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Tax Newsletter

Topics for discussion:

- Changes to the Trust reporting rules – old news is still not good news
- Mandatory disclosure rules – update on reportable and notifiable transactions
- Starting a home business
- Do you have a large bank account in another country?
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Changes to the trust reporting rules – old news is still not good news

If you are a trustee of a trust, you have likely heard of the proposed changes to the trust reporting rules that were first announced in the 2018 federal budget as part of the government's broader plan to crack down on tax avoidance. These proposed changes required extensive reporting for all trusts in Canada so as to assist the Canada Revenue Agency ("the CRA") in assessing the tax liabilities for trusts and their respective beneficiaries and imposed significant penalties where these new reporting requirements were not met.

The old news

Generally, under the currently enacted rules, an inactive trust (other than a deemed resident trust) that has no tax payable is not required to file a tax return unless it allocates all or a part of its income or capital to its beneficiaries or it has disposed of capital property. Draft legislation to implement the 2018 budget proposals to expand the reporting requirements for trusts effective for taxation years ending on or after December 31, 2021, was first released for public comment in July 2018 but it was not enacted. Under those proposals, trusts that are resident in Canada (including deemed resident trusts) and non-resident trusts that would not otherwise be required to file a return would now be required to file a T3 return and report the identity of settlors, trustees, beneficiaries, and anyone who has the ability to exert control over the trust or override the trustee's decisions regarding the distribution of income or capital. In addition to their name,

each party's address, date of birth (for an individual), jurisdiction of residence, and taxpayer number (such as a social insurance number of an individual, a business number of a corporation and the trust account number of a trust) must be disclosed.

Certain trusts are exempted from the new reporting requirements in the proposed legislation including mutual fund trusts, segregated funds, prescribed master trusts, trusts governed by registered plans (i.e., RRSPs, RRIFs, RDSPs, RESPs, TFSAs, DPSPs, pooled RPPs, etc.), lawyers' general trust accounts, graduated rate estates, qualified disability trusts, employee life and health trusts, trusts that qualify as non-profit organizations or registered charities, trusts in existence for less than three months, and trusts that hold less than $50,000 in assets throughout the taxation year if their holdings are confined to cash, deposits, government debt obligations and listed securities.

To increase compliance with the new requirements, stiff penalties were introduced for failure to file a return or a schedule reporting the required information of $25 per day, with a minimum penalty of $100 and a maximum of $2,500. If the failure to file is made knowingly or due to gross negligence, a further penalty equal to 5% of the maximum fair market value of the trust property held by the trust during the year will apply. Current late-filing and non-filing penalties with respect to the T3 Return which can include a penalty of up to $25,000 or a fine and imprisonment continue to apply.

In anticipation of the December 31, 2021 effective date, accountants and trustees began the arduous task of gathering the newly required information, however the CRA was late releasing the schedule on which the information was to be reported and in January 2022 announced that it would defer the reporting requirement until the legislation was enacted.

On February 4, 2022, draft legislation was released which included the July 2018 proposals with a number of amendments. The legislation is now applicable to taxation years ending on or after December 31, 2022 and does not require the disclosure of information that is subject to solicitor-client privilege. Trusts for which all units are listed on a designated stock exchange are exempted from the proposals but arrangements where a trust can reasonably be considered to act as agent for its beneficiaries with respect to all dealings in all the trust's property, i.e., "bare trusts" are now subject to the reporting requirements.

The new news

On August 9, 2022, the federal government released amendments to the current proposals to expand the lists of trusts excluded from the new reporting requirements to include a trust under an employee profit sharing plan, a registered supplementary unemployment insurance benefit plan and a first home savings account. The amendments provide that the reporting requirement will be met where the class of beneficiaries is sufficiently described to determine whether any particular person is a member of that class of beneficiaries when reporting on beneficiaries that are all members of certain Indigenous groups. The latest proposals also state that where not all

of a trust's units are listed on a designated stock exchange, the reporting requirement is met where the required information about the beneficiaries of those unlisted classes of units is reported.

So what's the big deal?

Much of the required information under the new reporting proposals may not be readily available and the identity of certain beneficiaries may not be easily ascertained. By the very nature of trusts, much of the information about them is private and some beneficiaries may not even be aware that they are beneficiaries of a trust. How will a trustee explain to a beneficiary that they need their social insurance number to report to the CRA? With this additional administrative burden and with the risk of triggering a penalty, many trustees may consider resigning from their role leaving trusts scrambling to find replacement trustees. In the past, the role of a settlor was merely to establish a trust with a gift to the beneficiaries and there was little or nothing required of them beyond that original gift. Now with the increased scrutiny by the CRA, individuals may be less inclined to settle trusts in the future.

Where are we now?

The February 2022 and August 2022 announcements merely fine-tune the 2018 proposals. While trustees had a temporary reprieve of one year, the March 31, 2023 filing deadline is very quickly approaching and now is the time to complete the process of gathering the information that will now need to be reported.

While the Agency has not yet released the forms to report the increased disclosure given the heavy lifting required to obtain all the data, we are recommending that clients start to accumulate the data. We will provide a further update of the reporting requirements once the Agency releases the updated forms.

Homework

Pull up any trusts that you have or are aware of including "bare trust" agreements, summarize, settlor, trustees, and beneficiaries, names, addresses, SIN numbers, and corporate business numbers. Accumulate the SIN numbers and corporate business numbers will require trustees often reaching out to settlors and beneficiaries to obtain the data.

Mandatory disclosure rules – update on reportable and notifiable transactions

On August 9, 2022, the federal government released amended draft legislation for the mandatory disclosure rules that were originally released in draft on February 4, 2022.

The February 4, 2022 draft legislation made these rules effective for transactions that were entered into after 2021. This caused uncertainty for taxpayers and their advisors who were involved in transactions that were required to be reported, when the legislation was still in draft and there were many unanswered questions. The good news is that the August 9th proposal has pushed the effective date of the legislation to 2023. These new rules are now proposed to apply to transactions that are entered into after 2022.

The deadline to report these transactions is generally within 45 days of the taxpayer (person who is receiving the tax benefit) entering into the transaction. There are significant penalties for not reporting that will be applicable once the legislation has been passed. As a result, these rules should be reviewed in detail and procedures to identify potential reporting requirements should be implemented.

Reportable transactions

The revised draft legislation states that a transaction is a reportable transaction if it can reasonably be considered that one of the main purposes of entering into the transaction (or series of transactions) is to obtain a tax benefit and one of the following conditions exists:

1. A promoter or advisor is entitled to a contingent fee based on the tax benefit obtained or number of taxpayers who participate in the transaction.

2. A promoter or advisor obtains confidential protection relating to the tax treatment of the avoidance transaction.

3. The taxpayer (or certain other persons) obtains contractual protection relating to the transaction (unless obtained in a normal arms-length commercial transaction).

The revised draft legislation narrows the scope of the confidential protection and contractual protection conditions. The confidential protection condition now must relate to the tax treatment of the avoidance transaction. The contractual protection now carves out normal commercial transactions provided it does not extend to the tax treatment of an avoidance transaction.

In the original legislation, if any person who is required to file a reportable transaction information return filed a “full and accurate” return, then everyone who was required to file a return was deemed to have filed a return. The revised draft legislation eliminates that deeming rule. It clarifies that there is no reporting requirement for a person who only provides clerical or secretarial services “with respect to the planning”. Everyone else involved in “creating, developing, planning, organizing or implementing the transaction”, including the taxpayer, advisors and promoters are required to disclose the reportable transaction and file an information return.

Notifiable transactions

A notifiable transaction is any transaction that is designated by Canada Revenue Agency (CRA) with the agreement of the Department of Finance or a transaction that is substantially similar.

Finance provided the following samples of notifiable transactions when the draft legislation was released on February 4, 2022 (there has been no update since):

1. Manipulating CCPC status to avoid anti-deferral rules applicable to investment income
2. Straddle-loss creation transactions using a partnership
3. Avoidance of deemed disposal of trust property
4. Manipulation of bankrupt status to reduce a forgiven amount in respect of a commercial obligation
5. Reliance on the purpose test in section 256.1 to avoid a deemed acquisition of control
6. Back-to-back arrangements

Similar to the reportable transactions, the revised draft legislation clarifies that there is no reporting requirement for a person who only provides clerical or secretarial services "with respect to the planning". The revised draft legislation also alleviates an employee's or partner's reporting requirement for a notifiable transaction if the employer or partnership has filed the required information return. Everyone else involved in "creating, developing, planning, organizing or implementing the notifiable transaction", including the taxpayer, advisors and promoters are required to disclose the notifiable transaction on an information return.

In the February 4, 2022 release, Finance indicated the following information will be required to be disclosed on the information return:

1. The expected, claimed, or purported tax treatment and all potential benefits expected to result form the transaction
2. Any related contractual protection
3. Any related contingent fees
4. A detailed description of the transaction sufficient to allow the CRA to understand the tax structure
5. Any provisions relied upon for the tax treatment, including relevant tax rules, treaties or any other enactments used to compute or determine tax or other amount payable or refundable

6. The identity of every person required to file an information return in respect of the transaction, to the best knowledge of the person filing the return

7. Other information as required by the information return

Stay tuned to see if CRA will expand the list of notifiable transactions. Some have speculated that they could follow Quebec's rules and add transactions that multiply the capital gains exemption to the list.

Starting a home business

Are you considering starting a home business? Here are some planning issues, tax rules and tips to keep in mind.

Incorporation

Many people are not clear on the difference between a business and a corporation, but the difference is extremely important, for both tax purposes and liability purposes.

You can carry on business without creating a corporation. Although you may give your business a name, it is simply you carrying on the business. You are a "sole proprietor".

If you create a corporation, it will have "Limited", "Inc." or "Corporation" as part of its name. The corporation is a **legally separate person** from you, and the corporation, not you, carries on the business. Although you control the corporation, the business is legally not "your" business. This means that **you are normally not liable for the corporation's debts**. (However, if the corporation needs to borrow money from a bank, the bank will insist on a personal guarantee from you, so in practice you will be liable if the corporation cannot repay the bank loan. Also, as a director, you are liable for certain obligations of the corporation, such as an assessment of GST/HST or employee payroll deductions that the corporation fails to remit.)

If you create a corporation, then the corporation will have to file annual T2 corporate income tax returns and pay tax on its profits. Your corporation will normally be a "Canadian-controlled private corporation" (CCPC), which pays a special low rate of tax on its first $500,000 each year of active business income (somewhere around 12%, depending on the province). This "small business deduction" rate is subject to many complex rules, however. Note also that *investment* income earned by a CCPC is usually subject to a very *high* tax rate, with much of the tax refunded once the corporation pays out dividends to you.

Normally the corporation must pay monthly instalments to the CRA after its first year of operations, so that it will not have a large tax debt at year-end.

Of course if the corporation is profitable, you want to be able to enjoy those profits. However, **you should not simply take the corporation's money for yourself**. To extract profits from the corporation, you should either have the corporation pay you **salary or bonus** (which the corporation can deduct and is taxable to you as employment income), or have it pay you **dividends** (which are not deductible to the corporation but are taxed to you at a lower rate, due to the dividend tax credit). These steps require certain paperwork, and it is important to document properly what you are doing; otherwise, the tax consequences can be serious if you or the corporation are audited. The corporation can also repay to you any money you have loaned to it, with no tax consequences.

Sole proprietorship

In many cases, a home business is simply carried on as a sole proprietorship. There are no legal requirements for doing this (other than the requirements noted below); you are not required to have a separate business name, though you may wish to create one in order to appear more professional to your customers. (If your business will be visible, such as with customers regularly visiting you, then you should check whether you may run afoul of local zoning bylaws, or condominium or apartment rules if you live in a building.)

If you pick a business name that is not simply your own name (or perhaps your own name plus something like "Consulting Services"), then when you are paid by your customers, you will need a business account into which to deposit cheques. For this purpose, your bank will normally require that you obtain a **business name registration** from the province. This is usually a simple matter that requires a modest fee.

GST or HST

Once your total sales exceed $30,000 per year (combined with the sales of any corporation you control), you must register for and collect the GST and HST. Until your sales top the $30,000 mark over four consecutive calendar quarters, you do not have to register or charge GST/HST. (Generally, you charge 5% GST to customers in non-HST provinces, 13% HST to those in Ontario and 15% HST to those in the Atlantic provinces; but the rules vary depending on the type of business, and in some cases depend on where you are providing services, or other factors.)

Even if you are under $30,000 in sales, if your sales are to businesses rather than consumers, you may wish to register. You will then need to collect GST/HST from your customers, but they generally will not care since most businesses get back all GST or HST they pay. You in turn will be able to recover all GST/HST that you pay on your business expenses. (Or you may be able to profit from the "Quick Method" of filing, which can allow you to make a little money out of the GST/HST if you have relatively few taxable expenses.)

You may need to register for and collect provincial sales tax as well, depending on the nature of the goods and services you provide, and your province of residence.

(The same rules apply to any corporation that you own: it may have to register for and charge GST/HST.)

Reporting your income

When you are carrying on a sole proprietorship, any income earned by the business is reported on your tax return under “Business income” (or Professional, Farming or Fishing income if you are engaged in one of those kinds of businesses).

The tax return requires you to show both gross revenues (total sales) and business income (after expenses). You will also need to file an income statement showing the details of your revenues and expenses (broken down by category — e.g., Advertising expenses, Office supplies, Meals & entertainment [which are only half deductible], Utilities, etc.). This is normally done on Form T2125 but is not required to be.

Your net business income is combined with your other sources of income on your return, like employment income and investment income, to reach “total income”.

Deducting business expenses

When calculating your (net) business income, you can deduct the expenses of carrying on business. Here are some things to make sure you do not miss:

- Office supplies: This would include computer paper, toner cartridges, USB sticks, pens and similar items that you buy for use in the business. It may also include publications such as business magazines and journals. Keep your receipts! If you buy supplies for a combination of personal and business use, estimate the business proportion.

- Telephone: If you have a separate business line, the cost is fully deductible. If you are using a personal line partly for business purposes, it probably falls within the “Home office expenses” category in the next heading. And don’t forget to deduct your monthly Internet connection service fees, and cell phone costs to the extent you use your cell phone for your business.

- Equipment: For expensive, long-lasting “capital” items like computers and furniture, you cannot deduct the expense immediately. Rather, you can claim depreciation, called “**capital cost allowance**” (CCA), applied to a declining (depreciating) balance over many years. The CCA rate depends on the kind of equipment; for example, it is 55% for computers and 20% for furniture. In most cases you combine all assets of the same “class” into one pool and claim CCA on the pool. For the year in which you acquire an asset, only ½ of the normal rate of CCA can be claimed for that asset. After that, you claim the regular rate based on the balance left in the pool after the previous year’s claim. But there are incentives encouraging purchases of capital equipment by giving fast write-offs. For

example, for 2022-24 (2021-2023 for corporations), there is a rule allowing "immediate expensing" of up to $1.5 million of many capital purchases.

CCA claims are optional in that you can "save" the amount claimable (the "undepreciated" capital cost) and claim it in a later year if you want to use up losses or have another reason to not want to claim the expense. However, if you don't claim an amount you could have claimed, the CRA will not let you amend your return later to claim it, if they think you are doing "retroactive tax planning". (See the article "Around the Courts" below.)

- Automobile expenses: You will need to track your business use of your car as opposed to your personal use. It is advisable to keep a daily logbook recording business use and note the odometer reading at beginning and end of the year. You can then figure out your business use proportion, and deduct that percentage of your gas, insurance, licence, carwashes, maintenance and repair costs. You can also deduct that percentage of capital cost allowance (which is 30% per year for cars). However, there is a dollar limit on a car's cost that can be used as your base for claiming CCA. The limit was $30,000 for many years beginning 2001 but has been increased to $34,000 for cars purchased in 2022 or later. (For a "zero-emission" vehicle such as an electric car, the limit is now $59,000.)

- Meals and entertainment: You can claim restaurant meals and tickets to sports events, shows, etc. where the expense was required for your business — e.g., you take a prospective client to lunch or a hockey game. However, you can only claim 50% of the cost as a business expense (long-haul truck drivers can claim 80% of meals).

Home office expenses

Home office expenses are deductible only if you fall into one of two categories:

- Your home is your principal place of business — that is, you do not have an office elsewhere. Note that even if you have a major client that provides you with an office on its premises, it is still the client's premises and it will not disentitle you to your claim for a home office.
  or
- The home office is used exclusively for your business and is used "on a regular and continuous basis for meeting clients, customers or patients".

You can only claim the expenses <u>against your income from the business</u>. You therefore cannot use home office expenses to produce an overall business loss that is applied against other income.

However, losses disallowed because of this rule can be carried forward and used in any later year against income generated from the same business (you will need to bring them in on each year's return to carry them forward).

The allowable expenses will normally be based on the fraction of the home that is used for your office. When making this calculation, you can normally exclude common areas, such as hallways and bathrooms, from both the numerator and the denominator. You can choose any calculation that is reasonable; calculations based on square footage or number of rooms are usually considered reasonable.

The expenses you can claim include:

- rent, if your home is rented
- mortgage interest (but not the principal portion of blended mortgage payments)
- home insurance
- property taxes
- utilities: electricity, heat, water, gas
- telephone, if your personal line is used partly for business
- home maintenance and repairs, as well as supplies (e.g., light bulbs).

You may also claim CCA (at 4% of the declining balance of the cost of the building) on the appropriate fraction of your home, but this is often not advisable. If you claim CCA, then when you sell the home you may lose part of the principal-residence exemption which applies to exempt you from tax on capital gains on a home. As well, any CCA you claimed can be "recaptured" into income when you sell your home. However, if you bought your home at the top of the housing market and do not expect to recover your costs when you sell, claiming CCA is likely a good idea.

Do you have a 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 "**Common Reporting Standard**" (CRS) rules, which have now been in force for five years.

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.

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. There are thresholds below which these rules may not apply (e.g., accounts under US$250,000), but the rules can vary by country and can change over time.

The tax authority then splits 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, are now resident in Canada, and you kept an account at an Italian bank branch, which now has EUR 300,000 in it. The Italian 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 changed the rules for voluntary disclosures, as of March 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.

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 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 fairly high tax bracket (taxable income, after all deductions, over $155,625 in 2022), this can pay off. Donations over $200 per year will give you a 29% federal credit plus a provincial credit, for a total savings of about 40-45% 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 may 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.

Note also that if you are GST/HST-registered, or your revenues from self-employment exceed $30,000 per year, you will be required to charge the charity GST or HST on your services (unless you are working for it as an employee, in which case it needs to withhold payroll deductions on your pay). The charity will be entitled to a rebate for a substantial fraction of this GST/HST, however.

Around the courts

Changing past CCA claims not allowed

As discussed earlier, capital cost allowance (CCA) claims are optional. In a given year a business may choose to not claim CCA, or to claim less than is available, so as to use up losses or otherwise cause business income to be higher than it has to be.

Usually the CRA allows changes to past returns if a deduction has been overlooked. However, the CRA will deny requests to change past CCA claims, if the purpose is considered to be "retroactive tax planning", because you have later determined that you did or didn't want to claim CCA in a particular year.

This is what happened in the *St. Benedict Catholic Secondary School Trust* case, decided recently by the Federal Court of Appeal. The Trust had claimed certain business losses that the CRA denied because they had expired. To fix this problem, the Trust wanted to retroactively reduce its CCA claims for its 1997-2003 years, so that it would have a higher "terminal loss" when it disposed of a property in 2013. The CRA refused and the Trust appealed to the Tax Court of Canada, and then to the Federal Court of Appeal.

Both the Tax Court and the Federal Court of Appeal ruled against the Trust. As the Court of Appeal put it, a taxpayer has no right to "amend a tax return that had been previously filed to change the amount of CCA that was claimed for a particular year". Even though CRA administrative policy often allows changes to past returns, that policy is not law and was not binding on the CRA.

Boat costs allowed as a business expense

In the recent *Jackman* case, the Tax Court of Canada held that a business used a boat primarily for marketing purposes, and not as a personal benefit to its shareholders.

The business operated a marina in Port McNeill on Vancouver Island and sold fuel and provisions to boaters. The owners, Bruce and Nancy Jackman, ran the business together. They used their boat, the *Port McNeill Explorer*, to market the business at boat shows and to meet potential customers visiting the area. They also used it for business deliveries at times.

The Jackmans made only occasional personal use of the boat (maybe 5% of the time), and they paid $18,000 a year to the company to reflect this use. Nevertheless, the CRA assessed them for personal benefits on the basis that they had use of the boat.

On appeal, the Tax Court listened carefully to the Jackmans' evidence and believed their explanations. The boat really was for business use and not personal use. As a result, the amount they had paid the company was sufficient, and they had no further personal benefit on which to pay income tax.

As you can see, sometimes it's possible to disagree with a CRA assessment and appeal successfully to the Tax Court.

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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.