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Tax Letter

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CRA GETTING MORE INFORMATION FROM TRUSTS — INCLUDING BARE TRUSTS

In February 2018, the federal government announced plans to require extensive tax reporting from all trusts in Canada. Trusts are used for many different reasons, such as to keep family assets private, and to protect children until they are old and mature enough to manage money wisely. But they are also used by some taxpayers to hide information from the government. While trusts that earn, income have had to file tax returns and pay income tax for many decades, they have not until now been required to disclose much detail about their ongoing structure, beneficiaries, and control — unless they are specifically selected for audit and the Canada Revenue Agency asks for this information. Also, trusts that were not actually paying tax — but might be holding significant assets — generally did not have to file tax returns.

Draft legislation to implement a new reporting regime was released in July 2018, for public comment, with the intention that the rules would come into force for the 2021 tax year. However, after receiving extensive comments, the Department of Finance did not release revised legislation, or include it in a Bill, for several years.

Finally, on February 4 of this year, Finance released revised draft legislation and regulations. At time of writing, they had not yet been introduced in Parliament as a Bill, but they will almost certainly be passed this year. The new rules will take effect for the 2022 tax year (technically, for tax years ending on December 31, 2022, or later), so they will apply to **trust tax returns for 2022 that must be filed by March 31, 2023**.

Under the new regulations (Reg. 204.2), every trust (with some exceptions, discussed below) will be required to disclose the name, address, date of birth, jurisdiction of residence and tax number of every trustee and beneficiary, as well as any person who

created the trust or transferred or lent money to it (not counting a transfer for fair market consideration or a loan at a reasonable rate of interest). Any person who is a "protector" or can make certain decisions affecting the trust must be listed as well.

The **penalties** for non-compliance with this new disclosure will be severe. For even innocent non-disclosure, the penalty for not filing or late filing will be $25 per day, minimum $100 and **maximum $2,500 (after 100 days)**. But on top of that, if the non-compliance is done knowingly or with gross negligence (e.g., wilful blindness), there will be an additional penalty, **minimum $2,500 and maximum of 5% of the highest value of the trust throughout the year.** So, for example, if someone deliberately doesn't report this information for 5 years before the CRA finds out, they may be subject to a penalty of 25% or more of the trust's assets — plus accrued interest on the penalty.

Also, under the changes announced on February 4, **bare trusts** will need to be disclosed as well (ITA s. 150(1.3)). Bare trusts are extensively used in Canada to hold commercial real estate — typically a nominee corporation is the legal owner of a property, as bare trustee for the real owners. If this proposal is not changed, it will mean a lot of compliance problems, and likely **extensive penalties being assessed** because not every existing bare trust will be identified and reported. **If you are involved in ownership of commercial property that is held by a bare trustee**, make sure to follow up to find out if this rule is enacted.

Certain trusts are excluded from these rules:

- a trust in existence for less than 3 months at year-end
- a trust holding only cash and certain investments (such as listed stocks and mutual funds) totalling no more than $50,000
- a trust account required by law for a regulated activity, such as for a lawyer or a real estate broker, provided it is not a separate trust for a specific client or clients
- a registered charity, non-profit organization, mutual fund trust, employee life and health trust, and numerous other trusts governed by the Income Tax Act (e.g., RRSP, RRIF, RESP, TFSA, registered pension plan and many others).

If these rules come into force as proposed, and you are a trustee or in control of trust property, you will have to make sure to comply with these rules by **March 31, 2023,** or you may be subject to the penalties. So, you will need to keep on top of this issue and find out when the legislation is enacted and how exactly the rules apply to you.

MUST YOU DISCLOSE YOUR TAX PLANNING TO THE CRA?

Income Tax Act section 237.3 has **"reportable transaction"** rules in place, effective since 2011, requiring certain tax planning to be disclosed to the CRA. If two of three "hallmarks" of a tax scheme are present, it must be reported. The hallmarks are:

(a) **contingent fees** for the promoter of the scheme — the amount they get paid depends on how much they save you

(b) **confidentiality** — you are not allowed to disclose the scheme to others (typically because the promoter doesn't want others copying a plan they developed)

(c) "**contractual protection**", such as insurance or a promise to cover the costs of appealing if you are reassessed by the CRA.

Draft legislation released on February 4, 2022, will make the reporting apply if you have **even one of the above hallmarks**. Thus, for example, if an advisor charges you a fee based on success of a tax plan, without either of the other hallmarks, it will now be a "reportable transaction" that you will have to disclose to the CRA.

Both taxpayers and promoters must report any reportable transactions. And the penalties for not reporting are severe. The penalty may be equal to the **entire contingent fee potentially payable** to the promoter. And both taxpayers and promoters are liable for the penalty. As well, until the reporting is done and the penalty is paid, the tax benefits of the scheme will be denied, and the usual limitation period for the CRA to reassess is suspended.

As well as the reportable transaction rules, the draft legislation introduces new **"notifiable transaction"** rules (section 237.4). The CRA will publish a list of schemes that it considers offside. If you are involved in one of these schemes, whether as taxpayer, advisor or promoter, you will have to notify the CRA or again be subject to severe penalties. The Department of Finance has published an initial list of the notifiable schemes. They include using bankruptcy to eliminate a debt in a way that prevents the negative tax consequences of the commercial debt forgiveness rules; arranging for a corporation to not be a "Canadian-controlled private corporation" so as to avoid the high tax on investment income; avoiding the "21-year deemed disposition" rule for trusts; and several others.

Finally, the draft legislation introduces **"uncertain tax treatment"** rules for corporations with assets over $50 million and audited financial statements. They will be required to disclose to the CRA the details of uncertainties that affect their financial statements.

At time of writing, all of these rules had not yet been introduced in Parliament as a Bill. However, they will almost certainly be passed this year. They are scheduled to apply for 2022 and later years.

GST OR HST BETWEEN RELATED CORPORATIONS

If you have more than one corporation under your control, what happens for purposes of the Goods and Services Tax (GST), Harmonized Sales Tax (HST) or Quebec Sales Tax (QST), if they charge amounts to each other?

(GST, HST and QST all follow the same rules. This discussion does not apply to the provincial retail sales taxes in B.C., Saskatchewan and Manitoba. For simplicity, we will refer simply to "**GST**" below.)

For example, Xco might charge Yco management fees, or Xco might charge Yco rent for use of Xco's office building. These arrangements might be set up for tax purposes, or for creditor proofing, to ensure that an operating company does not have too many assets in case of an unexpected lawsuit.

In most cases, except for interest paid on a loan, such fees are subject to GST.

Provided Yco is carrying on a business of making supplies that are taxable (or "zero-rated") under the GST, and is GST-registered, **Yco can claim input tax credits** to recover all GST it pays to Xco, so the GST cost is really just a temporary cash-flow cost. Nevertheless, there is still a cost, and the GST requires extra paperwork and accounting in addition to the cash flow.

However, for **"closely related" corporations**, an election is available to *not* have to charge this GST. "Closely related" basically means under common *corporate* control. For example, if Xco owns all the shares of Yco, or Zco owns both of them, then they are closely related. However, if you *personally* own all the shares of both Xco and Yco, they are not "closely related" (as this term is defined in the GST legislation).

From 1991 when the GST was first introduced, this "closely related corporations' election" did not require the corporations to file anything with the CRA. It was enough for them to simply agree between them that no GST would apply to the intercorporate charges, and to complete Form GST25 and keep it in their records in case of audit.

Since 2015, however, the election must be completed on Form RC4616 (available from canada.ca), and filed with the CRA. **Any old elections on Form GST25 are no longer valid.**

If you have corporations that charge fees or rent to each other without GST applying, make sure to have them complete a Form RC4616 and file it with the CRA. Otherwise, if it is ever audited, the corporation charging the fees or rent will be assessed by the CRA for the unremitted GST plus interest and possibly penalties.

Also, make sure that you are not using the election for corporations that are not "closely related" as defined in the legislation.

If you have an existing arrangement with corporations that are not charging GST or HST and have not filed the election, but the CRA has not yet

found the problem, it may be possible to avoid all interest and penalties with a Voluntary Disclosure, combined with the CRA's policy on "wash transactions". You will need professional advice on this.

COURT CASES — WHY ARE THEY IMPORTANT?

We regularly give you news about tax cases decided in the Courts. Why are they important?

First, you need to understand the legal basis on which our tax system operates. Tax is imposed by the *Income Tax Act*, which is legislation passed by Parliament (and amended every year). The Department of Finance proposes changes to the Act in the annual federal Budget and throughout the year, and draft amendments to the legislation, but the changes do not become law until Parliament passes them.

When we have a majority government, it is almost a foregone conclusion that all proposals from Finance will be enacted. Even under a minority government, it is almost certain that technical amendments that are not politically charged will be enacted eventually, although this can take years. And when they are enacted, they are usually made retroactive to the date indicated when they were first announced.

But the *Income Tax Act* is very complex — about 2,000 pages of difficult and sometimes unintelligible language. It takes a lot of interpretation, and its application in many situations is unclear.

The Canada Revenue Agency publishes extensive materials to help us interpret the Act. Most of this material can be found on canada.ca. CRA publications include Interpretation Bulletins, Information Circulars, Income Tax Folios, guides, pamphlets and other documents, as well as Web pages with extensive information. These can be used by taxpayers and their advisers in determining how the *Income Tax Act* will apply to any given situation. They are also used by CRA assessors, auditors and appeals officers (in addition to their internal manuals) in deciding how to assess or reassess taxpayers in any given situation.

However, the CRA **does not make the law**. As noted above, the law is made by Parliament. The CRA merely *interprets* the law. **Its interpretations are not legally binding.** There are many situations where taxpayers (and their advisors) disagree with CRA interpretations.
This is where the Courts come in. Any taxpayer who disagrees with an assessment or reassessment can file a Notice of Objection within 90 days of the date on the Notice of (Re)Assessment. The matter is then considered by a CRA appeals officer; this is a purely administrative process, very informal, with telephone discussions and correspondence but no formal hearing.

If after discussing the case with the taxpayer or the taxpayer's representative and reviewing their written submissions, the appeals officer believes that the assessment was correctly based on the Income Tax Act's rules, the appeals officer will "confirm" the assessment. Or the appeals officer may "vary" the assessment to reduce it, but perhaps not as much as the taxpayer would like.

At this point, a taxpayer who still wants the assessment changed has to go to Court. Appeals of income tax (and GST) assessments are filed in the **Tax Court of Canada**.

There is nothing wrong with appealing a case to the Tax Court. It will not cause the CRA to look at you as a "problem", nor will it result in extra audit attention to you in the future. If you genuinely have a good legal case, you should appeal. But you should **consult a tax lawyer or other qualified professional** to determine whether you do have a good case. Without expert advice, it's very easy to go wrong in trying to interpret the Act.

The Tax Court of Canada is an excellent Court: well run, efficient, humane and friendly, especially to taxpayers who do not have a lawyer and are appealing a relatively modest amount of tax. Where the amount of *federal* tax and penalty does not exceed $25,000 *for each taxation year in dispute*, an income tax appeal can be filed under the Tax Court's "Informal Procedure". (The same goes for a GST/HST appeal of a total up to $50,000.) The process is a formal Court hearing that follows the

rules of Court, but the judge is allowed to bend the rules of evidence and to be more flexible in reaching his or her decision. At the end of the day, however, the decision must still be based on the rules in the *Income Tax Act*, and the Tax Court will *not* allow a taxpayer's appeal merely because the result is otherwise unfair. There has to be a **legal basis in the Act** for allowing the appeal.

For larger appeals, the Court's General Procedure is used. While human taxpayers are allowed to represent themselves, it is highly advisable to retain a tax litigation lawyer to deal with the procedures, which include formal pleadings, Lists of Documents, discoveries, Status Hearings, motions and other procedural steps, as well as organizing and presenting the evidence properly and making the correct legal arguments.

If you are not happy with the Tax Court's decision, you can appeal to the Federal Court of Appeal, but normally only on a question of law. Any findings of fact reached by the Tax Court are binding (unless you can show that no judge could reasonably have reached that conclusion based on the evidence presented — a "palpable and overriding error"). You are not normally allowed to bring any new evidence to the Federal Court of Appeal — the decision is based on the written record of the evidence at the Tax Court trial.

If you win at the Tax Court, the CRA can appeal to the Federal Court of Appeal, under the same rules as above.
From the Federal Court of Appeal, an appeal is possible to the Supreme Court of Canada, but only with "leave" of that Court. Either side can file an "application for leave to appeal". Leave is granted only if the issue is of "national importance". Only a very few tax cases a year are heard by the Supreme Court.

Now, what does all this mean in terms of understanding Court decisions?

- Decisions of higher courts are more precedent setting. Lower courts are required to follow legal principles set out by the higher courts.

  Tax Court decisions under the General Procedure are less important but are still valuable. Even Informal Procedure decisions, which technically are not binding for future cases, are a good indication of where the Court is going on an issue, and in practice the CRA and other judges of the Tax Court will often follow them.
- The Courts will not give much weight to CRA publications such as Folios and Interpretation Bulletins. The judge will take note of such documents but will not consider himself or herself in any way bound to follow the CRA's interpretation — since the CRA is one of the litigants before the Court. The law is found in the *Income Tax Act* and the case law, not in CRA publications.

- If the government does not like a Court decision, they can effectively overrule it with legislation, by introducing amendments to the *Income Tax Act* that Parliament then enacts. Many "schemes" that have succeeded in the Courts have been subsequently shot down by amendments to the Act. However, in the interim, taxpayers can still take advantage of the Court decision — unless the legislative changes are made retroactive, which they sometimes are.

- It is rare for two cases to be *exactly* alike. Often there are differences in the facts. A statement of law by a Court may appear to be broad, but it may be interpreted as being confined to the facts of the particular case that was before the Court. So, there is often some "wiggle room" for a judge to effectively ignore a decision of a higher court that the judge does not like, by ruling that the facts of the cases differ and thus "distinguishing" the new case.

  In other cases, the decision depends on weighing various factors, and the Court makes a decision that is more an application of the law to the particular set of facts than a general statement of the law.

AROUND THE COURTS

Restrictions on fees for claiming disability tax credit put on hold for now

Disability Tax Credit (**DTC**) status is very valuable to taxpayers who qualify. Aside from the DTC itself (worth close to $2,000 per year in most provinces), taxpayers who are approved for DTC status are eligible for over a dozen other possible tax benefits, depending on their circumstances. DTC approval requires filing a Form T2201 (paper or online), with medical information that the CRA must approve. The CRA often denies DTC status, and many cases are disputed through the objection and appeal process. Filing a DTC claim is often not easy.
There are businesses that file DTC claims on behalf of taxpayers, in exchange for a percentage of the tax savings, sometimes 30% or more. This has raised concerns about predatory pricing.

The ***Disability Tax Credit Promoters Restrictions Act*** **(DTCPRA)** was introduced as a private member's bill and enacted by Parliament in 2014 and was scheduled to come into force on November 15, 2021. It limits the fee that can be charged for a DTC claim to $100 per taxation year and **prevents contingency fees.**

However, in *True North Disability Services v. Canada*, the British Columbia Supreme Court issued an **interim injunction** on November 4, 2021, **preventing the DTCPRA from coming into force**, on two grounds. First, it may be an infringement by the federal government into "property and civil rights", which is allowed only to the provinces under the *Constitution Act, 1867*. Second, it may breach the rights under the *Charter of Rights* of persons with disabilities to receive the tax advantages of DTC status.

True North then filed its petition for a permanent injunction on December 2, 2021. It remains to be seen whether the Courts strike down the DTCPRA as being unconstitutional.

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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 letter, which are appropriate to your own specific requirements.