficult. This issue is discussed under “Second defence” below.

Second defence: “I resigned more than 2 years before the assessment”

If you ceased to be a director more than two years before the Notice of Assessment is issued to you to assess you as a director, you’re not liable.

However, if your name wasn’t removed from the public registry of companies when you resigned, proving that you resigned may be difficult. The CRA is understandably suspicious of people who claim to have resigned more than two years ago but can’t really prove that they delivered their resignation letter to the company at the time. You’ll need to show from all the surrounding circumstances and other documentation that you really did resign.

Even if you resigned, if you continued to act as a *de facto* director, you’ll be out of luck.

If the company was dissolved more than two years before the assessment was issued, you ceased to be a director at that time. However, the CRA sometimes takes steps to ask a Court to “revive” a company retroactively so that the directors can be assessed. This step can be opposed, but you’ll need professional advice from a lawyer familiar with this issue.

Note that there is no other limitation period. Even if the corporation’s failure to remit GST happened 25 years ago, you can be assessed for it, with astronomical compounded interest charges that vastly exceed the original amount of tax. This happens all the time; the CRA often takes years and years to get around to assessing directors of failed companies, who could have resigned in the interim but remain liable because they didn’t.

Third defence: “The assessment of the corporation was wrong”

If you can show that the company wasn’t in fact liable for the amount of payroll deductions or GST/HST the CRA claims it owed, then you should be able to get the assessment reduced or eliminated.

The CRA used to reject this defence, saying that if the company didn’t appeal its own assessment, that assessment is “deemed to be valid and binding” by the legislation and thus can no longer be challenged. The Tax Court was mixed in whether it accepted this reasoning. However, it’s now clear from three decisions of the Federal Court of Appeal (*Abrametz*, *Doncaster* and *Gougeon*) that if you can show the corporation’s liability wasn’t as high as the CRA claims, you can get the assessment reduced. Doing this is often difficult, however, as the supporting documentation has disappeared. Simply claiming that the debt “couldn’t possibly have been that high” won’t work; you need real proof.

Fourth Defence: “I met the due-diligence test”

This defence will be offered to you by the CRA when it first writes to you to propose assessing you as a director, and asking you if you have anything to say.

This defence is: “A director of a corporation is not liable for a [corporation’s] failure [to remit payroll deductions or GST/HST] where the director exercised the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances.”

There have been hundreds of reported decisions from the Tax Court and the Federal Court of Appeal on this defence. This is an *objective* test: looking at your actions objectively, did you meet the test above? You have to show that you took active steps to ensure the taxes were being remitted, such as by setting up systems to make sure the remittances were made. Innocent good faith, or not being aware of the liability, will not be enough.

Note also that having taken active steps to remit the corporation’s outstanding liability — even if you put in your own money at that point — is irrelevant. You need to show that you met the due-diligence standard at the time the corporation’s remittance obligation arose — when the GST/HST return or payroll remittance was due.

Conclusion

If you are a company director, make sure the company is remitting all payroll and GST or HST it is required to remit. Be proactive: if you’re not running the company yourself, take steps to ensure the remittances are actually being made. *Document* what you are doing, if you’re an outside director and are depending on others: sending your inquiries by email is one way of doing this. If you’re not sure the remittances are being made, resign and ensure that your resignation is immediately recorded in the government registry of corporations — and then hope that two years go by without you being assessed.

If you’re not sure whether you’re a director, find out! A shareholder is not the same as a director; you can be one and not the other. Check the company’s minute book, or search the government companies register to find out if you’re listed. You need to know.

If you’re assessed as a director, or the CRA proposes to assess you, you should obtain professional advice as soon as possible to explore your options. You may be able to raise one of the defences above. Make sure you file a Notice of Objection with the CRA within 90 days of being assessed, or you may lose your right to appeal.

Employee expenses claimed by shareholders – CRA backs down from Adler

Under the *Income Tax Act* (ITA), a business can generally deduct any expenses that are incurred to earn business income, except where specifically prohibited.

Employees, by contrast, are only allowed to deduct expenses that are specifically allowed by the Act. Most of the rules allowing expenses contain various conditions and restrictions.

One condition that applies to many deductible employee expenses is that the employee be “required under the contract of employment” to pay the expenses. Normally, to claim such expenses the employee needs to be able to demonstrate that the employment contract states that the employee is required to incur the costs in question. Generally, the employer needs to certify on Form T2200 that this condition is met, as required by *Income Tax Act* subsection 8(10).

What happens if you own the company, and you are also an employee? Can the company “require” you to incur specific expenses?

In the 2009 *Adler* decision, the Tax Court of Canada ruled that a sole shareholder was not “required” by his company to incur expenses, even though the employment contract said he was, since there were no consequences to his breaching the agreement. (He was not going to fire himself, for example.)

Although *Adler* was an Informal Procedure decision, meaning that it’s not legally binding on either the CRA or taxpayers, the CRA decided last year to start applying it. Beginning September 2017, the CRA wrote to many employees who were major or sole shareholders of their companies, and reassessed them to deny employment expenses.

This caused an uproar among small business owners and their advisors, and many complaints were made to the CRA about this interpretation. It would become impossible for any major shareholder to claim these deductions, because they could never prove that the employment contract “required” them to incur the expenses. Numerous taxpayers were planning to appeal this issue to the Tax Court of Canada, but whether they could win was very uncertain.

Fortunately, the CRA has now backed down, will no longer issue these reassessments, and will reverse those already issued. On February 20, 2018, the CRA issued a notice entitled “Employment expenses review”, stating:

“Effective immediately, the Agency will stop reviewing and disallowing ‘other employment expenses’ claimed on line 229 of the T1...by shareholder-employees. We will also reverse those reassessments specific to line 229 already issued during the review period Sept. 1, 2017 to Feb. 10, 2018.... Consultation will be undertaken with stakeholders in the tax professional community to clarify the requirement of employer certification under subsection 8(10) ... as it relates to shareholder-employees. It is expected that clarification will be issued to take effect in the 2019 tax year.”

Canada child benefit to be indexed starting July 2018

In the 2016 Budget, the newly-elected Liberals announced a large increase in the Child Tax Benefit, renamed the Canada Child Benefit. It is now \$6,400 per year for each child under 6 and \$5,400 for each child age 6-17. It is gradually phased out once the parents’ net income exceeds

\$30,000, but the phase-out is quite slow. For example, with 4 children age 6-17 the benefit disappears entirely only when the family net income reaches \$211,375.

As originally announced, the Canada Child Benefit was not going to be indexed to inflation. Possibly the Liberals wanted future political credit for announcing increases, or else wanted the real cost eroded over time to reduce the federal deficit. However, the Parliamentary Budget Officer, in September 2016, publicized the fact that the new program would cost the government less than the old program by about 2025. As a result, indexing was restored, but it would not start until July 2020.

However, in its October 2017 Economic Statement, the government announced that indexing of the Canada Child Benefit will begin in July 2018 (instead of 2020). The earlier indexing was attributed to “growing economy and improved fiscal track”.

Finding the law

Do you ever want to look up and read legislation (passed by Parliament or a provincial legislature), or Court cases that you have read about? Here is a useful and free Web site to know about: canLii.org.

CanLII is the **Canadian Legal Information Institute**, a project of Canada’s law societies. It provides free and very efficient access to virtually all of Canada’s legislation, regulations and case law. You can search by title or case name, or search the full text of all the documents or a subset of them (e.g., just Tax Court of Canada cases, or just your province’s legislation).

Of course, if you are trying to read complex legislation such as the *Income Tax Act*, it is very difficult to read on its own without the annotations and explanations that are provided by the publishers of the commercial editions, such as Carswell’s *Practitioner’s Income Tax Act*.

Around the courts

Charitable donation receipts must meet every technical requirement

Two recent decisions of the Tax Court of Canada demonstrate how important it is to check your charitable donation receipts, in case the CRA challenges them on audit.

The *Income Tax Regulations* (subsection 3501(1)) state that every receipt must contain the following:

- (a) the name and address in Canada of the organization as recorded with the Minister;
- (b) the registration number assigned by the Minister to the organization;
- (c) the serial number of the receipt;

- (d) the place or locality where the receipt was issued;
- (e) where the gift is a cash gift, the date on which or the year during which the gift was received;
- (f) where the gift is of property other than cash
 - (i) the day on which the gift was received,
 - (ii) a brief description of the property, and
 - (iii) the name and address of the appraiser of the property if an appraisal is done;
- (g) the date on which the receipt was issued;
- (h) the name and address of the donor including, in the case of an individual, the individual's first name and initial;
- (i) the amount that is
 - (i) the amount of a cash gift, or
 - (ii) if the gift is of property other than cash, the amount that is the fair market value of the property at the time that the gift is made;
- (j) a description of the advantage, if any, in respect of the gift and the amount of that advantage;
- (k) the eligible amount of the gift;
- (l) the signature, as provided in subsection (2) or (3), of a responsible individual who has been authorized by the organization to acknowledge gifts; and
- (m) the name and Internet website of the Canada Revenue Agency.

In *Okafor v. The Queen*, 2018 TCC 31, the receipts were otherwise correct, but were missing “the place or locality where the receipt was issued”. It was not enough that the charity’s address was shown. The donation credit was denied.

In *Ruremesha v. The Queen*, 2018 TCC 57, the charity’s address was shown on the receipts, but it was not the same as “the one recorded with the Minister” (i.e., the CRA). Again, the donation credit was denied.

Often in these cases there are other problems as well, and the CRA and the Tax Court suspect the donation was bogus (e.g., not really paid for, or that there was a cash kickback to the taxpayer). But the case law makes it clear that any technical flaw in a donation receipt can cause the credit to be denied.

So make sure the receipts you receive from charities have all the information above! And if you’re involved with running a charity, make sure the receipts it issues comply with all the requirements.

NOTE that the CRA recently announced that for paragraph(m) of the Regulations, the Internet website of the CRA should be shown as canada.ca/charities-giving. However, charities have until March 31, 2019 to change from showing the old cra.gc.ca/charities address.

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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.