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TAX LETTER

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THE JULY 18 PROPOSALS — NEW TAX RULES FOR SMALL BUSINESS

You have likely read reports about the very broad income tax proposals released by the federal Department of Finance on July 18, 2017, relating mostly to the taxation of private businesses.

The new proposals are wide ranging and among other things may result in very high imposition of tax on income earned through a corporation in some cases, especially where the corporation earns passive income such as interest or dividends. You may have seen examples of total tax rates such as 73% or even 93%, depending on the facts (although these rates assume that people will not amend their current plans and structures to take into account the proposals). The proposals will also affect the capital gains exemption for small business shares, and other planning.

The Department of Finance has requested input from the public on these proposals, and is accepting comments until October 2. Many observers believe that the government is determined to make these changes and will basically ignore the storm of criticism currently being unleashed from many sectors of the business world. It remains to be seen whether the public's input will have any impact. We are also seeing significantly increased interest expressed by high-income individuals in leaving Canada to avoid crushingly high tax rates.

We will find out in due course the extent to which these proposals will actually be implemented. Since this Liberal government has a majority in Parliament, if the government decides to proceed there is little that can be done to stop it unless the Senate refuses to pass the changes.

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CONVENTION EXPENSES

When are convention expenses deductible?

If you are self-employed, then you may be able to deduct from business income the expenses of attending up to **two conventions** per year.

The rules allowing this deduction are found in subsection 20(10) of the *Income Tax Act*.

Business or professional organization

One of the conditions for the deduction is that the convention be "**held by a business or professional organization"**.

One "tax advice" company has interpreted this condition as though it read "held by a business or *a* professional organization". The company claimed on its website that a business can hold its own "convention" so as to make all kinds of travel and vacation expenses deductible. This advice is wrong and should not be followed.

The word "business" in the phrase "business or professional organization" is an adjective modifying "organization", not a noun. The convention must be held by a "business organization" or a "professional organization", not just by any business. This is quite clear from the French wording of the phrase, which is "une organisation commerciale ou professionnelle". (Under the *Official Languages Act*, the French and English versions are equally authoritative, and so the French can be used to help interpret the legislation if the English is ambiguous.)

Additional conditions

The following additional conditions apply before expenses can be claimed:

- The convention must be held in the same year as you are claiming the deduction.

- The expenses must be *paid* in the year (not simply be incurred or payable).

- The convention is held by a business or professional organization "at a location that may reasonably be regarded as **consistent with the territorial scope** of that organization". Thus, for example, a convention of the Winnipeg Widget Manufacturers' Association, held in a resort in Mexico, would not qualify.

  However, the Canada-U.S. tax treaty provides that a convention held in the U.S. will qualify if it would otherwise qualify if held in Canada. Thus, a *national* Canadian organization can hold a qualifying convention anywhere in the U.S. This will not necessarily assist a local organization, however.

- You must attend the convention "in connection with" your business or professional practice. However, you do not need to be a member of the organization sponsoring the convention.

Deductibility beyond these restrictions

Subsection 20(10), referred to above, is a *permissive* provision, not a restrictive one. Therefore, if attendance at a convention can be justified as being an expense **for purposes of gaining or producing income**, and **not on account of capital**, it should be deductible anyway without being subject to the restrictions of only two conventions per year and the other conditions above.

The Courts have sometimes held that convention expenses are "on account of capital", because their benefits are long-term. This was the ruling of the Exchequer Court of Canada in the 1956 *Griffith* case that led to subsection 20(10) being introduced. This was also the ruling of the Federal Court of Appeal in the 2004 *Shaver* case. In *Shaver*, the taxpayer was an Amway salesman who attended monthly business seminars. These were held to be "on account of capital" (i.e., not current expenses), and so he was limited to deducting two of these seminars per year.

Still, depending on the taxpayer's business and type of convention, the courts may take a broader view in certain cases. If a taxpayer can show the connection between attending annual conventions and earning *current* income as a result of the information and contacts obtained at the convention, the expenses will not necessarily be limited to two conventions per year or restricted to the conditions above.

Meals and entertainment

Only 50% of amounts paid for food, beverages or entertainment qualify as a deduction from business income generally. This rule applies to conventions as well. Where the convention fee entitles you to meals and entertainment without specifying a separate price for them, **$50 per day** is deemed to be for the meals and entertainment. Thus, $25 per day of the convention fee becomes non-deductible.

Employees

Since the deduction for conventions is from business income, employees cannot claim a deduction for such expenses.

If an employer requires an employee to attend a convention, reimbursement by the employer of the employee's expenses of attending will generally not be a **taxable benefit** except to the extent there is a personal element to the benefit of attending. Even where there is some personal benefit, it may not be taxable: the Tax Court of Canada held in the 1999 *Romeril* case that there was no taxable benefit because the main purpose of the trip was for business.

If an employee's spouse attends a convention (or travels to it without being registered) and the employer pays, the spouse's attendance is normally considered a taxable benefit to the employee. However, the Canada Revenue Agency considers that there will not be a taxable benefit if the spouse was requested by the employer to go and "the main purpose for going was to assist in attaining the business objectives of the trip".

More information

The CRA has published an Interpretation Bulletin, IT-131R2, that describes the Agency's position on convention expenses in more detail. As noted above, however, the Tax Court may be more flexible than the CRA in some cases.

LAST YEAR TO USE CHARITABLE DONATION "STRETCH" CREDIT

If you or a relative have not been making charitable donations and are considering doing so for the first time, 2017 would be the best year to start.

The normal federal tax credit for charitable donations is **15%** on the first $200 of donations per year, and **29%** on all others — but **33%** to the extent the taxpayer's income is in the 33% (top) federal tax bracket (which for 2017 means over $202,800 in taxable income). In addition, there is a provincial credit which varies by province and income level. Typically the combined credit for donations after the first $200 in the year is in the 40-50% range.

However, from 2013 through 2017 there is a "stretch" credit (or "super" credit) provided for new donors. If you (and your spouse or common-law partner) **have not claimed a donation credit for any year after 2007**, then the credit on the first $1,000 of donations is an extra **25%** of the amount donated. This increases the total credit significantly, and means the real cost of donating up to $1,000 to charity in 2017 becomes quite low.

This measure was introduced in 2013 as a five-year temporary incentive. The March 22, 2017 federal Budget has confirmed that it will be allowed to expire at the end of 2017 as planned.

So if you are eligible for the credit, consider making charitable donations in 2017. Your money will go further.

COMPUTER CONSULTANTS

Many individuals in the computer industry work as computer consultants. If you are in this group, are you aware of the various tax issues that affect your work?

Here are some points to keep in mind:

1. If you are an **employee** rather than an independent contractor, you cannot deduct most expenses, and your employer is required to withhold income tax at source, as well as Employment Insurance premiums and Canada Pension Plan (or Quebec Pension Plan) contributions. Similarly, if you have incorporated your business but your *relationship with your company's client* is really that of employee to employer, your company will be considered to be carrying on a "personal services business" and there will be a very high tax cost.

   If you are working entirely for one company or are under the control of one company, you may well be an employee. The dividing line between employee and self-employed is not always clear. The rest of this article will assume that you are an independent contractor (self-employed), and are *not* incorporated.

2. If you are an independent contractor carrying on business, the income you earn is **business income**. No income tax will be withheld at source, but you will have to set aside enough money to be able to pay your quarterly instalments (after your first year of carrying on business) as well as your April 30 income tax balance.

3. If you are an independent contractor, you can **deduct the expenses** of earning your self-employment income. This can include: office supplies; Internet access; advertising; liability insurance; capital cost allowance (depreciation) on capital assets such as computer equipment and furniture; travel from your home office to a client site; office telephone and cell phone charges; and, in most cases, a portion of your home expenses (such as mortgage interest or rent, insurance, utilities and maintenance) if you have a home office.

4. If you are an independent contractor, then your income tax filing deadline is June 15 rather than April 30. However, if you owe a balance at year-end, interest (currently at 5% per year compounded daily) accrues after April 30.

5. If you are self-employed as an independent contractor, you are normally not eligible for Employment Insurance (EI) benefits. (However, if you are working through a placement agency, a CRA administrative policy may consider you self-employed for tax purposes but still treated as an employee for EI and CPP deductions.) You can opt into the EI system so as to be eligible for certain benefits such as parental benefits on the birth of a new child. However, once you opt into the system you cannot leave, so you will have to pay EI premiums on your self-employment income forever.

6. Assuming you are self-employed, if your annual gross revenues (i.e., billings for your services) exceed $30,000 (when combined with any corporations you control), you must register for **GST/HST** with the CRA and **charge either GST or HST on your services**. The rate you charge (5% GST, or 13% or 15% HST) will normally depend on your **client's address** (there are some exceptions, such as where you provide services for a location-specific event, or for court litigation). Thus, for example, if you are billing a Calgary client you must charge 5% GST, while if you are billing a Toronto client you must charge 13% HST. (The Ontario HST rate is 13%; the four Atlantic provinces are 15%; and the rest of Canada is 5% GST.)

   Of course, you must collect and remit to the government the tax that you charge; but you can normally deduct all GST/HST that is charged to you for business expenses, as an "input tax credit" (ITC) on your GST/HST return. You may also be able to choose to use the "Quick Method" whereby you do not claim ITCs but remit less GST/HST than you collected, at a flat rate. (For example, for 5% GST, you may be able to remit 3.6% of your sales minus $300 instead of 5% minus ITCs.)

   If you and your client are both in Quebec, you normally must charge Quebec Sales Tax, which generally follows the same rules as the GST, though unlike HST it must be accounted for separately.

   The company that is paying you will usually not mind being charged GST, HST or QST, since they will receive an ITC (full refund) for all the tax that you charge them.

7. If you are a province that has a **retail sales tax** (BC, Saskatchewan or Manitoba), you may have to charge that tax. The details vary by province. These taxes are not recoverable by your clients.

8. Once you have been registered for GST/HST for your first year, you are required to pay quarterly **instalments** of GST/HST, unless your total GST/HST "net tax" remittance for the year or the previous year (prorated to 365 days if it was a short first year) will be less than $3,000.

9. If you have not been charging and collecting all of the sales taxes you should have, you may want to consider making a "voluntary disclosure", to inform the tax authorities and get penalties waived. You may still be able to collect the tax from your clients, even for work done years ago, so that you can remit the tax to the government. The availability and details of voluntary disclosures vary between the federal authority (CRA) and the various provincial authorities that administer provincial sales taxes.

AROUND THE COURTS

Construction contractors beware!
The CRA has new ways to find you

The Federal Court of Appeal recently approved a new mechanism for the CRA to find construction contractors who are not reporting all their income. (Residential contractors are notorious for doing renovations for cash and not reporting all their income and GST/HST.)

In *Canada v. Rona Inc.*, 2017 FCA 118, the CRA issued a Requirement for Information to Rona, which operates hardware stores across Canada, to disclose details about contractors who bought supplies from 57 Rona stores from 2012 through 2015. Unlike consumers, contractors normally have accounts at hardware stores that allow them to buy materials at a discount. This means that the stores keep records identifying these customers and their purchases, even if they pay cash.

The CRA can normally issue a Requirement without a court's assistance, for purposes of audit. However, where information is sought about "unnamed persons", a Court Order is required. This is a protection against "fishing expeditions". For the Court to authorize the Requirement, the persons about whom information is sought must be ascertainable, and the Requirement must be justified as aimed at verifying whether the persons are complying with their tax obligations.

The CRA brought this application in Federal Court and Rona resisted it. The Federal Court granted the application in 2016. Rona argued that the CRA was trying to "intimidate" the construction industry with threats of criminal prosecution, but there was no evidence of this. The request was legitimately for audit purposes.

Rona appealed further, to the Federal Court of Appeal. The Court of Appeal has now confirmed that the order issued was within the Federal Court's discretion, and would not be overturned. The fact a CRA auditor had obtained Rona's contractor registration form under pretext of being a contractor did not matter; the form was generally available to the public.

Rona has filed an application for leave to appeal this decision to the Supreme Court of Canada, so there is still a remote chance the decision will be overturned. Meanwhile contractors who use Rona may wish to consider using the CRA's Voluntary Disclosure Program to disclose unreported sales and GST/HST. If the CRA starts an audit, it will be too late for a voluntary disclosure.

It may be unwise to go to Court with a story about defrauding someone else!

The recent Tax Court decision in *Mineiro v. The Queen*, 2017 TCC 109 (released only in French so far), is a lesson in how not to conduct one's affairs. It was an appeal under the "non-arm's length transfer-of-property" rule (section 160 of the Income Tax Act, or section 325 of the Excise Tax Act for GST/HST), whereby the CRA or Revenu Québec (RQ) can assess a relative to whom a "tax debtor" (person with an unpaid tax liability) transfers property. The relative to whom money or property is transferred is liable for the transferor's tax debt, up to a limit of the value transferred (minus any "consideration" given back).

Marisa was Joe's daughter. She received a $15,000 cheque from Joe's company in 2012. At the time, the company owed GST. RQ, which administers the GST in Quebec, assessed Marisa for the company's GST debt.

Marisa appealed to the Tax Court of Canada, arguing that the cheque was partial repayment of a loan she had made to her father. Both she and her father testified in Court. Their explanation went back to a condominium she had bought in 2002 together with her then-fiancé. Joe did substantial renovation work on the condo, intending to do this for free. When Marisa and her fiancé broke up, they sold the condo and split the proceeds after paying off the mortgage. However, to reduce the value of those proceeds, Joe billed Marisa $32,000 for the renovation work he did, and then registered a "legal hypothec" (equivalent to a construction lien) on the property. Joe was paid the $32,000 out of the proceeds, with the ex-fiancé's agreement.

Marisa and Joe testified that the $32,000 was not really for Joe. It was secretly agreed to be a loan from Marisa to Joe, so that when Joe's company paid her $15,000, that was a partial repayment of the loan. Thus, Marisa argued, she had provided "consideration" for the $15,000 by reducing the amount of the loan owed to her.

The Tax Court judge dismissed Marisa's appeal. The story Marisa and Joe told was not sufficiently probable to be believed. There was no documentation of this supposed loan, which contradicted notarized documents, and no reason why the company rather than Joe would have repaid part of it to Marisa. The evidence was also inconsistent with testimony that Joe had given on appeal of his own assessment some years earlier. As well, Marisa's credibility was questionable, both because she had never reported her gain on the condo and because she herself testified to using this false-invoice scheme to cheat her ex-fiancé.

The Court's conclusion was fair. Marisa and Joe may indeed have conspired to cheat the ex-fiancé as they described, but the Court did not need to approve such conduct by allowing Marisa to use it to escape her GST assessment.

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