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# TAX NEWSLETTER
## MAY 2023

- TAX SHELTERS RELATED ISSUES – SALIENT POINTS TO LOOK OUT FOR
- LIANG V. THE QUEEN IS A CRUCIAL CASE
- TO UNDERSTAND LIMITATIONS OF TAX SHELTERS
- BUDGET 2023 – INTERESTING PROPOSALS AND POTENTIAL TAX INCREASES
- TAX FREE FIRST HOME SAVINGS ACCOUNT – $40K LIMIT –
- OPEN FHSA ACCOUNT FROM APRIL 1, 2023

## TAX SHELTERS RELATED ISSUES – SALIENT POINTS TO LOOK OUT FOR

Tax Shelters are the stuff of legend. Often times these instruments are publicized in the media for providing tax evasion strategies to the extraordinarily rich. On the other hand, illegitimate tax shelters use of tax law, inevitably earn the wrath of GAAR (General Anti Avoidance Tax Rules designed to ferret this behavior out) from CRA and the public at large.

### GAAR: General Anti Avoidance revisited

General Anti Avoidance Rule was enacted in 1987 to combat abusive tax avoidance transactions and arrangements which technically complied with Income Tax Act. GAAR is meant to stop these abusive practices which reduce the CRA's amount of tax revenue. GAAR's discussion can assume reams of pages. Suffice it to say that one can comply with GAAR by conducting bona fide transactions with a legitimate business objective in mind. If one's primary objective is just avoidance of tax, and transactions do not make any commercial business sense, then the road to GAAR violation opens up. For tax shelters, these are general principles to keep in mind, as GAAR can easily apply its claws to tax shelters.

It is important to note that tax shelters are actually in various governmental taxation systems worldwide. This is because despite the various negative connotations associated with them, tax shelters serve a particularly important function, to minimize tax liabilities effectively legally, often so that the recipient can use these funds for productive, income earning business ventures, or to support a noble social cause. Case in point is the RRSP Registered Retirement Savings Programs. Effective utilization of RRSP enables millions of Canadians to defer higher marginal tax rates during their prime earning years, while using the invested funds to save for their golden retirement years. RRSP serves as an important retirement payment plan for Canadians and is a valid use of a tax shelter.

### Mass Market Tax Shelter Schemes do not work!

Tax shelters when done legally, can be quite effective. A crucial issue is to demystify tax shelters. Often times, dodgy promoters mass market tax shelters to unsuspecting customers, with novel ideas such as giving greater amount contribution receipt, when the consideration donated amounted to a pittance. According to CRA's own website, every one of these nebulous schemes has been found wanting in regard to compliance with the Income Tax Act. Inevitably, its unsuspecting clients suffer the worst of the fallout, with the taxes due plus interest and penalties paid painfully.

Example: Person A goes to a marketer of a lucrative tax scheme. Marketer promises Person A that they can issue a $10,000 tax receipt to A if A gives a donation in-kind amounting to $200 dollars. The marketer can assess the donated in-kind product's value at $10,000, and the person can claim this as a charitable contribution tax credit on their tax return. Person A is assured by the marketer that the tax scheme is registered, and the marketer

may even have a business number, and head office location. The marketer also informs Person A that many clients have utilized this service to receive large tax refunds, and if CRA contests the claim, then the marketer will back up Person A through litigation.

This is a fairly typical story, and the end is nigh. At the finale, Person A is the one who gets assessed taxes plus penalties plus interest. Cost is greater than the benefit. Do not fall for this scheme!

## LIANG V. THE QUEEN IS A CRUCIAL CASE TO UNDERSTAND LIMITATIONS OF TAX SHELTERS

A crucial case to discuss tax shelters is Liang v. The Queen, with the judgement delivered on June 7th, 2022. In this case, some of the most primary issues relating to tax shelters are discussed, including mathematical calculation that forms basis of tax shelter, eligibility for business loss deduction, and penalties associated with false statements. Not only is this case important for the edification of the readers in terms of the basic know how of tax shelters, but it also serves as a cautionary tale for readers who do not effectively use these tax shelters and are reluctant to consult professionals in the setup.

**Background of the case:**

Mr. Billy Liang, upon retirement, created a company called Pony Pictures Inc, which he setup to ostensibly pursue a passion in film making. Pony applied for a Tax Shelter Identification Number pursuant to Section 237.1 (2) of the Income Tax Act.

Crucial point to note: registering for tax shelter identification number per Section 237.1(2) is an administrative matter; it does not validify the tax shelter, as the appellant learned to their chagrin in this case!

Mr. Liang withdrew $30K from his RRIF (Registered Retirement Income Fund) each year for 13 years and invested these funds in a professional financial management company, despite the funds being earmarked for Pony's expenditure. If funds were earmarked for Pony, they should have been used for Pony's operations, but they were not. Pony filed Form T5004 "Claim for Tax Shelter Loss or Deductions" in the amount of $30K for each of these 13 years. In addition, Pony filed Form T5003 "Statement of Tax Shelter Information" indicating a loss of $30K for each taxation year.

In computing his taxation income for each of these years, Mr. Liang claimed $30K as Other Deductions in line 232 for each year. Since its inception, Pony never made any movies or made any considerable progress in starting production of a film. In effect, the tax shelter was being utilized to shield Mr. Liang's mandatory RRIF withdrawals from taxation.

**Penalties levied and appeal denied**

Accordingly, CRA reviewed Mr. Liang's tax returns, and denied his other deductions. CRA, on behalf of the Minister concerned, levied penalties against Mr. Liang pursuant to Section 163(2) of the Income Tax Act for knowingly making a false statement or omission in his tax returns. This case was presented in the Tax Court of Canada with Mr. Liang as the appellant, and his appeal of the penalties were dismissed.

**Issues of the Case**

There were four key issues the court addressed in this case, and they will be relevant to all readers of this article, since many such loose shelter schemes abound.

1) Was the Appellant entitled to deduct $30,000 as other deductions for each taxation year?

2) Was the Appellant entitled to claim the business losses/expenses that he did for each of the taxation years?

3) Did the Minister properly assess the Appellant for the 2014 taxation period beyond the normal reassessment period, pursuant to subsection 152(4) of the *Act*?

4) Did the Minister properly assess penalties for gross negligence pursuant to subsection 163(2) of the *Act* for the taxation years?

**Question 1: Tax Shelter: Was the Appellant entitled to deduct $30,000 as other deductions for each taxation year?**

To answer question 1, the court analyzed the validity of a tax shelter. What constitutes a valid "tax shelter" is set out in Section 237.1 of the *Act*. For brevity, we have not included the entire definition, but will paraphrase and clarify its meaning in the following lines.

Paraphrased quote for brevity:

> " "tax shelter" means
> (b) ... a property (including any right to income) ... in respect of which it can reasonably be considered, having regard to statements or representations made or proposed to be made in connection with ... the property, that, if a person were to ... acquire an interest in the property, at the end of a particular taxation year that ends within four years after the day on which ... the interest is acquired,''

A great simple description of the tax shelter is provided by referencing another important judgement, paragraph 254 of Paletta v. The Queen. In it, Justice Hogan stated the following conditions must be satisfied for a property to be considered as a tax shelter:

i. There must be a property in respect of which statements and representations are made or proposed to be made;

**Analysis:** a property must be referenced in a tax shelter, some sort of asset.

ii. The statements and representations must be made by a "promoter";

**Analysis:** The statements and representations must be made by a "Promoter." CRA provides a definition of what is a "Promoter." It is a tax shelter promoter who in the course of business:

1. sells, issues, or promotes the sale, issuance, or acquisition of the tax shelter

2. acts as an agent or advisor for these activities

3. accepts some sort of consideration for the tax shelter either as a principal or agent.

A person who is engaged in these promotional activities to sell a tax shelter and receives consideration is a "Promoter," and this individual must be the one to make any representations and statements.

iii. It must be reasonable to consider, having regard to the statements or representations, that there is an amount that is represented to be deductible in respect of the property; and

**Analysis:** There is a reasonable amount that is deductible in respect of the property. Therefore, this would not be an outlandish amount that would not make any business sense if one were to hold the property.

iv. The amount represented to be deductible must exceed or be equal to the investor's cost in the property less "prescribed benefits".

**Analysis:** The amount deductible must be equal or greater than the property's costs less its associated benefits, thus the genesis for claiming that deduction.

Mathematical Calculation

A crucial point the Tax Court noted in regard to Tax Shelters was its mathematical calculation.

The appellant withdrew $30K in RRIF funds every year and claimed these as other deductions. Thus, the cost of acquiring the tax sheltered property was $30K each year. The amount by which losses, deductions or tax credits exceeded this $30K cost minus prescribed benefits was zero.

*If the Tax Shelter losses or deductions do not exceed the cost of the tax shelter minus the prescribed property, then the losses or deductions cannot be claimed!*

Conclusion of Tax Shelter definition

At the end of any taxation year that ends within four years after the acquisition of the said property by the purchaser, the purchaser can deduct amount from his income, which would be equal or greater than the acquisition cost of the property at the end of the taxation year less prescribed benefits. This description rules out flow through shares arrangement or certain prescribed properties.

**Question 2: Was the Appellant entitled to claim the business losses/expenses that he did for each of the taxation years?**

To assess this question, the Court analyzed the two-step process confirmed by the Supreme Court of Canada to determine business loss deductibility:

a. Is the activity undertaken in pursuit of profit, or is it a personal endeavor?

b. If it is not a personal endeavor, is the source of the income a business or property?

In Mr. Liang's case, for (a) the Tax Court assessed whether a source of income existed. There was nominal existence, hardly anything, so he failed the first step. Since Mr. Liang could not prove that his activities were undertaken for pursuit of profit, his business losses were denied.

**Please note:** Two-step Process is the criterion used to determine business loss deductibility. Make sure if you are claiming business losses, it passes this test. While it is a two-step test, the first test is crucial litmus test, and often where people fail to prove their case, as their rationale for profit pursuit falls, and the activities are labelled a personal pursuit.

**Question 3: Did the Minister properly assess the Appellant for the 2014 taxation period beyond the normal reassessment period, pursuant to subsection 152(4) of the *Act*?**

This is an important question; it relates to the general thinking among taxpayers that the CRA can only audit up to three previous years. This is correct, except for the following important exemption which is especially important for the dear readers to note.

*This means that if the Minister can prove that the misrepresentation was attributable to neglect, carelessness, or willing conduct, then the Minister can override the normal reassessment period and assess prior years beyond the normal 3-year reassessment period. Do not take too much comfort in the 3-year time period!*

In this case, the Judge ruled that Mr. Liang clearly misrepresented his situation, his expenses were clearly not of a business nature for a variety of distinct reasons, and thus CRA was justified in going beyond the normal reassessment period. In his assessment, the Judge considered relevant facts in the case, finding Mr. Liang to be an intelligent man who had researched up on tax shelters. Please note though that if it were the inverse and Mr. Liang was found to have been not intelligent, that also may not have been a justified defense as carelessness and neglect are also included in Section 152(4).

**Question 4: Did the Minister properly assess penalties for gross negligence pursuant to subsection 163(2) of the *Act* for the taxation years?**

Subsection 163(2) of the Income Tax Act allows the Minister to assess gross negligence penalties if a person knowingly or under circumstances amounting to gross negligence made, participated, assented or acquiesced in making false statements or omissions in their return.

In this case, it was clear for the judge, especially given the balance of probabilities, that the appellant was using the tax shelter to shield his RRIF mandatory withdrawals, and therefore he dismissed his appeal.

**Overall Conclusions**

1. **Tax Shelter identification number** does not confer legitimacy on a tax shelter. It is best to consult with professionals, accountants, and lawyers on setting up tax shelter. This advice should be independent of the promoter of the tax shelter, who will have a biased interest in selling the tax shelter.

2. **A proper Tax Shelter has series of criteria that must be met**, it is not easy to set one up, so it should be cautiously set up, understanding the relevant rules and consequences, and with professional advice!

3. **CRA can go beyond 3-year reassessment period to** assess a person's tax return if the agency believes the person has shown neglect, carelessness, or willful conduct of misrepresentation.

4. **On balance of probabilities, Minister can assess gross negligence** or false statements or omission penalties on individual(s) concerned. This just makes it easier for the CRA to assess penalties. Don't be under the illusion that one must be proven guilty beyond a reasonable doubt, as this is not criminal law.

## BUDGET 2023 – INTERESTING PROPOSALS AND POTENTIAL TAX INCREASES

Federal government budgets over the years have had some key common traits: loss of brevity, increasing amounts of details for the public (despite all the focus on openness hardly anyone aside from industry experts reads the budget, and a more voluminous version conversely makes the budget even more daunting to tackle). With the 270 page volume budget released, here is the recap of the salient tax topics addressed:

**Alternative Minimum Tax (AMT) rate increases – more taxes to pay**

Alternative minimum tax rate per budget proposal will increase from 15% to 20.5%, while the minimum threshold under which AMT applies will increase from $40,000 to $173,000. Alternative minimum tax was introduced by the federal government to ensure wealthy individuals who could use specific tax credits and deductions to limit tax on their applicable income, were made to pay a minimum effective tax rate on their yearly income regardless. The

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increase in the AMT rate and the increase in threshold will mean wealthier Canadians with access to tax preferences that can reduce their tax liabilities for the year, will have to pay more taxes.

**General Anti Avoidance Rule (GAAR) being strengthened**

The background of the GAAR Law and its applicability was explained earlier in this article. GAAR is a very wide and pervasive law, and practically most transactions that are not done for a commercial purpose, but rather with a tax reduction goal in mind, come under its tentacles. Courts have time and again sided with CRA in most GAAR cases. The Budget proposes to start process of consulting and further fireproofing GAAR. This will make it very difficult to utilize creative tax schemes, details to follow.

**RESP withdrawal increase good news!**

Good news for students! Maximum RESP withdrawal yearly limits are being increased to $8K for full time students and $4K for part time students in specific situations. This will make post-secondary education with its escalating tuition and associated costs more affordable for the average Canadian.

**TAX FREE FIRST HOME SAVINGS ACCOUNT – $40K LIMIT – OPEN FHSA ACCOUNT FROM APRIL 1, 2023**

To tackle the bane of unaffordable housing prices, the federal government has introduced a novel program, which is a RRSP + TFSA combined. In this program, first time home buyers will be able to allocate up to $40K of income to this program, get a tax deduction on the $40K life RRSP (Maximum yearly contribution of $8K) and upon withdrawal of funds for house purchase, like TFSA the funds will not be taxed. The best parts of both TFSA and RRSP are included in this rather creative program, as a savings mechanism to help young Canadians buy a house. One key point to note about this program is that it is not the RRSP home buyer's plan. Both plans cannot be used simultaneously. Additionally, unlike in a RRSP home buyers plan where funds are borrowed from RRSP, these funds will not have to be paid back to the RRSP program.

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**If you have any questions regarding the foregoing or other tax matters, please contact our tax group at (403) 262-2116.**

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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.