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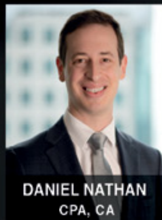
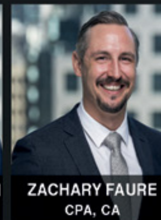

DANIEL NATHAN
CPA, CA

MICHAEL MACLAREN
CPA, CA


ZACHARY FAURE
CPA, CA

PRINCIPALS

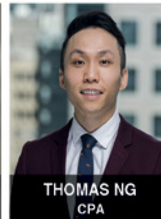
FRANK LIN
CPA

LESLEY LI
CPA

SUN KIM
CPA, CA

SENIOR MANAGERS

MANESA HO
CPA, CGA, CPA (WA)


THOMAS NG
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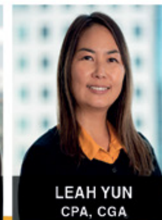
TINA ZHENG
CPA, CGA

TOM PROTHEROE
CPA

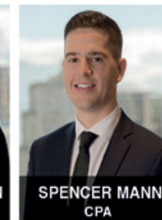
MANAGERS

DESMOND MAK
CPA

FRANCIS QUINLAN
CPA


LEAH YUN
CPA, CGA

NICOLE CHARLTON
CPA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CPA

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March 2022

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US TAX CORNER

International Reporting Schedules K-2 and K-3 for Pass-throughs

The IRS introduced Schedules K-2 and K-3 to standardize the international tax reporting for pass-through entities, for tax years commencing in 2021. The new U.S. federal tax forms are intended to replace, supplement and clarify international tax reporting previously reported on Schedules K and K-1. The schedules should be attached to the following U.S. federal tax forms:

- Form 1065
- Form 1120-S
- Form 8865

The two new IRS schedules streamline international tax reporting and provide clarity for pass-through entity partners or shareholders to accurately calculate their U.S. federal tax liability for foreign transactions.

- Schedule K-2 captures the pass-through entity's items of international tax relevance, including any foreign tax credit limitations.

- Schedule K-3 is delivered to each partner/shareholder to reflect their distributive share of international transactions reported on the pass-through entity's Schedule K-2.

The updated international tax reporting requirements significantly increase the federal income tax compliance and complexity for pass-through entities with non-U.S. operations or non-U.S. partners.

The IRS is listening to taxpayer feedback! On Feb 16, 2022, the IRS posted an FAQ for Schedules K-2 and K-3, extending limited transition relief in 2021 for certain qualifying U.S. pass-through entities with no foreign activities, no direct foreign partners or shareholders, and that lack knowledge of any partners or shareholders requesting information regarding items of international tax relevance. Thus, qualifying domestic (U.S.) partnerships and S corporations will not have to file Schedule K-2 and K-3 for the 2021 tax year.

Want to know more? Reach out to one of our US Tax Professionals at 604.687.0947 or email: nhallak@Davidson-co.com

SHOULD YOU FILE IF YOU CAN'T PAY?

Suppose you are (or your corporation is) ready to file your income tax return, or a GST/HST return, by the filing deadline (which might be, say, April 30 or June 15). But you don't have enough money to pay the balance. Should you file anyway?

We recommend that you **always file on time**. If you have tax to pay for the year, you're legally required to file by the deadline, and you should do so. This article explains the consequences if you do not.

Penalty for filing late

If you file late, there is a late-filing or **"failure to file" penalty.**

For an income tax return, the penalty (Income Tax Act section 162) is 5% of the balance owing as soon as you're one day late, plus an additional 1% for each complete month you file late, to a maximum of 12 months. So once you are over a year late, **the penalty is 17%.** This penalty is doubled if the CRA sends you a demand to file a return, and you fail to file in two out of four consecutive years.

For a GST/HST return, the penalty (Excise Tax Act section 280.1) is 1% of the balance owing as soon as you're one day late, plus an additional 0.25% for each complete month you file late, to a maximum of 12 months. So if you are over a year late, the penalty is **4%.**

Both of these penalties are **non-deductible,** so they must be paid out of after-tax income.

So filing on time and paying the balance later is better for you, financially.

Of course, if you have a balance owing — whether or not you have filed on time — **interest** will continue to run on your outstanding balance, compounded daily. The prescribed rate of interest is currently 5% annually for January-March 2022, compounded daily; the rate is adjusted every quarter based on current treasury bill rates. (The same rate applies for both income tax and GST/HST.) A rate of 5% compounded daily is equivalent to an annual rate of about 5.13% over a full year.

What happens if you file on time and do not pay the balance?

If you file on time but do not pay, the **late-filing penalty will not apply**. However, CRA Collections will be after you to pay, once 90 days have passed from CRA issuing a Notice of Assessment. Because you've filed, the CRA knows exactly how much to assess you and therefore how much you owe.

For both income tax and GST/HST, one way to slow down the Notice of Assessment, without filing late, is to file your return on paper.

Paper returns are processed much more slowly than those filed electronically. For personal income tax returns, for example, the CRA's official "service standard" is to issue a Notice of Assessment within 2 weeks for electronic returns and 8 weeks for paper returns. (If your T1 return is prepared by a tax preparer, there is a $25 penalty for filing on paper, for each paper return above 10 per year. The preparer should be able to use the same software they use to file electronically, and print out a return that is then sent to the CRA on paper.)

What happens if you don't file?

If you don't file on time, the CRA will send you notices demanding that you file. If you still don't, the CRA may eventually issue a "notional assessment", where they guess how much you owe based on past years and assess that amount.

The CRA might also send you a formal demand that threatens criminal prosecution if you do not file; or obtain a compliance order from the Federal Court ordering you to file. In that case, not filing would be a criminal offence (contempt of Court, if there is a compliance Order), and you must comply within the deadline, or you will be subject to fines and even jail.

Either way, you'll be subject to the late filing penalty, but collection action won't start until the CRA has issued a Notice of Assessment.

How soon can the CRA take legal action to forcibly collect tax?

For an **income tax** debt, Collections normally cannot take legal action (such as seizing your bank account or sending a Requirement to Pay to your employer to seize wages) until **90 days** have passed from when the Notice of Assessment is issued that establishes your liability. After 90 days, collection enforcement can start, but it will usually be some time before Collections actually takes steps to seize funds from you (depending on the size of the debt and whether the debt is considered to be at risk). Also, if you file a Notice of Objection contesting your assessment — even if the assessment matches what you filed — that stops collection action, although interest will continue to accrue on the unpaid balance. (If you continue this process with an appeal to the Tax Court, collection action is normally still suspended, but the Court can impose a 10% penalty under Income Tax Act section 179.1, and can also award costs to the CRA, which become part of your tax debt (section 222.1).)

However: during the 90-day period or the objection or appeal process, if the CRA believes that **collection is in jeopardy** (because you are dissipating your assets or moving them offshore, or are planning to leave Canada), the CRA can apply to the Federal Court ex parte (without notifying you) for a "jeopardy order" (section 225.2) allowing the CRA to take collection action. If the Court grants such an order, the first notification you will get will be when your bank accounts are cleaned out, a lien is placed on your home, and/or Requirements to Pay are sent to employers or anyone who owes you money.

For a **GST/HST** debt, there are **no restrictions on legal action** as soon as a Notice of Assessment is issued. Because amounts of GST/HST collected are trust funds (deemed held in trust for the federal government), CRA Collections officials are usually quite prompt in insisting on immediate payment, and may take action to seize your bank account or garnish your wages almost immediately after if you are not paying.

CONVENTION EXPENSES

As we (hopefully) reach the end of COVID-19 lockdowns and restrictions, conventions are starting to be held again.

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.

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.

- 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" (i.e., capital expenses), 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. (This $50 figure, in Income Tax Act subsection 67.1(3), has not changed since 1987.) 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.

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.

   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 need 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; people you hire to work for you on the project; 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 GST-included sales minus $300 instead of 5% minus ITCs. In Ontario, for 13% HST, you remit 8.8% of your HST-included sales minus $300.)

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 in 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, if you are filing annually then 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.

NO TAX ON INVESTMENT INCOME — ARE YOU MAXING OUT YOUR TFSA?

The **Tax-Free Savings Account (TFSA)** is an extraordinarily generous tax break, with very little planning or action required for you to benefit from its largesse.

TFSAs have now been around for over 13 years. One can easily lose track of the available contribution room, as the maximum that can be contributed has changed over the years.

Contribution room is cumulative. Once you are 18 or older in a year, you can contribute the maximum for that year, and if you do not, you can carry forward the excess room and contribute that amount in any later year.

All investment income earned in a TFSA, such as interest and dividends, as well as capital gains, is **tax-free.** This makes TFSAs more and more useful as the years go by.

Of course, you can withdraw any amount from the TFSA at any time, tax-free. Doing so re-creates that amount of contribution room, **but only on the next January 1,** not immediately.

The annual TFSA contribution limit was $5,000 when TFSAs were first introduced in 2009. It was indexed to inflation, but the amount was rounded to the nearest $500, so with low inflation it wasn't until 2013 that the first increase to $5,500 appeared. The Conservatives increased the limit to $10,000 in 2015, and cancelled the inflation indexing. Then the Liberals, newly elected in the fall of 2015, changed the limit back to $5,500 as of 2016 but restored the indexing.

So the limit for each year is:

2009	$ 5,000
2010	5,000
2011	5,000
2012	5,000
2013	5,500
2014	5,500
2015	10,000
2016	5,500
2017	5,500
2018	5,500
2019	6,000
2020	6,000
2021	6,000
2022	6,000

The total of the above amounts is **$81,500.**

So if you were born before 1992, and you have any investments that are not in a TFSA, you should seriously consider putting them into a TFSA until your total contributions reach $81,500.

Just be very careful about withdrawals! If you take out, say, $5,000 to spend, and you have maxed out your contribution room, **wait until January 1 to put the money back.** Otherwise you'll be subject to a 1% monthly "penalty tax" on your over-contribution.

If you become non-resident, make sure to stop contributing, as severe "penalty taxes" will apply to any contributions you make while non-resident.

* * *

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.

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1200 - 609 Granville Street
PO Box 10372, Pacific Centre
Vancouver, B.C. Canada V7Y 1G6

Tel: (604) 687-0947

Davidson-Co.com