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TAX LETTER

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ARE YOU A DIRECTOR OF A CORPORATION? BEWARE!
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ARE YOU A DIRECTOR OF A CORPORATION? BEWARE!

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) — and even if you are *not* legally a director but are effectively responsible for an incorporated company — you need 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 thousands 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. Countless Canadians have had their assets confiscated and their lives ruined by this mistake.

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

What corporate tax liabilities can a director be assessed for?

The main tax liabilities are:

- **Payroll deductions** (income tax, CPP and EI) that were withheld and not remitted, *or that should have been withheld*
- **GST/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 not collected, 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 a non-arm's length 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 December 2012 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 held to be a *de facto* director. In such a case, you'll be just as liable as if you had legally been a director.

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** ("solitarily" 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 a "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, unless the issue goes to court (see below). If you appeal the assessment, the onus is on you to prove that you are *not* liable because one of the defences below applies.

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.

Note that there is no other limitation period. Even if the corporation's failure to remit GST/HST happened 20 years ago in the early 1990s, 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, and then you should be able to get the assessment reduced or eliminated. There have been three decisions recently by the Federal Court of Appeal that an assessment can be reduced.

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."

Conclusion

If you are a company director, make sure the company is making all required payroll and GST/HST remittances. 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: 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.

ESTATE PLANNING AND ESTATE FREEZING

Overview

Estate planning encompasses a number of areas:

- You should have a Will that takes into account both your desires and tax considerations.
- You may wish to consider steps to minimize probate fees (called Estate Administration Tax in some provinces) on your death.
- You should carry enough insurance to meet your family's needs on your death.
- If you hold any assets in other jurisdictions or if you are a U.S. citizen, you must consider the effects of foreign estate taxes.
- If you are leaving assets to your children who are or may be married, you can plan around the provincial family laws that apply on marriage breakdown.

In this article we focus on the **tax aspects** of estate planning, and specifically on "estate freezing" techniques that can be used to reduce the tax cost of death.

Taxes on death

Canada has no estate or inheritance taxes, although provincial probate fees ("estate administration tax", in some provinces) can be as high as 1.5% of the value of your estate.

The primary income tax effect of death is a **deemed disposition of capital property** at its fair market value. All of your capital property (essentially, all property except inventory in a business) is treated as though you had sold it immediately before your death at its current value. Thus, any accrued **capital gains are recognized and taxed** in your final tax return, which is filed by your executor.

Capital gains are half-taxed, so the tax rate on such gains can be as high as 25%, depending on your province of residence. In planning for your death, you should assume that the tax resulting from the deemed disposition will be substantial.

One way of deferring the tax on your death is to leave assets to your **spouse** or a qualifying **spousal trust**. Provided certain requirements are met, the deemed disposition on death will be at your *cost* of the assets rather than at their current *value*, so there will be no tax to pay. That cost will then be "rolled over" (transferred) to your spouse, so that the tax deferred will in effect be paid on your spouse's death. (The same rules apply to a "common-law partner", if your common-law relationship meets certain conditions.)

Estate freezing

Estate freezing is the term used to describe steps taken to "freeze" some of your assets at their present value, so that future growth can go to your children or grandchildren and not be taxed on your death. It is most worthwhile if you have a business (or investment portfolio held in a corporation) that is expected to grow significantly in future years.

There are many different forms of estate freeze, and the appropriate one for you will depend on many different factors, such as: the value and nature of your assets; the expected growth of your estate; the number, ages and spousal status of your children; your age; your and your spouse's financial needs, both now and on retirement; and many other factors.

Below we describe just one example of an estate freeze.

Example — a "Section 86" freeze

This is the simplest estate freeze. Section 86 of the Income Tax Act allows an exchange of one class of shares in a corporation for another class with no tax consequences, as long as all of the shares of the class are being exchanged.

Suppose you run an incorporated business, XYZ Co. The corporation has 1,000 issued common shares, all registered in your name. You originally invested $1,000 in the corporation ($1 per share), and the shares are now worth $200,000. You expect that in a few years they may be worth as much as $1 million. You have an adult daughter who works in the business, and you want her to inherit it.

If you simply leave your shares to your daughter in your Will, the deemed disposition on your death will trigger a substantial capital gain. If the shares are indeed worth $1 million when you die, your estate might have to pay up to $250,000 in tax.

Let's look at how you can use an estate freeze in this situation.

You **exchange** your 1,000 common shares in XYZ Co for **1,000 preferred shares** (with share conditions that we'll explain below). Your daughter then invests $100 in 100 new common shares of XYZ Co, at $1 each.

The object is to "freeze" the value of your investment at $200,000, which is what the shares are worth now. Any increase in value *above* the $200,000 level will accrue to your daughter, and not to you. Therefore, your preferred shares will be set up to have a value of exactly $200,000 — a value that does not increase even though the value of the company as a whole increases.

However, you want to keep control of the business as long as you are alive.

With this in mind, here is how you can design the preferred shares that you will own:

- The preferred shares will be **voting shares**. Each preferred share should carry 1 vote, and each new common share should carry 1 vote. Since you will have 1,000 votes to your daughter's 100, you can elect the board of directors, and thus you will continue to control the corporation.
- The preferred shares should be **retractable**, at the option of the holder (you), for $200 each, or $200,000 in total. In other words, you will have the legal right to force the corporation to pay you $200,000 for your shares at any time. That makes it clear how much the shares are worth — since you can cash them in at any time.
- Preferred shares must pay a **dividend** in preference to the common shares. The dividend could be in the discretion of XYZ Co.'s directors, or could be fixed at, say, $6 per year per share (i.e., 3% of their value), and payable quarterly. The dividend can be made "non-cumulative", so that if XYZ Co. chooses not to declare a dividend in any given quarter, the unpaid dividends will not accumulate to prevent dividends from being paid to your daughter on the common shares.

The specific details should be worked out with your professional advisers as part of your customized estate plan. Everyone's situation is different.

Now, what have you accomplished?

- First, because of section 86 of the Income Tax Act, there is no cost to exchanging your common shares for preferred shares. In other words, the $199,000 accrued gain on your shares isn't taxed for now. (The preferred shares take on the cost base of your original common shares, so they have a deemed cost to you of $1.)
- Second, you have "frozen" the value of your investment at $200,000, since the preferred shares will only be worth that much in the future. (They can't go up in value because of the fixed dividend.) So if the value of the business increases, the growth will be allocated to the common shares. On your death, if the business is worth $1,000,000, you have a capital gain of just under $200,000 instead of just under $1,000,000, so the tax cost is far less.
- Third, you have kept control of the business. You can continue to elect the board of directors that hires employees and runs the company. And you can continue to be the sole director, if you wish.
- Fourth, if you need income, you can cause the directors of the corporation to declare dividends on the preferred shares, in addition to any salary, bonus or consulting fees the corporation pays you. Since the dividends are non-cumulative, you can also choose to have the corporation *not* pay them, as long as you are not paying dividends on the common shares during the same quarter.
- Fifth, if you ever need the capital, you can require the corporation to redeem the shares for $200,000. (This will result in a "deemed dividend" to you of $199,000, on which you will pay tax of up to about 40%, depending on the province.)

The possibilities are endless...

The above is only one example. Estate freezes can be much more complex, and can involve such features as: family trusts owning shares for your children; "section 85 rollovers" whereby you transfer shares or assets to a holding company; crystallization of the $800,000 capital gains exemption on small business corporation shares; and many other techniques.

There are many technical traps and pitfalls in the Income Tax Act to watch out for, however. These include attribution rules, deemed dividends, stop-loss rules, surplus stripping rules, capital gains stripping rules, and others too numerous to mention.

AROUND THE COURTS: THE NEW HOUSING REBATE

The Tax Court of Canada is starting to see many new appeals of the GST/HST new housing rebate. This rebate is available to a purchaser of a new home who meets certain conditions. Usually the rebate is credited by the builder on closing and then paid back by the purchaser to the builder under the terms of the Agreement of Purchase and Sale — so the purchaser never really sees the money. But the CRA is actively auditing these entire rebate claims sent in by builders, and assessing any purchaser that the CRA believes did not qualify for the rebate.

The maximum **GST/HST** new housing rebate has never exceeded $8,750 and is currently $6,300, and only reaches that figure when the new home costs exactly $350,000 (from $350,000 to $450,000, the rebate is phased out to zero).

However, under the **Ontario HST**, the Ontario portion of the new housing rebate for any new home is 6 percentage points of the 8% provincial portion of the HST, up to a new home value of $400,000 but not phased out above that level as the HST rebate is. Thus, any expensive new home will generate a **$24,000 rebate** — if the purchaser qualifies. (In British Columbia, where the HST was in force from July 2010 through March 2013, the maximum rebate was $20,000.)

With so much more at stake and with the CRA assessing many purchasers to take back a rebate they never saw in the first place, hundreds of aggrieved purchasers are appealing to the Tax Court of Canada.

A typical recent example is the *Kukreja* case.

Mr. and Mrs. Kukreja bought a $500,000 new home in Mrs. Kukreja's name. They claimed that they intended to move in, but did not due to financial reversals in their family business, and they moved back to India instead. They sold the home for a $100,000 gain after closing, before anyone had moved in.

One of the conditions for the rebate is that the purchaser (or a family member) **intended to live in the home as their primary place of residence**, at the time of signing the Agreement of Purchase and Sale.

The CRA assessed the Kukrejas to recover the $24,000 rebate, and they appealed.

The Tax Court dismissed the appeal. The judge did not believe that the Kukrejas actually intended to live in the home. There was no evidence of any documents or e-mails talking about moving to a new home.

Quite aside from losing the new housing rebate, taxpayers in this situation are also likely to be reassessed by the CRA for tax on their gain on the home on the basis that such gain is business income. The principal-residence exemption that they assumed would apply for income tax purposes does not apply if the property is found to have been inventory (purchased with at least a secondary intention of resale) rather than capital property.

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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.