Davidson & Company
CHARTERED PROFESSIONAL ACCOUNTANTS

TAX UPDATE

Did you know? We have found our best hires come from referrals within the Davidson Family. If you or someone you know is a designated professional or a student looking to become a CPA, we want to hear from you! Email: recruiting@Davidson-co.com

U.S. TAX CORNER

Valuable R&D Payroll Tax Credit

The recently signed 2022 Inflation Reduction Act (IRA) doubled a tax credit for eligible small businesses, for up to $2.5M over five years. The significance of this credit is the cash flow opportunity for companies with significant R&D investments, even if they have reported little or no U.S. federal income tax liability. As a result, this credit is especially helpful for those start-ups, with gross receipts of less than $5M in the current year (and historically gross receipts for no more than the past five years) that are not able to take advantage of IRC Section 41 tax credit for in-house and contract research activities.

Starting in 2023 eligible businesses will be allowed to apply an additional $250,000 against their 1.45% Medicare payroll tax liability, increasing the total maximum credit

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available to $500,000. However, only $250,000 of the credit can be separately applied to the 6.2% FICA (Social Security) or Medicare.

Eligible research expenses include wages for employees that were involved with the research, supplies to conduct it, any amounts paid for the use of computers and 65% of the cost incurred for contractors.

The runway for the election to offset payroll taxes remains at 5 years. Although the credit is allocated amongst the aggregated related group of entities, each entity must still file the Form 6765 (Credit for Increasing Research Activities) election separately with the company's Federal income tax return. The claim can then be credited with a Form 8974 (Qualified Small Business Payroll Tax Credit for Increasing Research Activities) with the employment tax return.

Although a taxpayer that missed the R&D credit claim in prior years can file an amended Federal tax return for those open tax years, the payroll tax credit can only be claimed on an original return. Please reach out to our U.S. tax team, for any help claiming this valuable R&D payroll tax credit, at nhallak@Davidson-co.com

RESIDENTIAL PROPERTY FLIPPING

If you buy a home or condo, and then sell it soon after you get title — certainly if it's within 18 months or so — the CRA will usually consider that you have "flipped" the property, and that any gain is **fully taxed as business profit**, not half-taxed as a capital gain. This also means that you don't get the principal-residence exemption, even if you moved into the home, because the exemption is available only for ***capital*** property, not for business inventory. And if you had the intention — or even a "secondary intention"— of selling the home at the time you agreed to buy it, then the CRA will be legally correct.

The same is the case if you build your own home and the process takes some years, and you sell the home soon after it's ready for occupancy — even if you move in first.

In practice, you need to wait about 3-5 years before selling, to be reasonably sure the CRA will not consider your gain to be business income. Your personal background will be very relevant here: if you or family members are in the construction or real estate business, or if you have sold multiple properties in recent years, the CRA is far more likely to presume that any property you purchased was bought with the intention of resale.

Legally the test is what your ***original*** intention was, but CRA auditors will generally reject explanations of "changes in circumstances", as every taxpayer can come up with reasons why they had to sell the home despite having "intended to live there".

However, if you can genuinely prove your ***original*** intention as well as the change in circumstances, it's often possible to convince a CRA auditor or Appeal Officer, or failing that a Tax Court judge, that the home really was capital property and thus that you qualified for the exemption. This will normally require showing that the home or condo was specifically chosen or designed for your family, and had special features that wouldn't normally be in a home that was bought with the thought of re-sale.

Some taxpayers are clearly in the "business" of flipping homes. They buy and sell many properties, sometimes renovating, sometimes moving in for a while and then not reporting the gain because they think the principal-residence exemption applies. The CRA goes after these taxpayers, and may assess them for income tax on their profit, plus GST or HST on the new home (including the land value), plus interest, plus substantial penalties. Of course, real estate records are permanently and publicly available, so the CRA can always find out who bought a property, when and for how much. And if the CRA believes that a taxpayer deliberately or negligently failed to report income, there is no time limit for the CRA to reassess the taxpayer. This is also the case if you didn't report the sale at all, even if the omission was innocent.

These rules are now going to get a bit more stringent. New rules for the ***Income Tax Act,*** announced in general in the April 2022 Budget, and released as draft legislation on August 9, 2022, will provide that a **gain on a "flipped property" is always business income**. (This will not apply to a loss, only to a gain.)

The term "flipped property" will be defined as any residential property that you own for **less than 365 consecutive days**, and that otherwise would be capital property. However, there will be an **exception** if you sold the property for any one of a number of listed reasons, such as: a death or addition to the family; marriage breakdown; serious illness or disability; insolvency; being fired; moving more than 40km closer to a new job; or a "threat to personal safety".

This change to the Income Tax Act will not really change the law very much. As explained above, if you own a home for less than a year before selling it, CRA Audit will almost always assess you for business profit anyway. In fact, this change may ***benefit*** taxpayers, because it may make it easier to argue that a property held for more than one year is capital property, and it may make it easier to argue that one of the listed "change in circumstances" exceptions applies so that the property is not "flipped property". However, you still would need to meet the original test of the property being capital property — i.e., not purchased with the intention or secondary intention of resale.

The new rules will have an effect on compliance, however: they tell taxpayers and tax preparers **not to report a disposition after less than 1 year as a capital gain** or to claim the principal-residence exemption, unless they can claim that a listed exception applies. A tax preparer who takes part in such a claim, while knowing that the property is "flipped property", is at risk of being assessed a third-party penalty. Note also that, since 2016, a gain on a principal residence must be reported for the principal-residence exemption to apply; before 2016 you could simply not report at all, taking the position that the property was your principal residence, and leave it to the CRA to try to find you.

Finally, note that under both the existing rules and the new law, if you buy a condo pre-construction, wait (say) four years and then get title, then quickly sell the property, CRA will take the view that you "owned" the condo for only a short time. However, two Tax Court decisions, ***Gosai*** (2020) and ***Wang*** (2021), both held that the time should be measured from when you signed the binding agreement to buy the condo.

INVESTMENT INCOME EARNED IN A CORPORATION

The top rate of tax on ***personal*** income is around 50% or higher, depending on your province of residence. Meanwhile, the top federal+provincial rate of tax on a corporation's income is somewhat lower.

As a result, there would be an incentive to have one's investments held in a corporation. As long as the income remained in the corporation, the tax paid on interest income would be lower. To counter this, since 1995 there has been a **refundable tax on investment income** earned by a Canadian-controlled private corporation (CCPC). The tax is currently 10.67% of the investment income. As a result, a CCPC pays about 50% combined federal+provincial tax on investment income. The tax is refunded once the CCPC pays out enough dividends — at which point the shareholder will be paying personal tax on the income.

The refundable tax applies to income such as **interest, rent** and **royalties**. It does not apply to dividends, which are taxed differently (but may also be subject to a refundable "Part IV" tax). Interest that pertains to or is incident to an active business (e.g., interest on a cash "float" needed to run the business) is not subject to the refundable tax. Similarly, rent from an active business (e.g., running a hotel) will not be subject to the tax.

In recent years, a number of tax planners devised structures to cause a corporation not to be a CCPC. Usually being a CCPC is an advantage, as it gives access to the small business deduction (low rate of tax on the first $500,000 of active business income each year), enhanced credits for scientific research and experimental development, and other benefits. But for investment income it was a ***dis***advantage. So some CCPCs arranged to be "continued" in a foreign country (e.g., Cayman Islands or British Virgin Islands), to no longer be a "Canadian" corporation and thus not a CCPC subject to the refundable tax. There were other schemes as well, such as introducing a foreign holding company so that the company was no longer "Canadian-controlled".

The CRA is attacking these plans using the General Anti-Avoidance Rule, but whether it will win these cases in the Courts is uncertain. To solve the problem, the Department of Finance announced changes in the April 2022 federal Budget, and released detailed legislation on August 9, 2022.

Under the new rules, a company that would be a CCPC except for the kinds of planning above will be considered a **"substantive CCPC"**. It will not get the benefits of a CCPC (such as the small business deduction), but it ***will*** be subject to the refundable tax on investment income. So it will pay tax of about 50% up-front on investment income, with the refundable tax refunded once it pays out enough dividends.

Evidently this planning had become widespread: the April 2022 Budget estimates that these changes will save the federal government over $4 billion over five years.

GUILTY UNTIL PROVEN INNOCENT?

If the Canada Revenue Agency assesses or reassesses you for income tax (or GST/HST), you have to prove the assessment wrong. If you file a Notice of Objection and the CRA turns you down, you can appeal to the Tax Court of Canada. But in Court you cannot simply challenge the government to prove that ***it*** is right. **The onus is on you to disprove the assessment**, on a "balance of probabilities".

Many people find this surprising and disturbing. They feel that it goes against one's right to be considered "innocent until proven guilty". However, it does not.

To understand this, you need to understand that when the CRA issues you an assessment, you are ***not*** being charged with an offence. You are simply being assessed tax. Even if you are assessed interest and "penalty", that is still a civil assessment. It may seem punitive, but the cost is purely monetary. You are not being "fined", merely assessed tax, interest and penalty. There is no concept of "wrongdoing" or "innocence"; there is only an assessment.

You have to show that an assessment is wrong to dislodge it. Otherwise it is valid. There is a reason for this. We have a "self-assessment" system of tax administration, and the facts relating to your income are normally solely within your possession. As a fair tradeoff for this information being in your hands, the onus is on you to disprove the assessment.

On the other hand, there are also **offences** under the Income Tax Act (for GST/HST, under the Excise Tax Act). If you are charged with an offence, you are into the criminal system of rules. Punishment can be a fine (not a "penalty") or imprisonment, and the Crown must prove its case "beyond a reasonable doubt". As with other criminal charges, you are innocent until proven guilty.

It is important to understand the difference between civil assessment and criminal prosecution, if you receive something indicating that you are being penalized by the CRA.

CHARITIES AND GST/HST

If you are on the board of a charity, or involved in helping a charity, you should make sure the charity knows about the special complications for charities in complying with the GST/HST.

(A "charity", for this purpose, means a registered charity for income tax purposes. However, it does ***not*** include a university, hospital, school, public college or a local authority that has been determined by the CRA to be a municipality — these are called "public institutions" under the GST/HST, and are subject to different rules.)

There is a **Public Service Body rebate** for charities. Charities are entitled to claim a rebate of a portion of the GST/HST they pay on their purchases. For the 5% GST (or 5% federal portion of the HST), the rebate is **one-half of**

the 5%. For the 8% or 10% provincial portion of the HST, the rebate is **82% of the 8%** in Ontario; **35% of the 10%** in PEI; and **50% of the 10%** in the other three Atlantic provinces. The total rebate can be quite substantial. For example, in Ontario a charity gets back 9.06 points of the 13% HST.

Staying out of the GST/HST system

A charity need not register for the GST/HST — or may choose to "de-register" — if its annual *taxable* sales do not exceed **$50,000.** (The limit for businesses generally is $30,000.) Below this level, a charity is a "small supplier", and can choose not to register, so that it does not charge GST/HST on taxable sales.

In addition, there is a "total revenue" threshold, below which a charity or public institution may choose to remain a small supplier and not register (even if it is over $50,000 in taxable sales). This "total revenue" threshold is **$250,000**. Total revenue for this purpose includes all sources — grants and donations as well as sales.

Due to the above rules, **many charities can choose not to register** and stay out of the GST/HST system entirely. Effectively, even their supplies that would have been taxable are exempt.

Note that if a charity is GST-registered and chooses to de-register, it may have to repay certain input tax credits it claimed in the past.

Many charges are exempt

The rules above apply only to taxable sales. **Most supplies by a charity are exempt**. However, certain supplies are taxable: e.g., most admissions, recreational activities, and most sales of goods in a charity's store.

Examples of a charity's supplies that are exempt include:

- hall rentals, room rentals, and other short-term leases or licences of real property (except where a special election on Form GST 26 makes them taxable); and
- almost all services, including catering services.

Example

A church has a hall that it rents out for weddings. It also supplies catering services at the weddings.

The hall rentals and catering charges are exempt. Even if the church is GST-registered, it should not collect GST or HST on these charges.

"Simplified accounting" on a charity's GST/HST returns

For charities that are registered, a special set of rules applies to the **calculation of "net tax"**, which is what any GST/HST registrant must remit to the CRA.

For businesses generally, net tax is normally:

- GST and HST collected and/or billed (on taxable supplies); and

minus

- input tax credits (GST or HST paid or payable on inputs to taxable or "zero-rated" supplies).

Most charities must use **"simplified accounting"**. Instead of the above formula, net tax is calculated as:

- 60% of GST/HST collected (or billed), with ***no*** input tax credits.

However, ***all*** GST/HST paid by the charity becomes eligible for the Public Service Body rebate, rather than only the tax paid on inputs to non-taxable activities.

There are some exceptions to this rule, most notably for purchases of real property (e.g., land and buildings) and capital property, for which input tax credits are allowed. As well, certain charities are permitted to elect out of the simplified-accounting rules and use the regular calculation.

Know whether you're registered

Note that a charity can have a GST/HST number without being registered! Charities that apply for the Public Service Body rebate, but are not registered, are given a GST/HST number by the CRA, and the **number** looks ***exactly*** like a GST/HST registration number. It's in the format 12345 6789 RT 0001, where the first 9 digits are the charity's Business Number, "RT" is for a GST/HST account, and "0001" is for a charity that has only one branch filing returns.

But such a charity is not "registered". A charity that is "registered" will normally be asked by the CRA to file a GST/HST ***return*** (not a rebate application) at least once a year. If you are not sure whether your charity is registered, call the CRA or check at tinyURL.com/gstregistry (this links to the CRA's online GST/HST registry, which is actually:

https://www.canada.ca/en/revenue-agency/services/e-services/e-services-businesses/confirming-a-gst-hst-account-number.html).

AROUND THE COURTS

Tax Court cancels penalty for not reporting foreign property

As you probably know, you are required to file a **T1135 Foreign Income Verification Statement** with your income tax return each year, if you own foreign property that cost you more than $100,000. This includes foreign bank accounts, foreign real estate (except a personal vacation home), and shares of non-resident corporations.

If you do not file a correct T1135 form, you are subject to a penalty of $25 per day, maximum $2,500 once the return is 100 days late. This penalty applies to **each year** that you do not file. (If you report false information, knowingly or with gross negligence, the penalty is far higher.)

In the recent ***Chan*** case, Mr. Chan did not report a Bank of China account that his father has opened in his name, because he believed it belonged to his father. After his father passed away, the CRA found out about this account (which at this point had about $2 million in it), and assessed Mr. Chan a T1135 non-filing penalty for several years, as well as gross-negligence penalties for not reporting the income earned in the account. Mr. Chan appealed to the Tax Court of Canada.

Mr. Chan explained to the judge that his father had apparently wanted to have this account in China to pursue a legal claim going back to the Chinese civil war in the 1940s. His father kept the bank card and PIN associated with the account, and Mr. Chan never had access to it. He did not know that his father was putting unreported income into the account.

The Tax Court judge believed Mr. Chan's evidence, and held that he was not the owner of the bank account, so he was not required to report it. And for good measure, the judge wrote: "Should I be wrong" in this conclusion (i.e., if the government were to appeal and the Federal Court of Appeal were to hold the Tax Court was legally wrong), then the judge held that Mr. Chan "had reasonable cause to believe" that his father owned the bank account, and so he had validly made out a "due diligence" defence to the penalties.

As can be seen, these penalties can sometimes be successfully challenged in Court!

De facto director liable for company's unremitted GST

Under the Income Tax Act, a director of a corporation is liable for the corporation's unremitted source deductions (payroll deductions) — that is, income tax, CPP and EI withheld from employees' pay but not remitted to Revenue Canada. A director is also liable for the corporation's unremitted GST/HST. (There is a "due diligence" defence, where the director shows that he or she exercised due diligence in trying to prevent the corporation from failing to remit.)

Past Court cases have held that this rule applies to a ***de facto*** director as well a validly appointed, legal director.

A recent such decision from the Tax Court of Canada is the ***Lamothe*** case. Mr. Lamothe was not legally registered as a director of the company in question, which was a janitorial-services company in Quebec that apparently issued false invoices to allow other companies to falsely claim business expenses and GST input tax credits. However, he was the company's President, and the company was owned by his brother. He opened the company's bank accounts, made deposits, and signed cheques for the company.

Mr. Lamothe was assessed as a ***de facto*** director for the company's unremitted GST of some $54,000, plus several years of interest. He appealed to the Tax Court of Canada, arguing that his brother ran the company in question and he knew almost nothing about it.

The Tax Court judge did not find Mr. Lamothe's evidence credible, and ruled that Mr. Lamothe exercised sufficient control over the company that he was a ***de facto*** director. Thus he was liable for the unremitted GST plus interest.

Mr. Lamothe has appealed this decision to the Federal Court of Appeal.

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